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SPECIAL REPORT
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Worldwide Interest Apportionment Has Arrived: What Do We Do Now?

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In this report, the authors explore the technical and policy questions that taxpayers must consider in evaluating a worldwide apportionment election under section 864(f) in the absence of statutory updates or administrative guidance on implementation of the not-so-new provision.

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At 16 years old, section 864(f) could get a driver's license in many states. After three effective date changes delaying implementation for 12 years,[1] taxpayers will finally be able to take worldwide apportionment out for a spin this year and beyond.[2] But the rules of the road are vastly different now, and turning on worldwide apportionment without any statutory updates or

[1] As originally enacted under the American Jobs Creation Act of 2004, the worldwide interest allocation rules were effective for taxable years beginning after 2008. However, the Housing and Economic Recovery Act of 2008 delayed the effective date of section 864(f) until taxable years beginning after 2010. Worldwide interest allocation was further delayed another seven years, until taxable years beginning after 2017 by the Worker, Homeownership, and Business Assistance Act of 2009. The effective date was delayed yet again by the Hiring Incentives to Restore Employment Act of 2010 to taxable years beginning after 2020. The Senate version of the Tax Cuts and Jobs Act included a provision to accelerate the effective date back to taxable years beginning after 2017, but that provision was not included in the final bill.

[2] Optimistically assuming that section 864(f) will not be delayed yet again.

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regulatory guidance raises novel and difficult technical and policy questions that we explore in this report.

Indeed, when section 864(f) was first added to the code in 2004, commentators identified many of the complex issues raised by the new worldwide apportionment provision.[3] Even under the "old" deferral regime with only a general and passive basket, no global intangible low-taxed income regime, and no section 250 deduction, the statutory architecture of section 864(f) left many gaps for Treasury and the IRS to fill.

Filling in those gaps now — or potentially identifying and modeling possible outcomes in the absence of guidance — will be particularly important given the procedural requirements for the section 864(f) election. First, the election must be made for the first taxable year beginning after December 31, 2020, that a worldwide affiliated group is eligible to make the election.[4] Second, once the election is made, it is irrevocable without the consent of the Secretary.[5] So unless there is regulatory relief, existing worldwide groups will be required to opt in or out, potentially for good, for their first taxable year beginning in 2021.

Preferably, Treasury and the IRS would allow taxpayers to make the election after final regulations are published. The statute's plain terms do not require that the election be made by any particular time, only that the election be made "for" the first taxable year beginning after December 31, 2020. Thus, an election could, in theory, be made on an amended return for the 2021 taxable year filed after the due date for a taxpayer's original 2021 return. In similar situations, Treasury and the IRS have given taxpayers reasonable extensions to comply with a statutory effective date for a new regime in the absence of guidance.[6] Alternatively, section 864(f) also allows a taxpayer to revoke the election with the Secretary's consent. Treasury and the IRS could provide for automatic consent to revoke the election with retroactive effect, provided the revocation is made within a reasonable time after final regulations are issued.[7] This would allow taxpayers to elect in for the 2021 taxable year with the understanding that they would have the option to revoke that election once regulations are promulgated.

At a minimum, we expect that preliminary guidance (regulations, a notice, or otherwise) or public statements will confirm that the election can be filed with the common parent's timely filed income tax return (including extensions),[8] giving many taxpayers until at least late 2022 to decide whether to make the election.

We briefly review the history and mechanics of section 864(f) before turning to a series of issues that Treasury and the IRS will need to face, and taxpayers will need to consider, in evaluating a section 864(f) election in a post-Tax Cuts and Jobs Act tax world.

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[3] *E.g.*, Kevin Cunningham, "The U.S. Worldwide Interest Apportionment Rules: Ready, Set, Wait," *Tax Notes*, May 29, 2006, p. 1021; and Emily S. McMahon, "Interest Expense Allocation After the Taxpayer Refund and Relief Act of 1999," 28 *Tax Mgmt. Int'l J.* 793 (1999) (analyzing an earlier legislative proposal substantially similar to section 864(f)). The IRS requested comments on a number of issues regarding section 864(f) in Notice 2008-54, 2008-26 IRB 1191.

[4] Section 864(f)(6).

[5] *Id.*

[6] *E.g.*, Notice 2018-8, 2018-4 IRB 352 ("In consideration of [implementation issues] raised by stakeholders, and to allow for an orderly implementation of the requirements of new section 1446(f), the Treasury Department and the IRS have determined that withholding under new section 1446(f) should not be required with respect to any disposition of an interest in a publicly traded partnership (within the meaning of section 7704(b)) *until regulations or other guidance have been issued* under new section 1446(f)." (Emphasis added.)); and Notice 2011-53, 2011-32 IRB 124 ("While the Act provides that the provisions of Chapter 4 are effective beginning in 2013, Treasury and the IRS have determined that because Chapter 4 creates the need for significant modifications to the information management systems of [foreign financial institutions], withholding agents, and the IRS, it is reasonable for regulations to provide for a phased implementation of the various provisions of Chapter 4.").

[7] *E.g.*, Rev. Proc. 2019-43, 2019-48 IRB 1107 (providing a list of changes in accounting methods or periods which taxpayers may elect, and in some cases revoke, with automatic consent, including for provisions for which the relevant statute requires consent); and Rev. Proc. 2009-41, 2009-39 IRB 439 (providing automatic consent for a late check-the-box election in some circumstances).

[8] The IRS previously approved this approach in Notice 2006-47, 2006-1 C.B. 892, and reaffirmed it in Notice 2008-54 (stating that the due date for the election is "generally expected to be the due date (including extensions) of an eligible taxpayer's return for its first taxable year beginning after December 31, 2008"). Notice 2006-47 states that it applies until further guidance is issued, but given the length of time that has passed and that the statutory effective date was subsequently modified, confirmation of this approach would be welcomed.

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I. Background and Mechanics

A. History of Worldwide Apportionment

Since their inception, the rules regarding interest allocation and apportionment have been premised on the notion that money is fungible, as reflected in reg. section 1.861-9T(a):

> The method of allocation and apportionment for interest set forth in this section is based on the approach that, in general, 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. Exceptions to the fungibility rule are set forth in [reg.] section 1.861-10T. The fungibility approach recognizes that all activities and property require funds and that management has a great deal of flexibility as to the source and use of funds. When borrowing will generally free other funds for other purposes, and it is reasonable under this approach to attribute part of the cost of borrowing to such other purposes. Consistent with the principles of fungibility, except as otherwise provided, the aggregate of deductions for interest in all cases shall be considered related to all income producing activities and assets of the taxpayer and, thus, allocable to all the gross income which the assets of the taxpayer generate, have generated, or could reasonably have been expected to generate.

This fungibility principle has been embodied in the code and regulations for decades. Despite this unequivocal proclamation that money is generally fungible and interest expense is attributable to all activities and property, that principle stops at the border under current law. Under what has long been known as water's-edge allocation and apportionment, a U.S. affiliated group (with some modifications) is treated as a single taxpayer in allocating and apportioning interest expense, but that affiliated group generally does not include foreign corporations.[9] As a result, the U.S. affiliated group will generally combine its interest expense and allocate that expense to the combined assets of the group, treating stock of a foreign corporation (even a wholly owned foreign corporation) as a separate asset that attracts interest expense, typically to foreign source income. This approach tends to result in an overallocation of interest expense to foreign source income when controlled foreign corporations borrow directly, because the CFC-level interest expense is not taken into account when allocating and apportioning additional interest expense of the affiliated group to the stock of the CFC. Effectively, interest expense is allocated and apportioned to the CFC's income twice — once at the CFC level, and again at the affiliated group level.[10]

For over three decades now, the United States has been on the cusp of permitting worldwide apportionment to alleviate this problem. The Senate draft of the Tax Reform Act of 1986 would have allowed worldwide apportionment under section 864(e).[11] Worldwide apportionment was ultimately abandoned in the final bill, which instead adopted the water's-edge approach in section 864(e).

Congress once again came close to enacting worldwide apportionment in the Taxpayer Refund and Relief Act of 1999, which was passed by Congress August 5, 1999, and vetoed by President Clinton September 23, 1999.[12] The 1999 act would have amended section 864(e) to treat a worldwide group as an affiliated group in allocating and apportioning the group's worldwide interest expense. This provision was substantially similar to the version of worldwide apportionment that was almost included in TRA 1986.

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[9] Section 864(e)(5); reg. section 1.861-11T(d) (adopting a definition based on section 1504 affiliation with some modifications, notably that an unaffiliated domestic corporation is treated as a member of the affiliated group if it is 80 percent owned by vote *or* value by an includible corporation or by members of the affiliated group).

[10] *See also* Cunningham, *supra* note 3, at 1023 (describing how water's-edge apportionment results in an overallocation to foreign source income in comparison to identical activities conducted through a branch).

[11] 132 *Cong. Rec.* S8817, at S8869 (June 26, 1986).

[12] H.R. 2488 (vetoed Sept. 23, 1999).

