Debt Push Downs and the Curious Application of the Debt-Netting Rule

By William Skinner

The reduced rate of tax on GILTI and overall reduction in the U.S. corporate tax rate has left more U.S.-based multinational companies in an excess foreign tax credit position, often due to an allocation and apportionment of interest expense under Code Sec. 861 to the GILTI basket. For a U.S. taxpayer that suffers from a loss of foreign tax credits due to allocation and apportionment of interest expense, the taxpayer might consider various means of having the CFCs bear a portion of the interest expense, either through locating third-party borrowing at the CFC level, or more commonly by having the U.S. Parent advance or "push down" the debt to the CFC level through an intercompany loan.

From a Code Sec. 904 perspective, a debt push down might secure two benefits. First, the interest expense at the CFC level may reduce foreign taxes that would be otherwise be subject to the Code Sec. 904 limitation. Second, the additional foreign source interest income generated on the intercompany loan might increase the U.S. Parent's total foreign source income. Code Sec. 904(d) generally will provide for foreign source general basket treatment for the U.S. Parent's interest income on a loan to a related CFC.[1] This additional, presumably low-taxed foreign source income could offset the excess foreign tax credits on the CFC's remaining earnings.

As with most other areas of international planning, the 2017 Tax changes the fundamentals here. With GILTI in place, the U.S. Parent will not increase its foreign source income through an intercompany loan, but rather "re-basket" the income from GILTI to the general basket.[2] Whether this effect is favorable or not will depend on the taxpayer's facts and circumstances, but in many cases, will be unfavorable. However, as discussed below, a push down of debt through a CFC finance co remains viable from a U.S. tax perspective and would allow for cross-crediting the interest income on the loan against the foreign taxes on CFC operations in the GILTI basket.[3]

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Pushing Down Debt by Having the CFC Borrow Directly

If a U.S. Parent is suffering a foreign tax credit limitation as a result of interest expense, the most basic means of pushing down debt would be to have the CFC

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borrow directly from the third-party lender supported by a Parent guarantee. In this case, the interest expense would be incurred at the CFC level and no longer enter Parent's Code Sec. 861 calculation of interest expense.

In addition to the commercial challenges of this structure, having a CFC borrow directly would cause the parent would give up any potential to deduct the interest expense at the U.S. corporate rate of 21%. If the U.S. Parent has a mix of U.S. and foreign assets and the foreign rate is below the regular U.S. corporate rate, then generally the U.S. Parent's loss of the U.S.-level deduction will outweigh the impact of allocating additional interest expense against GILTI. Further, in cases where the U.S. Parent has an exclusion from tested income for Qualified Business Asset Investment ("QBAI"), the CFC's borrowing would erode the U.S. Parent's QBAI benefit.

For example, assume U.S. Parent owns CFCs that generate GILTI of $100 with a blended foreign tax rate of 15% and an inclusion percentage of 100%. U.S. Parent has $2,000 of U.S. assets generating $200 of U.S. taxable income and $1,000 of foreign assets in the form of CFC stock producing GILTI. U.S. Parent is contemplating locating $500 of additional borrowing with annual interest expense of $25 at U.S. Parent level or at the CFC level.

If the $500 of additional borrowing is located at the U.S. Parent level, U.S. Parent would obtain the benefit of a $25 deduction at 21%, or $5.20 of tax savings. A portion of this interest expense would be allocated under Code Sec. 861 principles against the GILTI basket equal to 20% of $25 or $5.[4] As a result of this allocation, Parent's Code Sec. 904(d) income in the GILTI category would be reduced from $50 to $45, yielding a Code Sec. 904 limitation of $9.45 instead of $10.50. Effectively, the Code Sec. 861 allocation rules would result in a loss of GILTI foreign tax credits worth $1.05 due to the Code Sec. 904 limitation. U.S. Parent, however, would still save a net $4.15 from incurring the additional debt at the U.S. shareholder level.

By contrast, if the additional borrowing were incurred by the CFC, the CFC would save foreign taxes equal to $3.75 (*i.e.*, $25 interest deduction × 15% foreign rate). U.S. Parent would give up the value of the U.S.-level interest deduction as noted above, which after Code Sec. 861 effects, is worth $4.15.

