Originally published in:
The Canadian Tax Journal **December 1, 2002**

Thomas Bill Currently Pending in Congress Includes Many Important Foreign Tax and Other Legislative Proposals

By: Peter A. Glicklich and Abraham Leitner

A bill is pending in Congress that would make a number of important changes to the US federal income tax rules in the area of foreign taxation. The proposed changes to the interest stripping-rules of Code section 163(j) should be of particular interest to Canadian and other non-US taxpayers with US activities.

There has been a great deal of discussion in the press lately about US corporations undergoing " whereby a corporation moves to a tax haven jurisdiction to avoid future US tax. Under existing US law, inversion transactions generally result in gain recognition (at the shareholder or corporate level) to the extent of any unrealized gain. As a result of the current depressed US stock market, many corporations have recently been able to expatriate with little or no gain recognition at the shareholder level. Moreover, in the current economy, many corporations have net operating losses that can be used to offset any corporate-level gain recognized when assets are transferred offshore.

Various legislative proposals intended to prevent or reduce expatriations have been widely discussed. The American Competitiveness and Corporate Accountability Act of 2002, a bill introduced by the House Ways and Means Committee chair, William Thomas, on July 11, 2002 ("the Thomas bill"), includes a number of anti-inversion provisions.[1] One provision would treat a foreign corporation that is established by an inversion by a US corporation as a domestic corporation subject to US taxation on its worldwide income if the former US shareholders own 80 percent or more of the foreign corporation after the transaction.[2] Less drastic provisions would apply if a lower ownership threshold (60 percent) is met.[3]

The foregoing provisions are fairly narrow in scope, strictly targeting former US corporations that have expatriated. In an effort to reduce the incentive for US corporations to expatriate, however, the Thomas bill also includes broader provisions that would apply to all foreign corporations. These provisions would amend the interest-stripping rules of Code section 163(j)[4] and would sharply reduce the ability of foreign corporations to use debt financing to reduce US taxes on their US subsidiary operations.

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1 American Competitiveness and Corporate Accountability Act of 2002, HR 5095, 107th Cong., 2d sess. (2002).

2 Thomas bill, section 202.

3 If the 60 percent threshold is met, then the corporation would be prohibited from using tax attributes such as net operating losses or foreign tax credits from offsetting any income recognized from the inversion transaction.

4 Internal Revenue Code of 1986, as amended (herein referred to as "the Code"). Unless otherwise stated, statutory references in this article are to the Code.

Interest-Stripping Proposals

The interest-stripping rules generally defer interest deductions with respect to certain related-party debt. Under current law, these rules apply only where

- the corporation's debt-to-equity ratio exceeds 1.5 to 1 *and*
- its "net interest expense" exceeds 50 percent of its "adjusted taxable income."[5]

Net interest expense is the excess of the corporation's interest expense for the taxable year over its interest income for the period.[6] The adjusted taxable income of the corporation is determined by adding back to its taxable income the amount of net interest expense, any net operating loss deductions, and any depreciation, amortization, or depletion deductions that were claimed by the corporation.[7]

If the debt-to-equity and net interest expense thresholds are exceeded, then no current deduction is allowed for "disqualified interest" to the extent that the corporation's net interest expense exceeds 50 percent of the corporation's adjusted taxable income. Disqualified interest includes interest paid to a related person that is exempt from US withholding tax (or a proportionate part of interest that is subject to a reduced rate of withholding tax under an income tax treaty) ("exempt interest").[8] In addition, interest paid with respect to indebtedness that is guaranteed by a related foreign person is treated as disqualified interest.

Under present law, interest deductions that are disallowed under the interest-stripping rules may be carried forward indefinitely and may be deducted in a subsequent year in which the debt-to-equity or net interest expense thresholds are not exceeded.[9] Section 163(j) also provides a three-year carryforward of any excess limitation - that is, the amount by which net interest expense falls short of the 50 percent threshold.[10]

Thus, under current law, the interest-stripping rules allow foreign shareholders to use additional leverage to reduce US income tax on their US subsidiaries' operations as long as the specified debt-to-equity threshold is not exceeded. Moreover, even if the threshold is exceeded, interest deductions are merely deferred rather than disallowed.