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Finally, the American Jobs Creation Act of 2004 added section 864(f) to the code, allowing taxpayers to elect to allocate and apportion interest expense on a worldwide basis for taxable years beginning after December 31, 2008. As noted earlier, Congress has since delayed the election's availability three times, but section 864(f) has finally become operative for taxable years beginning after December 31, 2020.[13]

B. Basic Mechanics of Section 864(f)

Section 864(f)(1)(A) provides that "the taxable income of each domestic corporation which is a member of a worldwide affiliated group shall be determined by allocating and apportioning interest expense of each member as if all members of such group were a single corporation." That is, the general rule literally adopts pure worldwide allocation and apportionment by combining all the assets and interest expense of the entire worldwide group, thus CFC interest expense could offset U.S.-source income of the U.S. affiliated group. The statutory mechanics, however, do not actually provide for pure worldwide interest allocation, at least not in the sense that all of the worldwide group's interest expense is allocated to all of the worldwide group's assets. [14] Instead, section 864(f) determines the amount of a *U.S. taxpayer's* interest expense,[15] if any, that is allocated to foreign source income under the following formula:

$$USP\ Interest\ to\ FSI = Worldwide\ Interest * \frac{Foreign\ Assets}{Worldwide\ Assets} - CFC\ I$$

This formula effectively limits the U.S. group interest expense allocated to foreign source income based on the amount of interest expense that would be allocated to foreign source income under pure worldwide apportionment. Broken into component parts, the formula first establishes the amount of interest expense allocable to foreign assets by multiplying worldwide interest expense (which includes CFC interest expense) by the percentage of worldwide assets that are foreign. This represents the maximum amount of interest that can be allocated to foreign source income for purposes of section 904. This amount is reduced (but not below zero) by interest expense incurred by CFCs that is allocated and apportioned to foreign source income (presumably a vast majority of CFC interest expense).[16] In effect, the U.S. affiliated group gets a credit or offset to the allocation of any U.S. group interest expense for interest expense incurred by CFCs.[17]

Figure 1 (below) depicts a simple example that assumes that USP owns 100 percent of CFC; USP and CFC hold assets that earn a 10 percent return; USP and CFC have $1,000 of debt on which they incur 5 percent interest expense annually; and CFC earns solely subpart F income that is not passive.

For purposes of the section 864(f) formula, many of the same concepts applicable to water's-edge apportionment are imported. For example, assets are measured by average tax book value;[18] exempt assets are excluded; and the basis of stock of nonaffiliated 10-percent-owned corporations is adjusted for earnings and profits.[19] Further, intercompany debt, expanded to include CFC debt, is expected to be (in some manner) subject to

[13] *See supra* note 1.

[14] A worldwide affiliated group consists of the includible members of an affiliated group, determined without regard to section 1504(b)(2) (excluding insurance companies subject to tax under section 801), and all CFCs that meet the 80 percent value and voting power test of section 1504(a)(2). Section 864(f)(1)(C). It is not clear whether the modifications to the definition of an affiliated group for purposes of section 864(e), such as the expansion to include corporations 80 percent owned by vote *or* value under reg. section 1.861-11T(d)(6), apply for purposes of section 864(f). Issues regarding the determination of an affiliated group, in the context of section 864(f) or otherwise, are not addressed in this report. Specifically, the treatment of financial institutions under section 864(e)(5)(B), (f)(4), and (f)(5) and reg. section 1.861-11T(d)(4) is not addressed.

[15] The interest expense of the U.S. group would include interest expense incurred by a branch. *See* reg. section 1.861-9(f)(2).

[16] This is a slight simplification. The actual reduction equals "the interest expense of all foreign corporations which are members of the worldwide affiliated group to the extent such interest expense of such foreign corporations would have been allocated and apportioned to foreign source income if this subsection were applied to a group consisting of all the foreign corporations in such worldwide affiliated group." Section 864(f)(1)(B)(ii).

[17] We refer to this reduction for CFC interest expense as the CFC interest expense "offset" to avoid confusion with "credits" in the technical sense.

[18] Potential disparities between adjusted asset and stock basis can create planning opportunities and pitfalls under section 864(f). For example, the purchase by a U.S. company or CFC of another CFC with high-value but zero- or low-basis self-made intangibles can be beneficial as long as no section 338 election is made, given that the stock is eliminated under section 864(f). As a result, section 864(f) planning may be one factor against making section 338 elections going forward.

[19] Section 864(f)(3).

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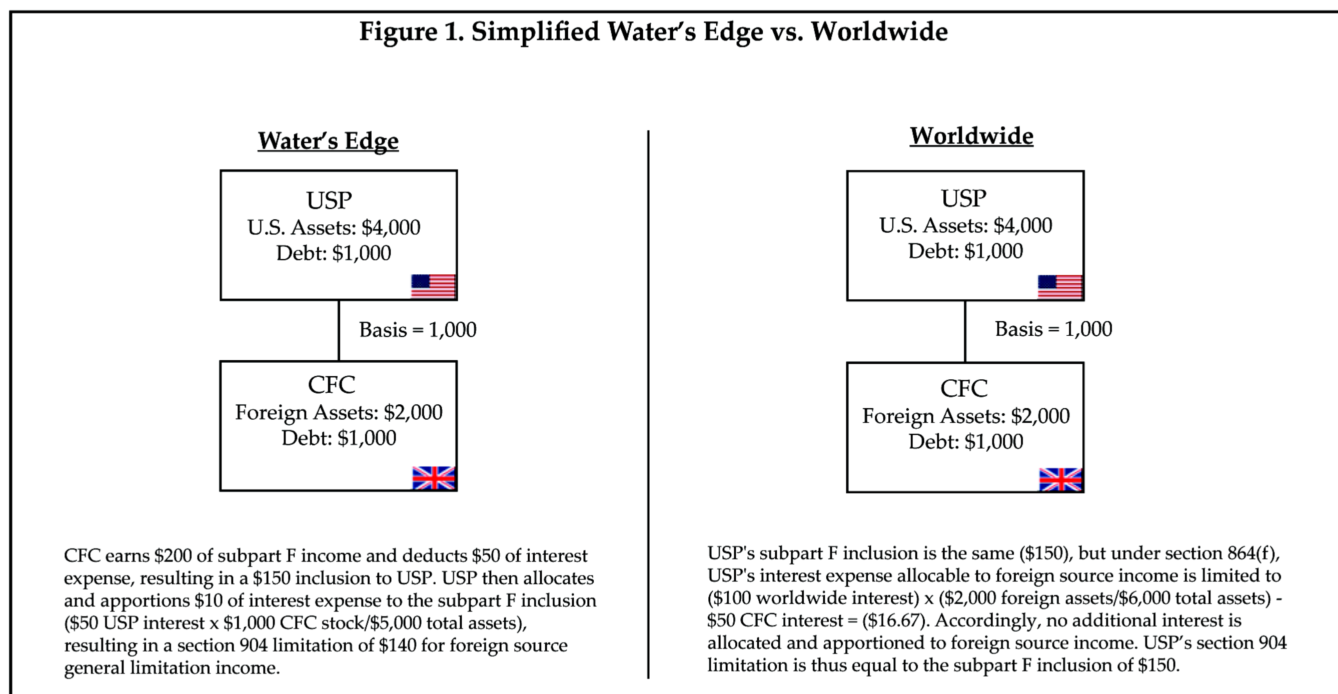

the rules of reg. section 1.861-11T(e),[20] under which intercompany receivables are disregarded as assets, and special rules for allocating and apportioning interest apply (that is, income follows expense in the same basket).

Other expense allocation rules that taxpayers have grown accustomed to may no longer be permissible under worldwide allocation, including the modified gross income method to characterize CFC stock. Although the section 861 regulations generally require taxpayers to allocate and apportion interest expense based on the value of assets,[21] stock of a CFC can be characterized based on the assets the CFC owns *or* the gross income earned by the CFC.[22] In practice, most taxpayers use the modified gross income method to characterize CFC stock, perhaps in part because that income information is required for compliance with Form 5471, "Information Return of U.S. Persons With Respect to Certain Foreign Corporations." It is not clear if taxpayers will be permitted to use the modified gross income method or a substantially similar method to approximate the portion of CFC assets in each basket, which regulations could presumably allow.

Not only are there new wrinkles with existing concepts but also many aspects of worldwide apportionment are entirely new, and their interaction with the TCJA is uncertain, to say the least.

C. Benefits of Worldwide Approach

For decades, commentators have argued that worldwide allocation and apportionment is superior to the water's-edge approach from a policy perspective, and the fungibility of money principle that animates that policy argument has even deeper roots. Yet worldwide apportionment is only now becoming the law, and the reason is scoring — worldwide apportionment has been

[20] H.R. Rep. No. 108-755, at 377 n.207 (2004) (Conf. Rep.) ("For purposes of determining the assets of the worldwide affiliated group, neither stock in corporations within the group nor indebtedness (including receivables) between members of the group is taken into account. *It is anticipated that the Treasury Secretary will adopt regulations addressing the allocation and apportionment of interest expense on such indebtedness that follow principles analogous to those of existing regulations*. Income from holding stock or indebtedness of another group member is taken into account for all purposes under the present-law rules of the Code, including the foreign tax credit provisions." (Emphasis added.)). *But see infra* Section II.B.