As the local CFCs tax rate increase and come closer to the U.S. corporate rate of 21%, these effects will reverse and eventually the benefit of saving local tax will outweigh the net benefit of borrowing in the United States. However, even in that scenario, the Parent might consider whether there is an equally effective and less cumbersome way of pushing down debt.[5]

Pushing Down Debt by Having the CFC Borrow Through an Intercompany Loan

A more common structure for causing a CFC to bear a portion of the U.S. Parent's external debt is through an intercompany loan. For example, assume that U.S. Parent advances to its CFC an amount equal to a portion of its third-party debt at the third-party interest rate, plus a small spread. In this case, the CFC would have interest expense locally that would generally be deductible subject to local interest-deductibility requirements. In addition to reducing foreign tax by having the CFC bear a portion of the debt, the U.S. Parent potentially could generate additional foreign source income on the intercompany loan. Prior to the TCJA, this interest income would create additional foreign source general basket income. To the extent the interest expense on the third-party borrowing was allocated and apportioned under Code Sec. 861 between U.S. and foreign sources,[6] the net of effect of this transaction would be to increase the U.S. Parent's foreign tax credit limitation.

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> **Base Case Example.** Assume U.S. Parent owns $2,000 of U.S. assets and $1,000 of foreign assets consisting of CFC stock. Assume further that the CFC stock is assigned under Reg. §1.861-13 solely to the general basket, CFC's earnings are fully taxable as subpart F income, and none of CFC's stock is assigned to the §245A subgroup. U.S. Parent incurs an additional $500 of third-party debt, bearing interest at 6%, and simultaneously recapitalizes the CFC, so that it now owes U.S. Parent a $500 receivable, also at a 6% and its stock basis is reduced from $1,000 to $500. U.S. Parent would have $30 of foreign source general basket income on the intercompany receivable. At the same time, the $30 of third-party interest expense would be allocated and apportioned to U.S. and foreign sources based on the U.S. Parent's mix of assets (2/3 U.S. and 1/3 foreign). Accordingly, ($20) of this expense would be allocated against U.S. source income and ($10) would be allocated against foreign source income. On a net basis, U.S. Parent's general basket income would increase by $20.

Shortly after the 1986 tax reform act, this potential conversion of U.S. Parent's U.S. source income into foreign

source income led to the promulgation of the debt-netting regulations to curb this beneficial result. Specifically, these regulations (Reg. §1.861-10(e)) prevent the conversion of U.S. source income into foreign source income using the borrowing and on-lending transaction described above where there is a simultaneous increase in external debt (*i.e.*, "USSI") and the loans receivable from CFCs (*i.e.*, related group indebtedness or "RGI") as compared to a five-year base period. Where they apply, the debt-netting regulations provide for a special allocation of interest expense to foreign source income from the RGI owing from CFCs.

In the base case above, if all of the $500 receivable were subject to the debt-netting rules as an allocable increase in RGI, Parent would have $30 of foreign source income on the CFC loan and directly allocate $30 of third-party interest expense to foreign sources. Due to this special allocation of third-party interest expense to foreign sources, as compared to normal apportionment, U.S. and foreign source income would be unaffected by the additional borrowing and on-lending to the CFC.[7]

After the TCJA, the calculus is different. The Example above assumes that all of CFC's stock was in the general category, rather than the Code Sec. 951A category, and that the CFC does not produce any exempt earnings. This assumption is not a very common fact pattern, in that most CFC stock is in the GILTI basket and a large fraction of CFC earnings are subject to current inclusion under Code Sec. 951A. At the same time, the look-through rules of Code Sec. 904(d) continue to assign related-party interest income to the general basket, absent the CFC having any passive income.[8] Typically, interest income on an intercompany loan to a CFC is assigned to the general basket, while the interest expense reduces tested income that would give rise to an inclusion under Code Sec. 951A. Rather than generating additional foreign source income, a debt push down will change the basket of U.S. Parent's foreign income:

> **Revised Example.** U.S. Parent owns $2,000 of U.S. assets and $1,000 of foreign assets, of which $500 is CFC stock in the GILTI basket and $500 of which is a CFC loan receivable in the general basket.[9] Assume that U.S. Parent has $30 of external interest expense. Assume for the moment that the debt-netting regulations do not apply. For Code Sec. 861 allocation purposes, U.S. Parent's assets are $2,000 U.S., $500 foreign source general and $500 GILTI, $250 of which is excluded from the Code Sec. 861 fraction as a tax-exempt asset.[10]

In this revised and more realistic example, the intercompany loan has different effects. First, the U.S. Parent has converted GILTI, eligible for a Code Sec. 250 deduction,[11] into $30 of general basket income subject to tax at full corporate rates. Second, U.S. Parent has hopefully obtained a foreign tax deduction for the $30 of interest expense locally. To some extent, the benefit of this local tax deduction outweighs the cost of subjecting the same income to U.S. corporate tax at 21% rate. Third, from an interest expense allocation perspective, U.S. Parent's GILTI category assets have been reduced by $500 and its general category assets have increased accordingly.