Under the proposed Thomas bill, the interest-stripping rules of Code section 163(j) would be expanded in several respects.[11] First, the debt-to-equity threshold would be eliminated. Second, the percentage of adjusted taxable income above which net interest expense becomes subject to the disallowance rule would be reduced from 50 percent to 35 percent. In addition, to the extent that interest is disallowed under the modified rules, the disallowed interest could be carried forward only five years, after which it would expire. The proposal would also eliminate the excess limitation carryforward.

The Thomas bill would also add a new "super disallowance" rule if a US corporation that is a member of a worldwide affiliated group has "excess domestic disqualified interest" for the taxable year, which would be immediately and permanently disallowed. Excess domestic disqualified interest would be found to exist if a US subsidiary is more highly leveraged than the overall worldwide corporate group.

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5 Code section 163(j)(2).

6 Code section 163(j)(6)(B).

7 Code section 163(j)(6)(A).

8 Code section 163(j)(3).

9 Code section 163(j)(1)(A).

10 Code section 163(j)(2)(B)(ii).

11 Thomas bill, section 201.

This new super disallowance rule would require a series of calculations. First, the corporation would have to determine the amount, if any, of its "disproportionate indebtedness" by comparing its debt with what its debt would have been if it were leveraged to the same degree as the overall worldwide group. Then, the US corporation would have to determine the percentage of its related-party debt that is attributable to its disproportionate indebtedness (this percentage is referred to as the "disproportionate domestic related party indebtedness percentage"). For this purpose, disproportionate debt would be attributed first to related-party debt. Finally, the interest paid by the US corporation on its related-party debt would be multiplied by the disproportionate domestic related-party indebtedness percentage to yield the amount of interest subject to the super disallowance rule.

The following example included in the Staff of the Joint Committee on Taxation's description of the Thomas bill[12] illustrates the operation of the super disallowance rule. If a worldwide group had $500 of total external debt and $1,000 of total assets, for a debt-to-assets ratio of 50 percent, and the US affiliated group had $75 of total debt ($45 unrelated and $30 related, all at a 10 percent interest rate) and $100 of total assets, for a debt-to-assets ratio of 75 percent, then the US affiliated group would be regarded as being overleveraged by 25 percentage points, or $25. Using a related-party-first ordering rule, the entire $2.50 of interest on this $25 would be disallowed under the proposed rules. More specifically, under the calculation provided in the proposed rule, the US affiliated group would have $75 minus [($100/$1,000) times $500] equal $25 of disproportionate debt. The disproportionate domestic related-party indebtedness percentage would be $25/$30 equal 83.33 percent. Of the US affiliated group's $3 of interest incurred on its $30 of related-party debt, 83.33 percent of this interest, or $2.50, would be disallowed. If the US affiliated group's $30 of related-party debt had consisted of three $10 loans at interest rates of 8, 9, and 10 percent, respectively, for total related-party interest of $2.70, then the amount disallowed would be 83.33 percent of $2.70, or $2.25 (thus effectively applying the average related-party interest rate of 9 percent to $25 of disproportionate related-party debt).

The modified present-law disallowance rule and the super disallowance rule would be coordinated by disallowing the greater of the two amounts in the current year and by permitting only the excess of the amount determined under the modified present-law disallowance rule over the super disallowance rule to be carried forward.

The Technical Explanation does not address whether the proposed amendments to the interest-stripping rules would override the antidiscrimination provisions contained in many US income tax treaties. The legislative history of section 163(j) indicates, however, that Congress believes that the interest-stripping rules are not discriminatory against non-US taxpayers.[13] That conclusion was based on several arguments, the strongest of which appears to be that the interest-stripping rules could also apply to US tax-exempt entities. Congress also apparently intended that if the interest-stripping rules were ultimately determined to be discriminatory, then they would override any contrary treaty provisions.

Tax Shelter Proposals

The Thomas bill also includes a number of proposals targeting tax shelters. The proliferation of corporate tax shelters as well as shelters marketed to wealthy individuals has become an area of great concern in Treasury and Congress during the past few years. Accordingly, it seems likely that regardless

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12 United States, Staff of the Joint Committee on Taxation, *Technical Explanation of H.R. 5095 (the "American Competitiveness Act of 2002")*, JCX-78-02 (Washington, DC: Joint Committee on Taxation, July 19, 2002) (herein referred to as "the technical explanation").

13 HR rep. no. 101-247, 101st Cong., 1st Sess. (1989), 1249.

of the fate of the other provisions in the Thomas bill, certain of its tax shelter proposals may be enacted in one form or another, despite their controversial nature.