[21] *See* reg. section 1.861-9T(f)(1) and (g).

[22] Reg. section 1.861-12(c)(3).

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Table 1. FTC Limitation as a Function of CFC Debt

Debt at CFC	(a) CFC Income	(b) Interest Allocation WE	(c) Interest Allocation WW	FTC Limit (WE) (a) - (b)	FTC Limit (WW) (a) - (c)
$0	$100	$25	$25	$75	$75
$100	$95	$21.32	$20	$73.68	$75
$200	$90	$17.78	$15	$72.22	$75
$300	$85	$14.41	$10	$70.59	$75
$400	$80	$11.25	$5	$68.75	$75
$500	$75	$8.33	$0	$66.67	$75
$600	$70	$5.71	$0	$64.29	$70
$700	$65	$3.46	$0	$61.54	$65
$800	$60	$1.67	$0	$58.33	$60
$900	$55	$0.45	$0	$54.55	$55
$1,000	$50	$0	$0	$50	$50

viewed as a significant revenue loser.[23] This is because worldwide apportionment was expected to result in less interest expense being allocated to foreign source income, and therefore taxpayers could claim more foreign tax credits, assuming they could incur debt abroad.

Consider the simple example shown in Figure 2:

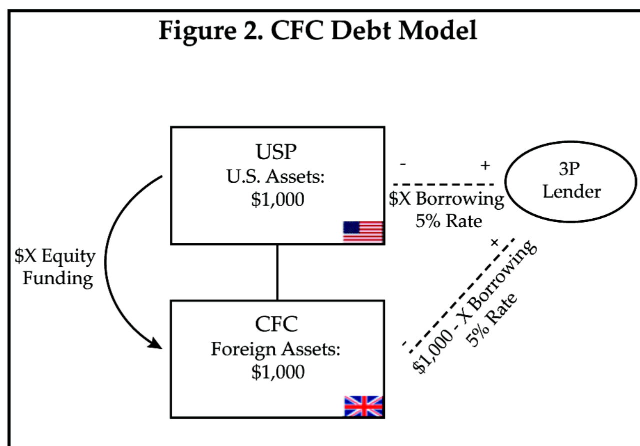

Figure 2. CFC Debt Model

Here, USP owns 100 percent of CFC. USP and CFC each have $1,000 of assets that generate $100 of U.S.-source and foreign source general limitation income (that is, non-passive subpart F income), respectively. CFC can be funded by equity from USP, CFC's own borrowing, or a combination of both, at an assumed borrowing rate of 5 percent for both USP and CFC.[24] Table 1 shows the allocation of interest expense and the resulting FTC limitation as the CFC is funded in $100 increments, beginning with $0 of CFC borrowing (that is, entirely equity-funded) through $1,000 of CFC borrowing (that is, entirely CFC-debt-funded), assuming that CFC asset basis (including retained earnings) less liabilities is equal to CFC stock basis.[25]

Figure 3 graphs the data in Table 1, modeling the FTC limitation as a function of the CFC's debt.

This model reveals some interesting preliminary observations. First, water's-edge and worldwide apportionment provide the same result at the two extremes — when the CFC is completely equity-funded, and when the CFC is completely debt-funded and USP has no interest expense.

Second, at any point between the two extremes, worldwide apportionment provides a

[23] Accelerating the effective date of section 864(f) three years as proposed in the Senate draft of the TCJA was projected to reduce revenue by $2 billion over the scoring period. Finance Committee, "Chairman's Mark and Section-by-Section Summary of the Tax Cuts and Jobs Act," at 70 (Nov. 16, 2017).

[24] For simplicity, this ignores any withholding taxes or other frictions that may result from pushing debt down to the CFC.

[25] This simplifying assumption will not always be true in practice, but it serves as a reasonable assumption for illustrative purposes.

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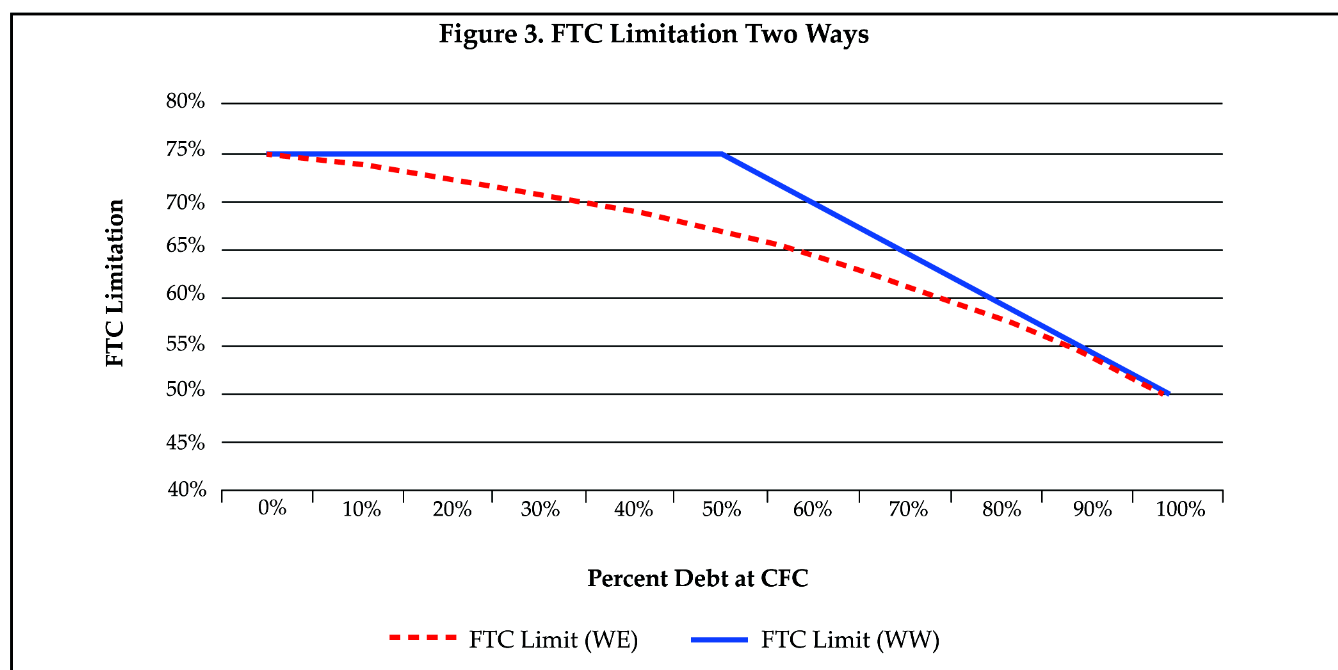

more favorable answer. Undoubtedly, this phenomenon explains the expected revenue loss that caused worldwide apportionment to be continuously postponed.

Finally, as debt is pushed down to the CFC, the FTC limitation remains the same under worldwide apportionment until the CFC becomes overleveraged (that is, more leveraged than the U.S. group). There is an inflection point at which the CFC's interest expense exceeds the proportionate amount of foreign assets — at this point, the interest expense continues to be deducted at the CFC level (and reduce tested income or subpart F income) but provides no offset to USP for purposes of section 904. This reflects that interest is never allocated back to the U.S. group from the CFC. That is, overleveraging CFCs provides no marginal FTC benefit once beyond the inflection point.[26]

The above case illustrating the benefits of worldwide apportionment holds when the foreign source income of the group is taxed currently under subpart F. But in more realistic cases — when a group has tested income taxed under GILTI, income eligible for the section 245A deduction, and foreign source branch income realized directly by the U.S. group — the determination whether worldwide apportionment is beneficial is much more complex and largely depends on regulatory decisions that Treasury and the IRS need to make in implementing the provision.

D. Treasury Authority

Curiously, section 864(f) does not include a paragraph conferring a general grant of authority to Treasury and the IRS. Instead, it provides authority in subparagraph (f)(5)(F), which deals with a special election to expand a financial institution group, to provide "regulations as necessary to carry out this subsection." The placement of this authority could call into question its breadth as applied to issues unrelated to the financial institution election.

Fortunately, but also somewhat curiously, section 864(e)(7) provides authority to "prescribe such regulations as may be necessary or appropriate to carry out the purposes of this section." This could arguably grant Treasury authority to write regulations addressing issues under section 864 generally, including section

[26] As discussed later, section 864(f) does not actually focus on a CFC's leverage relative to the U.S. affiliated group but instead uses the CFC's interest expense in calculating the offset. In this simplified example with USP and CFC borrowing at the same rate, interest expense relative to assets provides a reasonable approximation of relative leverage. But when interest rates vary, which will be the case in practice, interest expense may be a poor indicator of whether a CFC is over- or underleveraged.

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864(f). Given that section 864(f) can be viewed as an extension of section 864(e), it could be argued that these two provisions together give Treasury and the IRS authority to reasonably integrate the provisions of section 864(f) with other FTC provisions.