Overall, this trade is unlikely to be beneficial in many cases, because of the conversion of GILTI eligible for a reduced rate of tax into general basket income subject to a higher rate of tax. However, if the U.S. Parent had excess credits in the general basket, the creation of additional general basket income could be beneficial. In addition, the adjustment to U.S. Parent's mix of assets for the Code Sec. 861 fraction would allocate interest expense away from GILTI to the general basket.

Impact of the Debt-Netting Regulations Under §1.861-10(e)

The debt-netting rules continue to apply after the TCJA but yield surprising results in the basic fact pattern above. Under those regulations, the special allocation of interest expense is designed to counteract the additional interest income created by a related-party loan. This is done by specially allocating interest income on the loan to the Code Sec. 904(d) category or categories *to which additional stock basis would have been assigned under Reg. §1.861-12T(c)(3)*.[12] This rule seems premised on the rules assigning the interest income and the additional stock basis under Reg. §1.861-12T(c)(3) to the same separate categories under Code Sec. 904(d). However, after the Tax Cuts and Jobs Act, this usually will not be the case.

> **Example of the Debt-Netting Rule Post-TCJA.** Assume the same facts as the Revised Example above—*i.e.*, U.S. Parent owns $2,000 of U.S. assets and $1,000 of foreign assets, of which $500 is CFC stock in the GILTI basket and $500 of which is a CFC loan receivable in the general basket. U.S. Parent earns $200 of U.S. source income, $70 of GILTI (before the Code Sec. 250 deduction) and $30 general basket interest income. U.S. Parent has $30 of interest expense, all of which is specially

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allocated to foreign sources under Reg. §1.861-10(e)(4)(v).

If U.S. Parent had $500 of additional stock basis in the CFC, it would have an additional $500 of Code Sec. 951A category stock, $250 of which would be tax-exempt and disregarded. Therefore, the RGI would be assigned 100% to the GILTI basket. As a result, the $30 special allocation of interest expense would be solely to the GILTI basket, even though the loan receivable produces $30 of income in the general basket.

[A] push-down of debt through a CFC finance co remains viable from a U.S. tax perspective and would allow for cross-crediting the interest income on the loan against the foreign taxes on CFC operations in the GILTI basket.

The net effect of this conversion would be to specially allocate interest expense allocated to the GILTI basket, despite the fact that the loan generates additional general basket income. This would result in a significant impairment of the GILTI basket foreign tax credit. Assuming most of the taxpayer's credits are in the GILTI basket, the application of the debt-netting regulation could be a major trap for the unwary. To the extent it applies, it not only counteracts the benefit of borrowing and on-lending, but it makes the taxpayer's GILTI basket Code Sec. 904 limitation even lower than it would have been had no borrowing and lending occurred.

Hybrid Scenario

A third way to structure a debt push down would be to indirectly lend funds to the foreign operating company through a foreign finance company. This structure is illustrated in Figure 1.

This form of financing structure has a number of benefits. First, since CFC2, the foreign operating company incurs debt locally, this structure results in a local interest deduction where CFC2 does business. Second, the structure also allows U.S. Parent to deduct interest in the United States against U.S. source income. Third, and unlike the scenario where U.S. Parent holds the intercompany debt itself, the loan from CFC1 to CFC2 should produce tested income to CFC1,[13] rather than general basket income. Thus, in this structure, the interest income from the loan receivable is in the same Code Sec. 904(d) basket as the foreign taxes on CFC2's remaining income. This generally would allow cross-crediting in the GILTI basket of high-taxed operating income against low-taxed interest income, as was possible in the general basket prior to the Tax Cuts and Jobs Act.[14]

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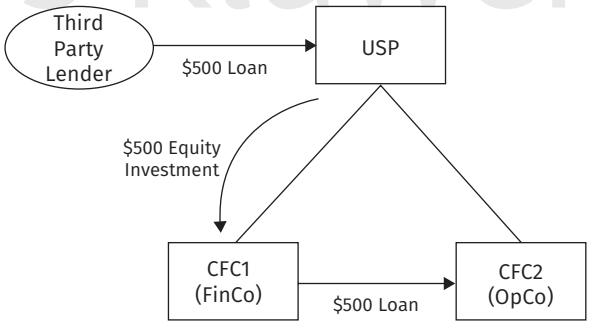
FIGURE 1.