In particular, the Thomas bill would codify the present common law "economic substance doctrine," under which tax benefits arising from a transaction that lacks economic substance may be disallowed.[14] Under current law, courts apply the economic substance doctrine differently--some courts apply an objective test focusing on the potential economic benefits of the transaction, some apply a subjective "business purpose" test, and yet others apply some combination of the two tests. The Thomas bill would provide that tax benefits are disallowed unless a transaction meets *both* an objective and a subjective test. The objective test would require that the transaction "change" the taxpayer's economic position "in a meaningful way." While the bill does not really clarify these two tests, it does authorize interpretative regulations. The Technical Explanation appears to provide some guidance as to the sponsor's intentions regarding the meaning of the proposed provisions. For example, the requirement that the transaction result in a meaningful change in the taxpayer's economic position would not necessarily require realization of an overall economic profit apart from tax benefits, because the sponsor recognizes that some legitimate transactions do not always provide for a direct economic pre-tax profit (for example, leveraged leases). The Technical Explanation notes, however, that if the transaction purports to meet the meaningful change requirement by having profit potential, then the amount of potential profit must be substantial in relation to the present value of the expected tax benefits.

The subjective test would require that the taxpayer have a substantial non-tax purpose for entering into the transaction and that the transaction be a reasonable means of accomplishing such purpose. The Technical Explanation notes that an objective of achieving a favorable accounting treatment for financial reporting purposes would generally *not* be a substantial non-tax purpose. The "reasonable means" prong of the business purpose requirement is, according to the Technical Explanation, intended to broaden the ability of courts to bifurcate a transaction in which independent activities with non-tax objectives have been combined with an unrelated item having only tax-avoidance objectives in order to disallow the overall benefits of the transaction.

The Thomas bill also includes several proposals that target specific transactions that have received recent publicity. One arrangement marketed to wealthy individuals involves the purchase (generally from a non-US person) of an interest in a partnership that holds assets with large built-in losses; such losses are recognized after the US person purchases the partnership interest. The Thomas bill would effectively disallow the loss in the hands of the purchaser.[15] Another targeted arrangement involves the purchase of stock or bonds prior to a dividend or interest payment date, with a US taxpayer claiming a foreign tax credit for foreign withholding taxes that are paid on the dividend or interest payment. This transaction was analyzed in a prior article by the authors appearing in this feature,[16] which addressed the lower court case of *Compaq Computer Corp.*[17] The Thomas bill would require a 15-day holding period for any asset in order to claim a foreign tax credit for withholding taxes on any payments made on the asset.[18] A third proposal in the Thomas bill expands the existing rules addressing the treatment of "dividend stripping"

14 Thomas bill, section 101.

15 Thomas bill, section 106.

16 Sanford H. Goldberg, Peter A. Glicklich, and Abraham Leitner, "US Court Finds Foreign Tax Credit Strip Does Not Compute," Selected US Tax Developments feature (1999) vol. 47, no. 6 *Canadian Tax* Journal 1568-72.

17 113 T.C. 363 (1999), rev'd 377 F. 3d 778 (5th Cir. 2001).

18 Thomas bill, section 122. Under present law, a 15-day holding period is required to claim a foreign tax credit for withholding tax paid with respect to a stock dividend. Code section 901(k).

transactions, which seek to circumvent the current accrual of income under the original issue discount rules that apply to debt instruments by effectively converting stock into a debt-like instrument.[19]

The Thomas bill also includes a number of new penalties and increases in existing penalties applicable to understatements in tax resulting from a tax shelter or failures to disclose a tax shelter transaction. For example, failure to report a "listed transaction" (that is, a transaction previously identified by Treasury in published guidance) under section 6011 would be subject to a penalty of up to $200,000.[20] Currently, no specific penalties apply to taxpayers who ignore those requirements. An accuracy-related penalty of up to 30 percent (the current maximum is 20 percent) would be imposed on any understatement attributable to a listed transaction or any other transaction with a significant tax-avoidance purposes that is not adequately disclosed.[21] The Thomas bill would also add a 40 percent penalty for any understatement attributable to a transaction that lacks economic substance (under the economic substance definition proposal described above) or is otherwise a sham transaction.[22] Notably, this penalty would be a strict-liability penalty and would have no reasonable cause or other exceptions.