That authority is potentially important because the FTC provisions applicable today are far different from what they were in 2004, so the integration is necessary. Most significantly, the TCJA reduced the corporate rate to 21 percent, added a new section 951A (GILTI) inclusion provision and FTC limitation basket, and created a new branch basket. As a result, many taxpayers now have excess credits in their GILTI basket, and potentially in their branch basket, but excess limitation in their general basket. For these taxpayers, how interest expense is allocated to their GILTI and branch baskets is now a critical issue. This issue is even more acute for GILTI because of the section 960(d) reduction to deemed paid taxes on GILTI, and amendments to section 904(c) that deny the ability to carry back or carry forward excess FTCs in the GILTI basket.

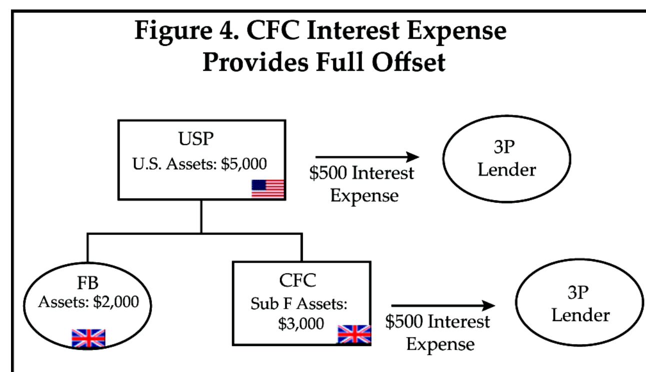
The remainder of this report discusses many of the issues that need to be resolved to implement worldwide apportionment under the current FTC limitation regime. We first discuss the basic limitation of section 864(f) on allocations of interest expense to foreign source income generally and how to further allocate any foreign source interest expense to the various limitation categories of foreign source income. We then consider the potential treatment of intercompany debt from the U.S. group to related CFCs. From there, we discuss more specific issues, such as the treatment of exempt assets as provided under section 864(e)(3) and (f)(3), the role of section 904(b)(4), the effect of tested losses, and the use of interest expense as a metric for a CFC's leverage. Until those (and no doubt other) issues are resolved, it will be difficult for most multinational taxpayers to know whether the election under section 864(f) will be beneficial.

II. Implementation Issues

A. Allocations to Foreign Sources

Section 864(f) by its terms limits the overall allocation of U.S. group interest expense to assets that generate foreign source income, and thus to foreign source income more broadly. As described earlier, it does so by first apportioning worldwide group interest expense based on the relative value of assets generating foreign source income to total worldwide group assets, and then offsetting any interest expense apportioned to foreign sources by the amount of interest expense incurred by CFCs in the group. As a literal matter, the foreign assets taken into account include assets owned by the U.S. group as well as by CFCs without regard to any basket allocation, and the interest that qualifies for the offset is any CFC interest expense allocable to foreign sources without regard to baskets.

This leads to some interesting results, even in a simple case, as in Figure 4:



Here, half the assets are foreign (setting aside for now the complexities regarding the characterization of CFC assets), resulting in up to 50 percent of the total worldwide interest expense being allocated to foreign source income. Because CFC paid $500 in interest expense, section 864(f) reduces the allocation of USP's interest expense to foreign source income to $0 ($1,000 worldwide interest * 50 percent foreign asset ratio - $500 of interest expense at CFC level). As a result, there is no interest allocated to the foreign branch basket, even though the branch has material assets and no borrowing. This is because the CFC interest expense can never be substantively deducted against foreign branch income, but under section 864(f), that CFC interest expense can reduce interest expense of the U.S. group allocated to foreign branch assets for purposes of section 904.

Given the clear language of the statute, it may be difficult for Treasury and the IRS to adopt rules that alter the above result when there is sufficient

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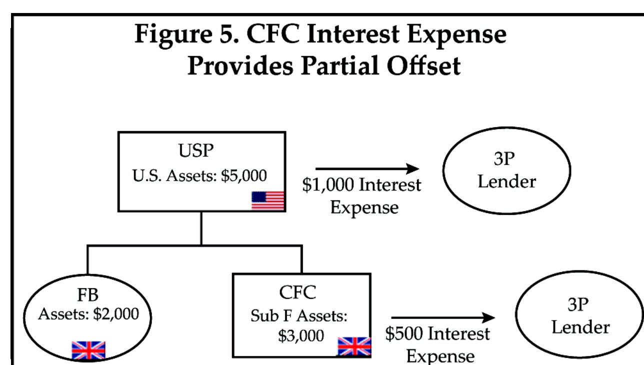
CFC interest expense offset to eliminate *any* allocation of the U.S. parent group's interest expense to foreign source income. But in more complex cases, in which the CFC interest expense offset reduces but does not entirely eliminate an allocation of U.S. group interest expense to foreign source income, it is unclear how the allocated foreign source interest expense should be further allocated and apportioned among the various baskets of foreign source income. Consider the same example with slightly different numbers in Figure 5:

Figure 5. CFC Interest Expense Provides Partial Offset



Here $250 of USP's interest expense would be allocated to foreign source income after taking into account the $500 offset for CFC's interest expense.[27] Arguably, Treasury and the IRS have authority under section 864(e)(7) to determine how that $250 would be allocated to USP's FTC baskets and could choose one of several potential approaches.[28]

1. Asset pro rata approach.

The asset pro rata approach is to apportion the amount of interest expense permitted to be apportioned to foreign source income based on the relative value of assets in each basket. Under this approach, USP would first determine the amount of interest expense potentially apportioned to foreign source income, which is $750 ($1,500 of worldwide interest expense * $5,000 foreign assets/$10,000 total assets). This would then be reduced by the amount of CFC interest expense allocated and apportioned to foreign source income, here $500, resulting in USP apportioning only $250 of interest expense to foreign source income. The $250 of interest expense would then be apportioned pro rata among the baskets based on asset value, resulting in $100 of interest expense being apportioned to the branch basket ($250 interest expense * $2,000 branch assets/$5,000 foreign assets), and $150 of interest expense being apportioned to the general basket ($250 interest expense * $3,000 general assets/$5,000 foreign assets).

Arguably, this approach follows from a strict application of section 864(f), which aggregates foreign source income and CFC interest expense allocable to foreign source income without regard to baskets. However, this approach does not take into account the basket to which the CFC interest expense that gives rise to an offset is allocated at the CFC level (that is, the $500 of interest expense incurred by CFC that reduced USP's subpart F inclusion for the income generated by CFC's assets).

2. Basket pro rata approach.

The basket pro rata approach is to hypothetically apportion interest expense to the baskets based on worldwide interest expense, then apply the offset to the baskets based on the apportionment of interest expense at the CFC level.

The $1,500 of total worldwide interest expense would be hypothetically apportioned $750 to U.S.-source income, $450 to the general basket, and $300 to the branch basket. Next, the offset of CFC-level interest expense would be applied on a basket-by-basket basis. Here, all $500 of interest expense incurred by CFC was apportioned to general limitation income of CFC, and thus the offset is first applied to that interest expense. Therefore, the potential apportionment of $450 of USP interest expense to the general basket is completely eliminated. Following this step, there is a remaining $50 of potential offset. Regulations could attempt to deny any offset for this $50, but that approach would run contrary to the plain language of the statute, which provides for a

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[27] The affiliated group's foreign assets are 50 percent of worldwide assets ($5,000/$10,000), and worldwide interest expense is $1,500, resulting in a potential allocation of $750 (50 percent * $1,500) to foreign source income. That $750 is subject to a $500 offset for the CFC interest expense, resulting in $250 of USP interest expense being allocated and apportioned to foreign source income.

[28] Because there are significant questions, explored later, regarding the GILTI basket, the example uses only the general and branch baskets for ease of illustration. Of course, USP could also directly own foreign assets in the general basket (*e.g.*, purchased intellectual property that is licensed to CFCs) or passive basket (*e.g.*, debt of foreign borrowers), as well as the branch basket.

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reduction in the allocation of interest expense to foreign source income without regard to baskets.[29] Accordingly, the remaining offset could be apportioned to the remaining baskets (that are not also completely offset by CFC interest expense) pro rata. Because the branch basket is the only additional basket in this example, all $50 of the offset would apply to the branch basket. The end result under this method is that $0 of USP interest expense would be apportioned to the general basket ($450 - $450), and $250 of USP interest expense would be apportioned to the branch basket ($300 - $50).

This approach would rely on the existing expense allocation rules for allocating and apportioning interest expense, including look-through rules for CFC-to-CFC loans. Given that many multinationals use foreign finance CFCs for third-party borrowings and then on-lend to related CFCs, the use of these rules would at least be familiar and yield more consistent results between the basket to which interest expense is apportioned and the basket for which it provides an offset under section 864(f).

3. Pure worldwide approach.

The pure worldwide approach is an extension of the basket pro rata approach. As with the basket pro rata approach, the $1,500 of total worldwide interest expense would be hypothetically apportioned $750 to U.S.-source income, $450 to the general basket, and $300 to the branch basket. The offset would then be applied in a manner to achieve this exact apportionment, including recharacterizing income if necessary.