ENDNOTES

1 *See* Reg. §1.904-5(c)(2). If the CFC has passive income, the interest income on the loan will be characterized as passive to the extent of such CFC's passive basket income.

2 Furthermore, if the taxpayers' CFCs have QBAI, interest expense at the CFC level will reduce the 10% deemed tangible income return on a dollar-for-dollar basis. *See* Code Sec. 951A(b)(2)(B). Intercompany debt from U.S. Parent to the CFC in this scenario may effectively convert exempt QBAI return into fully taxable interest income at U.S. Parent.

3 The Biden Administration has proposed new tax legislation that would appear to impose a per-country basket on the foreign tax credits with respect to GILTI. This rule would limit the opportunity to engage in such foreign tax credit planning in the GITLI category.

4 On facts above, U.S. Parent's Code Sec. 861 fraction would be 80% U.S. source and 20% foreign source Code Sec. 951A category due to the exempt assets adjustment for stock in the Code Sec. 951A category under Reg. §1.861-8(d)(2)(ii). Under such adjustment, half of CFC's stock basis is disregarded in the Code Sec. 861 fraction, leaving U.S. Parent with $500 of stock basis in the GILTI basket and $2,500 of total assets.

5 This calculus is also affected by the recent Coronavirus relief legislation's repeal of Code Sec. 864(f)'s election of worldwide apportionment. *See* American Rescue Plan Act of 2021, Sec. 9671 (Mar. 11, 2021). If Code Sec. 864(f) had not been repealed, a U.S. Parent would have obtained a Code Sec. 904 benefit from locating an equal amount of interest-bearing debt at

the CFC and U.S. Parent level commensurate with the relative assets.

[6] Reg. §1.861-10(e). One condition of the debt-netting rule's application is that the U.S. shareholder increase *both* its external debt at the U.S. shareholder level *and* its loans receivable from related CFCs during the base period. In the Example above, U.S. shareholder's receivables from CFCs increase by $500, but the debt-netting rule would not apply if U.S. shareholder indebtedness were constant relative to the base period. *See* Reg. §1.861-10(e)(1)(ii).

[7] The debt-netting rules specially allocate interest expense to foreign source income to the extent of income on so-called "allocable RGI." Allocable RGI is equal to an amount of RGI equal to the lesser of its excess RGI and excess USSI. *See* Reg. §1.861-10(e)(4)(ii). Where only some of the taxpayer's RGI is allocable RGI, only a ratable portion of the interest income on such RGI gives rise to a special allocation of interest expense. For simplicity, the examples in the text above assume that all of the CFC-level RGI is allocable RGI, so that interest expense equal to all interest income on the U.S. shareholder's loan to the CFC is subject to the special allocation.

[8] *See* Reg. §1.904-5(c)(2).

[9] The loan receivable would be in the passive basket to the extent related-person interest expense is allocated against passive basket income under Reg. §1.904-5(c).

[10] *See* Reg. §1.861-8(d)(2)(ii)(A).

[11] In addition, under Code Sec. 951A(b)(2), if the Parent has a positive QBAI position in its CFCs, this interest expense would reduce 10% of QBAI return that is exempt from tax.

[12] Reg. §1.861-10(e)(4)(v).

[13] *See* Code Sec. 954(c)(6); Notice 2007-9.

[14] From the perspective of the debt-netting regulation, this hybrid scenario does not give rise to allocable RGI or a direct allocation of interest expense against foreign source income. A special rule in Reg. §1.861-10(e) treats the additional $500 of equity investment in CFC1 as an increase in RGI. However, the income on the CFC stock (here, the GILTI inclusion attributable to CFC1) is not treated as income from RGI subject to a special allocation. *See* Reg. §1.861-10(e)(8)(v). Additionally, to prevent the application of this rule from distorting the normal allocation fraction under Code Sec. 861, proposed regulations issued in November 2020 (REG-101657-20) would repeal this special rule effective for taxable years ending on or after November 2, 2020. *See* Proposed Reg. §1.861-10(h). *See also* Reg. §1.861-10(e)(8)(vi) (making a similar change for the rules for hybrid debt effective in December 2018).

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