Repeal of Extraterritorial Income Exclusion

The Thomas bill also proposes to repeal the extraterritorial income exclusion (ETI) regime. This export incentive regime was enacted as a successor to the foreign sales corporation (FSC) regime and has had a short and troubled life. Export incentives have been a part of the Internal Revenue Code since the 1960's, beginning with the domestically incorporated sales corporation (DISC) regime, which allowed certain domestic corporations engaged in exporting goods abroad to defer tax on their earnings.[23] Congress largely eliminated the benefits of using a DISC in 1984 (by adding an interest charge for the DISC shareholders' deferred tax liability), as a result of pressure from European countries claiming that the regime violated the GATT prohibition on export subsidies, and replaced the DISC regime with the foreign sales corporation regime.[24] The FSC regime applied to foreign corporations rather than to domestic corporations and it went further than the DISC regime in allowing US corporate shareholders to claim a 100 percent dividend-received deduction for dividends paid by an FSC, thereby effectively exempting the FSC earnings from US corporate tax.

The European Union filed a complaint with the World Trade Organization (WTO) in 1998, alleging that the FSC regime constituted an illegal subsidy under GATT. The WTO ultimately ruled against the US, and Congress repealed the FSC regime in November, 2000. The FSC regime was replaced with the ETI regime, which is currently contained in Code section 114 and sections 940 through 943.

The ETI regime excludes "extraterritorial income" to the extent that it constitutes "qualifying foreign trade income."[25] Extraterritorial income is defined as income attributable to "foreign trading gross receipts," which in turn means receipts from "qualifying foreign trade property."[26] Qualifying foreign

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19 Thomas bill, section 121. The current rules applicable to dividend-stripping transactions are in Code section 305(e).

20 Thomas bill, section 102. The reporting requirements for such transactions are currently contained in Treas. reg. section 1.6011-4.

21 Thomas bill, section 107.

22 Thomas bill, section 104.

23 The DISC provisions are contained in Code section 991, et seq.

24 The FSC provisions were contained in Code section 921, et seq.

25 Code section 114(a).

26 Code sections 114(e) and 942.

trade property includes property held for sale, lease, or rental outside the US[27] Qualifying foreign trade income is the greater of the following three amounts: (1) 30 percent of the foreign sale and leasing income from a transaction; (2) 1.1 percent of the foreign trading gross receipts from the transaction; and (3) 15 percent of the foreign trade income from the transaction.[28] Unlike the FSC regime, the benefits available under the ETI regime apply to individuals, S corporations, and C corporations.

The European Commission (EC) filed a complaint with the WTO alleging that the ETI regime suffered from the same defects as the FSC regime. Indeed, the WTO ruled in favor of the EC in June, 2001 and a US appeal filed with the WTO was denied in January, 2002. The WTO ruling permits the EC to apply approximately $4 billion of annual trading sanctions against the US. Members of the EC are presently considering which products to subject to sanctions. It is against this background that the Thomas bill would repeal the ETI regime. The additional revenue from the repeal of the ETI regime and from the proposed expansion of the interest-stripping rules would be used to pay for other tax benefits included in the bill, which are discussed below.

Foreign Simplification Provisions

The Thomas bill includes a package of proposals that would substantially simplify and, in many respects, liberalize the taxation of US persons with foreign activities. First, the bill would repeal the current subpart F rules applicable to foreign base company sales and services income.[29] Those provisions prevent the deferral of base company income (that is, income from transactions with related parties) of a foreign corporation controlled by US shareholders (a CFC).[30] Another proposal would repeal the foreign personal holding company (FPHC) regime, which applies to closely held foreign corporations owned by US individuals that earn mostly passive income, as well as the foreign investment company (FIC) regime, which has largely been superseded by the passive foreign investment company (PFIC) regime.[31] Under present law, there is also a significant amount of overlap between the FPHC regime and the subpart F rules, which independently prevent deferral of passive income and which generally trump the FPHC rules when both would otherwise apply.

Conclusion

The Thomas bill includes a number of significant provisions, some of which are quite controversial. It is unclear whether the bill will be enacted in its present or in a revised form. With a Republican majority taking power in both houses of Congress in 2003, the Thomas bill now appears to have a greater chance of passage.

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[27] Code section 943.

[28] Code section 941(a).

[29] Thomas bill, section 301.

[30] The foreign base company sales and services provisions are contained in Code section 954(d) and (e).

[31] The FPHC provisions are contained in Code sections 551, et seq., and the FIC provisions are contained in Code sections 1246, et seq. The PFIC provisions are contained in Code section 1291, et seq.