This approach is arguably contrary to the mechanics of the statute, which, as described earlier, do not provide for so-called pure worldwide apportionment but instead limit the allocation and apportionment of interest expense to foreign source income at the U.S. affiliated group level. Section 864(f)(1)(A), however, does contemplate that interest expense should be allocated "as if all members of such [worldwide] group were a single corporation," so arguably, the section 864(f) limitation should be applied in a manner that comes closest to achieving true worldwide apportionment. Under this approach, the results would be the same as the basket pro rata approach, except that after $50 of USP interest expense is apportioned to the branch basket, an offsetting $50 of branch basket income would be reallocated to the general basket.

This approach is conceptually similar to the rules of reg. section 1.861-11T(g). Under those rules, if an affiliated group does not file a consolidated return or otherwise includes a nonconsolidated member, interest expense can be allocated and apportioned to a limitation category of a member for which the group has no gross income. In that case, the regulations provide for two adjustments to eliminate the resulting loss in a section 904 category: (1) losses created through group apportionment of interest expense in one or more limitation categories within a given member must be eliminated; and (2) a corresponding amount of income of other members in the same limitation category must be recharacterized on a pro rata basis.[30] Although re-sourcing income may seem to go beyond the purview of interest expense rules, these existing rules provide a precedent for that approach, and section 864(e)(7)(A) provides authority "for the resourcing of income of any member of an affiliated group or modifications to the consolidated return regulations to the extent such resourcing or modification is necessary to carry out the purposes of this section."

Table 2 summarizes the treatment of the $1,000 of USP interest expense under each approach:

Table 2. Summary of Basketing Approaches

	Asset Pro Rata	Basket Pro Rata	Pure WW (with income recharacterization)
U.S.-source	$750	$750	$750
Branch	$100	$250	$300 (after reallocation)
General	$150	$0	$-50 (after reallocation)

[29] Section 864(f)(1)(B). Although the GILTI and branch baskets did not exist when section 864(f) was added to the code, the general and passive baskets would have presented the same issue.

[30] *See* reg. section 1.861-11T(g)(3), Example 1.

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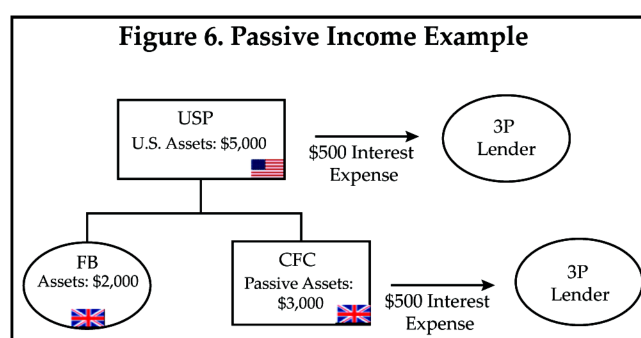
Although any of the above approaches are mechanically workable, given that the purpose of section 864(f) is to limit the allocation of U.S. group interest expense when a CFC has incurred its own interest expense, an argument can be made that the basket pro rata approach is most appropriate.

In determining which approach to adopt, however, Treasury and the IRS will have to address the potential planning opportunities that arise. Taxpayers have some flexibility (taking into account parent guarantees) to affirmatively determine both the amount of borrowing incurred by their CFCs as a group and the location of the borrowing within the CFC group. If the location of CFC borrowing affects the basket of the CFC interest expense offset resulting from any borrowing, taxpayers will have an incentive to structure the location of their borrowings to maximize the benefits of the CFC interest expense offset.

For example, a U.S. group might attempt to incur CFC debt in a manner that increases the interest expense offset without a corresponding increase to foreign operating assets. Indeed, at the extreme are situations in which taxpayers could conceivably leverage a CFC to the maximum extent and invest the proceeds in passive assets that generate a modest but positive spread over borrowing costs, such as in this example, shown in Figure 6:

Figure 6. Passive Income Example



The interest expense incurred by the CFC that earns passive income could conceivably be sufficient to fully offset any allocation of interest expense to foreign source income, including branch basket income. Under the statute as drafted, it is difficult to see how this type of planning can be completely constrained. Had the statute taken a CFC-level basket-by-basket approach and included a cream-skimming rule that allocates interest expense at the CFC level first against CFC passive income, similar to the interest allocation rules for FTC purposes,[31] this result could be minimized. But the statute did not take that approach, and instead takes an aggregate approach to foreign assets and interest expense.

Another approach Treasury and the IRS might consider would be to allocate only interest expense net of interest (or passive) income to foreign sources and then give an offset only to the net interest expense of CFCs. Although such an approach was considered in the 1970s during early regulatory discussions of interest expense allocation, it is not part of section 864(e) or (f) and thus would likely require a statutory amendment.

B. Treatment of Intercompany Lending

However the above issues are resolved, another fundamental element in implementing section 864(f) is determining the treatment of intercompany loans from members of the U.S. group to related CFCs. Under the section 864(e) regulations, those loans are potentially subject to a complex antiabuse netting rule that, if it applies, directly allocates U.S. group interest expense to interest income from CFC loans.[32] In developing those regulations in 1987, Treasury and the IRS originally proposed a general netting rule that first allocated U.S. group interest expense to any interest income from CFC loans. The intent was to minimize tax planning that involved borrowing in the United States, with interest expense apportioned on an asset basis (including to domestic assets), and on-lending the proceeds to CFCs, with the interest income increasing foreign source general basket income under the section 904(d)(3) look-through rule. Taxpayers argued that Treasury had insufficient authority for such a broad special allocation rule. The result of that

[31] Section 954(b)(5) ("Except to the extent provided in regulations prescribed by the Secretary, any interest which is paid or accrued by the controlled foreign corporation to any United States shareholder in such corporation (or any controlled foreign corporation related to such a shareholder) shall be allocated first to foreign personal holding company income which is passive income (within the meaning of section 904(d)(2)) of such corporation to the extent thereof."); and reg. section 1.904-5(c)(2)(ii)(C).

[32] Reg. section 1.861-10(e).

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debate was the current antiabuse netting rule based on narrower borrowing and lending fact patterns.[33]

In today's FTC world, with many taxpayers having excess credits in the GILTI basket but not in the general limitation basket, the stakes related to the treatment of U.S.-to-CFC intercompany loans have changed dramatically. The implementation of section 864(f) provides an opportunity for Treasury and the IRS to consider whether CFCs should receive a CFC interest expense offset for the interest incurred on intercompany borrowings from U.S. affiliates just as they receive the offset on interest from third-party debt. Parallel treatment of U.S.-to-CFC intercompany debt would mean that multinationals could reduce or eliminate their U.S. interest expense allocation by on-lending from the U.S. to their CFCs (rather than by either equity funding or requiring CFCs to borrow directly from third-party lenders).

In effect, to the extent a U.S. group borrows from third parties and lends to related CFCs, the U.S. group would be treated as a conduit for its third-party debt. The U.S. group interest expense to be allocated would be reduced, its intercompany debt asset would be ignored, and its CFC group would be allowed an interest expense offset for its related-party interest expense. For example, USP borrows $3,000 at a 5 percent rate from a third party, incurring $150 of interest expense. It also lends $1,000 to CFC at a 5 percent rate and earns $50 of interest income. A conduit approach would effectively treat the CFC as paying $50 of third-party interest expense in applying the offset. USP would first allocate $50 of its interest expense to its $50 of interest income and would allocate the remaining $100 of interest expense on a worldwide asset basis that ignores USP's intercompany loan receivable.

Regulations adopting this type of conduit treatment would facilitate self-help measures by taxpayers to eliminate interest allocation issues in the United States over time by pushing more debt offshore through intercompany loans. That would be in taxpayers' interests and, by bringing interest income into the U.S. tax net, would not be to the detriment of the U.S. fisc.[34] The question is whether Treasury and the IRS can be comfortable that they have sufficient authority to adopt conduit treatment for U.S.-to-CFC related-party debt.

The plain language of section 864(f) gives an offset to CFC interest expense generally; it does not specify the treatment for offset purposes of interest on CFC borrowings from its U.S. affiliates. The legislative history, however, describes the provision as applying to "third-party interest expense." That description could be viewed as an illustration rather than a determination, but it is simply not clear.[35] A footnote in the legislative history states that "it is anticipated that the Treasury Secretary will adopt regulations addressing the allocation and apportionment of interest expense on such [U.S.-to-CFC] indebtedness that follow principles analogous to those of existing regulations."[36]

The existing regulations referenced in the footnote are presumably the rules of reg. section 1.861-11T(e). Under those rules, a loan from one affiliated U.S. group member to another is not treated as an asset of the holder,[37] and the borrower deducts related-person interest payments using group apportionment fractions computed under reg. section 1.861-9T(f).[38] The holder includes the related-person interest income in the same class of gross income as the

[33] *See* preamble to T.D. 8228, 53 F.R. 35485 (Sept. 14, 1988) ("Numerous comments were received questioning the rule of [reg.] section 1.861-10T(c)(4) of the proposed regulations requiring the allocation of third party interest expense of a United States shareholder to the interest income received from related controlled foreign corporations. . . . Upon reconsideration, it has been determined that the objectives of this rule may be achieved more narrowly by eliminating any tax benefits resulting from the substantially disproportionate concentration of third party indebtedness in the United States group and that the adoption of a rule intended to prevent such concentration of third party indebtedness in the United States group is appropriate.").

[34] There are, of course, other considerations taxpayers will have to consider when analyzing whether to debt-fund a CFC. For example, overleveraging a CFC may run afoul of foreign-country thin capitalization or earnings-stripping rules, which (if applicable) could disallow interest expense for local law purposes and increase the total amount of foreign taxes paid. And although debt-funding with a distribution of proceeds back to USP might not be problematic from a U.S. tax perspective given the level of previously taxed E&P of many multinationals, such a distribution can trigger costly foreign dividend withholding taxes.

[35] H.R. Rep. No. 108-755, at 377 (2004) (Conf. Rep.).

[36] *Id.* at 377 n.207.

[37] Reg. section 1.861-11T(e)(1).

[38] Reg. section 1.861-11T(e)(2)(i).

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class of gross income from which the member borrower deducts the related-person interest payment.[39] These rules make sense in the context of a domestic affiliated group, in that the interest expense of one member is effectively matched with the income of the other member.

The result of these rules is that the existence of intercompany debt between U.S. domestic affiliated group members does not alter a taxpayer's allocation of interest expense to any FTC basket, which makes sense. But applying these rules to U.S.-to-CFC loans under worldwide apportionment would result in interest payments from CFCs to U.S. group members being characterized as partially U.S. source, depending on the asset ratios of the worldwide group. That does not make sense; most CFCs have no U.S.-source income to which to allocate the expense, and the current FTC rules allocate the expense based on CFC gross income or assets.

But the legislative history brings into focus broader questions about the treatment of interest income on U.S.-to-CFC loans. In general, the section 904(d)(3) look-through rule treats interest income received from a CFC as general limitation income to the extent the interest is not attributable to passive income of the payer CFC; it is not treated as GILTI basket income even if the deduction reduces a CFC's tested income.[40] When USP and CFC are members of an affiliated group under section 864(f), however, the footnote in the legislative history would imply that the intercompany debt rules of reg. section 1.861-11T(e) would effectively override the section 904(d)(3) look-through rule. If so, CFC would deduct the interest expense on an intercompany loan using the worldwide allocation factors, and USP would recognize the income under the matching rule in the same categories, thereby offsetting the amounts. In a worldwide interest allocation regime, in which the intercompany loan receivable is ignored as an asset, matching the assets of the CFC to which the intercompany interest expense is allocated to the interest income of USP makes sense. But using worldwide assets as the basis for that match does not.

Perhaps the legislative history footnote was motivated by the basket mismatches that can result from respecting the section 904(d)(3) look-through rule in a world of allocating interest expense based on CFC assets. As described above, the look-through rule mandates that the interest payment from the CFC be treated as general or passive income (rather than GILTI income) to USP, even when the interest expense of the CFC reduces the CFC's tested income and thus USP's GILTI inclusion. This creates an overallocation of USP interest expense to the GILTI basket: The interest expense converts CFC tested income to general limitation income, but there is no corresponding adjustment to the allocation of USP interest expense to the general basket because the intercompany loan is not regarded as an asset of USP.

These issues demonstrate that although the intercompany debt rules of reg. section 1.861-11T(e) should not be applied to U.S.-to-CFC loans as a general matter, rules do need to be implemented to minimize or avoid the GILTI/general basket mismatch that results from the section 904(d)(3) look-through rule. In that context, perhaps Treasury and the IRS can exercise their authority to adopt the CFC interest conduit rule described earlier. That rule would allocate USP third-party interest expense first to intercompany interest income. It would thus eliminate any mismatch except in the unusual situation in which USP interest income on loans to CFC exceeds total USP third-party interest expense.

C. Determining GILTI and Exempt Assets

In addition to developing rules for allocating interest expense to FTC baskets and dealing with intercompany loans, Treasury and the IRS need to determine the extent to which the rules of reg. section 1.861-13, which have only recently been finalized, will be imported into section 864(f). These rules apply a five-step process to the characterization of CFC stock[41]:

1. *Characterize stock as generating income in statutory groupings based on the asset method*

[39] *Id.*

[40] *See* reg. section 1.904-5(c)(2).

[41] Multiple examples in reg. section 1.861-13 demonstrate the application of these steps.

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or modified gross income method: Under either method, stock is assigned to one of 10 subgroups. For example, if a CFC earns exclusively tested income, its stock would be assigned to the general limitation category foreign source gross tested income statutory grouping. General limitation non-tested, non-subpart F income is specified foreign source general category gross income.

2. *Assign stock to the section 951A category*: A portion of the CFC's stock is assigned to the section 951A category equal to the U.S. shareholder's inclusion percentage[42] multiplied by the stock assigned to the foreign source gross tested income statutory grouping in the general category in step 1.
3. *Assign stock to a treaty category*: If any U.S.-source income under section 951(a) or section 951A(a) is subject to a treaty re-sourcing provision, this step would require some portion of the stock to be assigned to a special treaty category.
4. *Aggregate stock within each separate category*: The CFC stock assigned to foreign source statutory groupings that were not specifically assigned to the section 951A category are aggregated within the general category and the passive category.
5. *Determine the section 245A subgroup for each separate category*: For the portion of stock in the general category, the section 245A subgroup equals the value of the general category gross tested income stock of the CFC that is not assigned to the section 951A category, plus the value of the CFC stock that is assigned to the specified foreign source general category gross income statutory grouping. Similar rules apply for the passive category.

Treasury and the IRS will need to consider how, and to what extent, these rules should be mapped to the assets of a CFC.[43] Among the many difficult issues to be addressed, perhaps most important is the determination of exempt assets.

For decades now, foreign corporation stock owned by a U.S. affiliated group has been treated as an asset for purposes of interest allocation and apportionment. The treatment of stock as the relevant asset for interest allocation purposes effectively disconnects the U.S.-level interest allocation from the underlying assets owned by the CFC. The treatment of CFC stock in allocating interest expense to the GILTI basket is a perfect example — as explained in the preamble to the 2018 proposed FTC regulations, "gross tested income of a CFC is generally assigned to the general category, even though the stock of the CFC may give rise to a GILTI inclusion that is section 951A category income in the hands of a United States shareholder."[44]

Section 864(f) represents an abrupt departure from this stock-centric view of interest allocation, and looks through CFC stock to "foreign assets."[45] The statute does not define foreign assets but does provide that the exempt assets rule of section 864(e)(3) applies, which requires that any "tax-exempt asset (and any income from such an asset) shall not be taken into account" in allocating and apportioning any expenses.[46] Essentially, exempt assets become nonexistent in allocating and apportioning interest expense.[47] Whether this is helpful or harmful depends primarily on whether the exempt assets are foreign or domestic — treating foreign assets as exempt is generally helpful because it increases the relative weight of U.S.-source assets and pushes more interest expense to U.S.-source income.

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[42] *See* reg. section 1.960-2(c)(2) (defining the inclusion percentage as the U.S. shareholder's section 951A inclusion divided by the U.S. shareholder's aggregate pro rata share of tested income).

[43] Rules for characterizing stock of a CFC have, in limited circumstances, been applied to property other than stock. *E.g.*, reg. section 1.861-10(e)(4)(v) (applying the CFC stock characterization rules of reg. section 1.861-12T(c)(3) to some debt obligations of a related CFC).

[44] REG-105600-18.

[45] Technically, section 864(f) looks through stock of a foreign corporation that is treated as a member of a worldwide affiliated group, which is separate and apart from a determination of CFC status. Because the examples under consideration deal with foreign corporations that are wholly owned by a U.S. consolidated group, we refer to "CFCs" for ease of reading.

[46] *See* reg. section 1.861-8(d)(2).

[47] This treatment of exempt assets arguably runs contrary to the principle that money is fungible, and that interest expense funds all activities of the affiliated group (including exempt activities). We set aside any view on the merit of section 864(e)(3) — it is in the code for better or worse.

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It is not clear, however, how the *assets* of a CFC are assigned to the GILTI basket. The existing rules in reg. section 1.861-13 are solely focused on *stock* of a foreign corporation. Under those rules, generally half the stock of a CFC assigned to the section GILTI basket is treated as an exempt asset because of the section 250 deduction. It is not clear how this rule would apply under worldwide apportionment, which ignores the stock of a CFC and looks to the CFC's assets. Guidance to date has clearly stated a view that a CFC holds assets that generate tested income assigned to the general basket,[48] *not* the GILTI basket.[49] If that view applies for purposes of section 864(f), arguably no interest expense would be allocated to the GILTI basket.[50] It is doubtful that Treasury and the IRS will maintain that view. Accordingly, it is not clear how to characterize assets at the CFC level in the GILTI basket, which is relevant because a portion of the GILTI assets arguably should be treated as exempt as the result of application of the section 250 deduction.

If Treasury and the IRS change their view, they would likely assign a portion of CFC assets to the GILTI basket based on the inclusion percentage.[51] If this path is taken, exempt asset treatment for CFC assets ultimately giving rise to a section 250 deduction would recognize the express incorporation of exempt asset treatment in section 864(f)(3). It would also be consistent with the current treatment of non-stock assets that give rise to section 250 deductions under the foreign-derived intangible income rules.[52]

If some CFC assets are treated as exempt, the question is raised whether interest expense allocable to income from those assets for FTC purposes should be disallowed as an offset under the foreign source income allocation limitation calculation or any of the basket apportionment alternatives discussed earlier. Although that disallowance might seem appropriate at first glance, it would be inconsistent with the structure and purpose of section 864(f). By its terms, section 864(f) applies to aggregate worldwide interest expense and provides an offset for aggregate CFC interest expense without exception, even though it specifically incorporates the exempt asset rule of section 864(e)(3). Moreover, the purpose of section 864(f), as described earlier, is to avoid any allocation of U.S. group interest expense to foreign source income when CFCs bear their proportionate share of worldwide interest expense. One can question the statute's exempt asset provision, which excludes some domestic assets (assets related to the section 250 FDII deduction) as well as some foreign assets (assets related to the section 250 GILTI deduction) in determining the appropriate measure of the CFC's proportionate share of worldwide interest expense. But that does not call into question the fact that the U.S. group and the CFCs are each bearing the cost of all the interest expense they incur and should get "credit" for that cost.

D. Application of Section 904(b)(4)

For the section 245A deduction, Congress opted not to treat stock of a CFC as an exempt asset. Instead, the TCJA added section 904(b)(4) to the code, which provides that in determining a U.S. shareholder's FTC limitation, worldwide taxable income and taxable income in a particular basket are determined without regard to (1) the foreign source portion of any dividend received from a 10-percent-owned foreign corporation, and (2) deductions properly allocable or apportioned to income (other than amounts includible under section 951(a)(1) or 951A(a)) for

[48] It is also possible, although uncommon, for a CFC to generate passive tested income.

[49] Reg. section 1.861-13(a)(2) ("A controlled foreign corporation is not treated as earning section 951A category income."). Similarly, a CFC is not treated as earning branch basket income. *See* preamble to REG-105600-18, 83 F.R. 63200, 63209 (Dec. 7, 2018) ("Section 904(d)(2)(J) limits foreign branch income to income of a United States person. Therefore, foreign persons (including CFCs) cannot have foreign branch category income."). If worldwide apportionment were to completely look through CFC stock, however, and treat the worldwide affiliated group as a single corporation, then potentially the CFC assets could be treated as foreign branch assets. But this approach, taken to an extreme, would assign no assets to the GILTI basket. We assume that regulations would not adopt such an approach, but this issue highlights another tension between treating the worldwide affiliated group as a single taxpayer and the statutory changes made by the TCJA.

[50] Such an approach may be superficially appealing, but many taxpayers will have little income in the general basket, in which case the interest allocation would create a separate limitation loss under section 904(f)(5) and offset income in other baskets in any event.

[51] What portion of CFC assets should be viewed as potentially attributable to the GILTI basket and thus multiplied by the inclusion percentage raises several technical questions. In particular, it is not clear whether the starting point should be all assets that generate tested income or a more limited notion of equity-funded (rather than debt-funded) assets.

[52] *See* reg. section 1.861-8(d)(2)(ii)(C)(*2*)(*i*).

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Table 3. Applying Section 904(b)(4) to CFC Assets

	Asset Value	Interest Expense	Income Before Interest	Adjusted Taxable Income	Adjusted WW Income	FTC Limitation
U.S.-source	$5,000	$284	$1,000	$716	$1,434	
GILTI	$1,200	$68	$400	$332	$1,434	$68
Exempt	$1,200	$0	$0	$0	$1,434	
FS general	$2,000	$114	$500	$386	$1,434	$79
FS general (245A)	$600	$34	$0	$0	$1,434	

Table 4. Treating CFC Assets as Exempt

	Asset Value	Interest Expense	Income Before Interest	Adjusted Taxable Income	Adjusted WW Income	FTC Limitation
U.S.-source	$5,000	$305	$1,000	$695	$1,400	
GILTI	$1,200	$73	$400	$327	$1,400	$69
Exempt	$1,800	$0	$0	$0	$1,400	
FS general	$2,000	$122	$500	$378	$1,400	$79
FS general (245A)	$0	$0	$0	$0	$1,400	

stock of a specified 10-percent-owned foreign corporation, or such stock to the extent income on that stock is other than amounts includible under section 951(a)(1) or section 951A(a).[53]

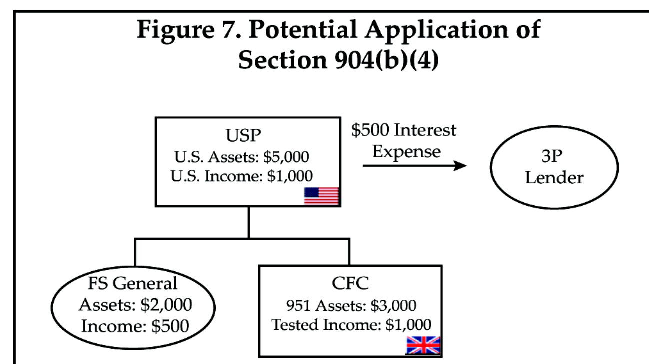
Mechanically, this rule has two major effects. First, stock that gives rise to a section 245A deduction is not treated as exempt, meaning that it attracts interest expense. This is generally helpful because it pulls interest expense toward assets that generate quasi-exempt income (and for which there are no permitted FTCs). But what the statute gives, the statute partially takes away by adding back to total worldwide income (the denominator of the section 904 fraction) the amount of interest expense allocated to section 245A category assets. The expenses are also added back to taxable income in the applicable separate limitation category (the numerator of the section 904 fraction).

Expressed as a formula, the new FTC Limitation is:

$$\text{FTC Limitation} = \frac{\text{Basket Taxable Income} + \text{245A Expenses in Basket}}{\text{Worldwide Income} + \text{All 245A Expenses}} * \text{Worldwide Income} * 21\%$$

This makes the formula more complicated than the pre-TCJA formula, which was effectively foreign source taxable income in the basket multiplied by the U.S. tax rate. Now the limitation must be calculated separately for each basket, taking into account the section 904(b)(4) adjustments. Applying the new formula to a simple example, as shown in Figure 7:

Figure 7. Potential Application of Section 904(b)(4)



[53] *See also* reg. section 1.904(b)-3.

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Assuming an inclusion percentage of 80 percent for simplicity and that USP's basis in CFC stock is $3,000. Table 3 shows what assets, interest expense, and FTC limitation USP would have under the section 904(b)(4) approach. In comparison, Table 4 shows what USP would have if stock assigned to a section 245A subgroup were instead treated as exempt.

Under the section 904(b)(4) approach, the $34 of interest expense allocated to the foreign source general (section 245A subgroup) basket dilutes the overall FTC fraction by increasing adjusted worldwide taxable income ($1,900 total pretax taxable income[54] - $500 interest expense + $34 section 904(b)(4) addback). This hurts every basket except the foreign source general basket, because in that basket, the $34 is also added to the numerator. So while a taxpayer's total FTC limitation may increase under section 904(b)(4) (measured by simply adding up the limitation in each category), in at least some cases, the GILTI limitation is ultimately harmed relative to exempt asset treatment. For some taxpayers, losing $1 of limitation in the GILTI basket is worse than losing $2 (or more) in the general basket because there are no excess credits in the general basket, and those credits can carry forward in any event. So while section 904(b)(4) may be favorable in an aggregate sense because interest expense is allocated to effectively exempt income, the adjustments could operate to the detriment of the GILTI basket in favor of the general basket.

The policy underlying section 904(b)(4) is not explained in the legislative history, and there are no floor speeches or other clues why Congress chose to deviate from treating stock giving rise to a section 245A deduction as an exempt asset, which would simply be ignored for purposes of interest allocation and apportionment. Perhaps the most plausible explanation is that Congress viewed the section 245A deduction as fundamentally different from a dividends received deduction under section 243 or section 245(a), which are intended to relieve duplicative taxation on distributions of earnings that have already been subject to U.S. tax at least once. Section 245A, on the other hand, could be viewed as excluding a portion of a foreign corporation's activities from the scope of the U.S. tax regime entirely, and therefore any shareholder-level expenses allocable to that income should be effectively disallowed for FTC purposes under principles similar to section 265. Whatever the rationale, it is unclear how section 904(b)(4) should be applied (if at all) to the assets of a CFC.

One approach is to simply apply the principles of reg. section 1.861-13 to CFC assets, preserving the five-step process in the current regulations. This would be relatively simple and avoid a potentially unintended disparity between the treatment of CFC stock and CFC assets.

As an alternative, because the provision references stock and no other assets, section 904(b)(4) could be viewed as not applying at all to CFC assets that correspond to the section 245A subgroup. In that case, the assets could be treated like any other asset and assigned to the relevant statutory grouping. Assets that give rise to high-tax exception subpart F income would be assigned to the general or passive basket grouping. Assets that give rise to tested income but are in the section 245A subgroup because of qualified business asset investment or the GILTI high-tax exception would also be in the general basket or the GILTI basket if Treasury and the IRS decide to attribute to that basket assets that generate tested income, as discussed earlier.

As a further alternative, Treasury and the IRS could take the view that section 904(b)(4) does not apply to CFC assets, but that the assets in the section 245A subgroup should be treated as exempt assets. Intuitively, it would seem sensible that income and assets giving rise to a section 245A deduction would be treated as exempt assets because section 864(e)(3) specifically treats assets that give rise to a section 243 or section 245(a) deduction as partially exempt. That is arguably not what Congress had in mind in the TCJA, or else it likely would not have enacted section 904(b)(4). But if that section applies only to allocations involving stock, and if taxpayers electing section 864(f) worldwide asset allocation are no longer allocating based on stock, an argument can be made that assets giving rise to income eligible for the section 245A deduction should be added to exempt assets,

[54] This is equal to the $1,000 of U.S.-source income, plus $500 of foreign source general limitation income, plus $400 section 951A inclusion ($1,000 tested income * 80 percent inclusion percentage - $400 section 250 deduction).

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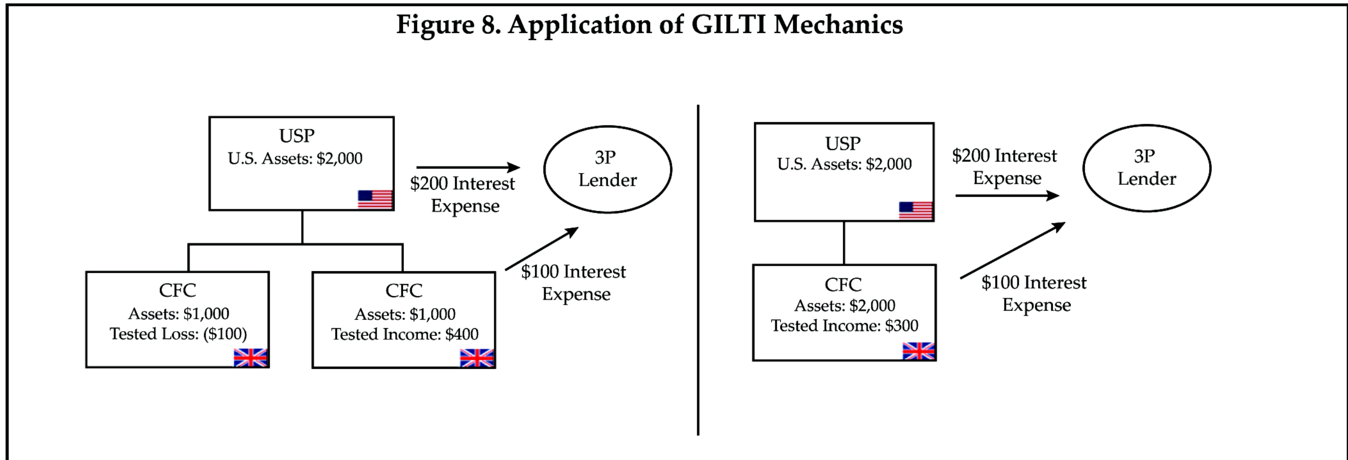
Figure 8. Application of GILTI Mechanics



in addition to the assets generating income matching the section 250 deduction.

It is peculiar that the legislative history to the TCJA, which added section 904(b)(4) to the code, provides no guidance on this issue, considering that the Senate draft would have accelerated the effective date of section 864(f) to taxable years beginning after December 31, 2017. Further, the conference report discusses worldwide apportionment and notes that "the new rules are generally expected to reduce the amount of the U.S. group's interest expense that is allocated to foreign source income."[55] Accordingly, it is clear that Congress did not simply forget about worldwide apportionment when drafting the TCJA. But it appears that even if Congress gave some consideration to section 864(f), its role in the larger statutory framework was not entirely thought through.

E. Treatment of Tested Loss CFCs

As a preliminary matter, it should be said that the treatment of tested losses raises several difficult policy questions and can result in disparate treatment of taxpayers based on whether activities are combined into one CFC or spread across multiple CFCs. Figure 8 compares two scenarios: First, USP owns CFC1 and CFC2, which both pay $40 of foreign taxes in the current year. CFC1 has $400 of tested income, but CFC2 incurs a ($100) tested loss. Under section 960 and the associated regulations, USP will not be deemed to pay any of the foreign taxes incurred by CFC2. If instead CFC1 and CFC2 were combined, USP would take into account the same aggregate tested income of $300, but all $80 of taxes could be treated as tested foreign income taxes.[56]

Fragmenting activities across multiple CFCs can also alter the inclusion percentage, potentially creating additional section 245A subgroup assets, in situations that are economically similar. In the separate CFC paradigm, USP's inclusion percentage will be 75 percent ($300 inclusion/$400 pro rata share of tested income), resulting in the stock of the CFCs being treated as partially section 951A category stock, partially exempt, and partially general/section 245A subgroup. In the combined example, the inclusion percentage will be 100 percent (assuming no QBAI), resulting in all the CFC stock being treated as section 951A category stock or exempt. This difference occurs under both water's-edge and worldwide allocation and apportionment, and it results from netting tested income and losses at the shareholder level (as in the separate example) or at the CFC level (in the combined example).

Accepting the architecture for tested losses under the TCJA, however, the principles of reg. section 1.861-13 treat a portion of the stock of a CFC that incurs a tested loss as section 951A category stock. That is, even though the CFC incurs a loss, its stock is still combined with other tested income or tested loss CFCs in determining

[55] H.R. Rep. No. 115-466, at 592 (2017) (Conf. Rep.).

[56] *See* section 960(d)(3).

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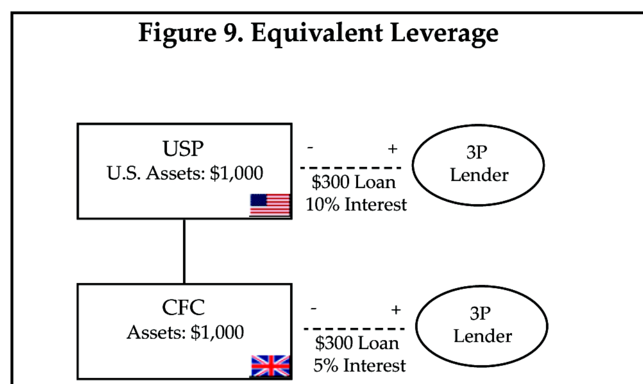
the total amount of stock assigned to the section 951A category. If the same principles apply to characterize the assets of a CFC that generates a tested loss, and if Treasury and the IRS determine that tested income assets generally are assigned to the GILTI basket, a portion of the assets of a tested loss CFC would likewise be assigned to the GILTI basket for purposes of section 864(f).

F. Interest or Liabilities as Measure?

Figure 9. Equivalent Leverage



Section 864(f) formulaically focuses solely on interest expense rather than relative leverage. In cases in which interest rates in the United States and abroad vary substantially, it can result in an allocation of interest expense to foreign source income when the CFCs are proportionately debt-funding their operations directly.

In Figure 9, USP and CFC are equally leveraged, but because CFC borrows at a lower rate, additional USP interest income will be allocated to foreign source income. If a CFC is equally leveraged, should any U.S. affiliated group interest expense be allocated to foreign source income? The conference report to the TCJA suggests that Congress was concerned with equal leverage, without regard to interest rates:

> A result of this rule is that interest expense of foreign members of a U.S. affiliated group is taken into account in determining whether a portion of the interest expense of the domestic members of the group must be allocated to foreign source income. An allocation to foreign source income generally is required only if, in broad terms, the domestic members of the group are more highly leveraged than is the entire worldwide group.[57]

This issue is particularly problematic for banks because interest rates on deposits vary substantially in different currencies and geographies. In today's world, for example, yen and euro deposits can generate no or even negative interest expense.

Given the statutory language, it is questionable whether Treasury has authority to apply the section 864(f) offset based on the amount of CFC liabilities rather than the amount of CFC interest expense, as a general matter. Section 864(f)(5)(F), however, provides authority for rules regarding financial groups, which could allow for potential consideration of a relative leverage rule for banks. Indeed, in recently proposed regulations, Treasury requested comments on whether a relative leverage test would be appropriate for allocating and apportioning interest expense of foreign bank branches.[58] If the answer to that question is ultimately yes, perhaps similar reasoning should apply to bank CFCs.

III. Conclusion

Cranking up section 864(f) after 16 years will finally deliver what seemed imminent as early as 1986. But while the statute provides a broad conceptual picture of how worldwide apportionment will function, there are ample details that remain to be filled in. How these issues are ultimately resolved will largely determine whether worldwide apportionment was worth the wait. ■

[57] H.R. Rep. No. 115-466, at 591-592.

[58] Preamble to REG-101657-20, 85 F.R. 72078, 72083 (Nov. 12, 2020) ("Comments are also requested as to whether adjustments to the amount of foreign branch liabilities subject to this rule are necessary to account for differing asset-to-liability ratios in a foreign branch and a foreign branch owner.").

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