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Interest-Stripping Changes Affecting U.S. Corporations Seem Likely; Only the Details Remain Opaque

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The proposed changes to the interest-stripping rules of Internal Revenue Code section 163(j) included in last session's Thomas bill were not enacted. Yet Congress and the Bush administration appear intent on tightening those rules, as well as blocking inversions, repealing export incentives, and easing subpart F inclusions.

Background

The interest-stripping rules of Internal Revenue Code section 163(j)[1] generally defer interest deductions with respect to certain related-party debt. A previous article by the authors in this feature discussed the proposed changes to the interest-stripping rules that were included in a bill proposed by the House Ways and Means Committee chairman, William Thomas, on July 11, 2002 (the "Thomas bill").[2] The reader may wish to refer to that article for a more detailed explanation of the interest-stripping rules and the amendments proposed in the Thomas bill.

Under present law, the interest-stripping rules generally apply only where

- a corporation's net interest expense exceeds 50 percent of its "adjusted taxable income"; and
- the corporation's debt-to-equity ratio exceeds 1.5 to 1.[3]

To the extent that the corporation's net interest expense exceeds 50 percent of its adjusted taxable income, any exempt interest paid on debt to a related party (or guaranteed by a related party) is deferred indefinitely until such time as the corporation no longer meets the foregoing thresholds. Exempt interest includes any interest upon which no US tax is imposed on the recipient or, in the case of interest with respect to debt guaranteed by a related party, upon which no US withholding tax is imposed.

Under the Thomas bill proposal, the interest-stripping rules of Code section 163(j) would have been expanded in several respects.[4] First, the debt-to-equity ratio threshold would have been eliminated. Second, the percentage of adjusted taxable income above which net interest expense becomes subject to the disallowance rule would have been reduced from 50 percent to 35 percent. In addition, to the extent

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[1] 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

[2] Peter A. Glicklich and Abraham Leitner, "Thomas bill Currently Pending in Congress Includes Many Important Foreign Tax and Other Proposals" (2002) vol. 50, no. 6 *Canadian Tax Journal* 2195-2202. The Thomas bill was formally known as the American Competitiveness and corporate Accountability Act of 2002, HR 5095, 107th Cong., 2d sess. (2002).

[3] Code section 163(j)(2).

[4] Thomas bill, section 201.

that any interest deductions were disallowed under the modified rules, the disallowed interest would have been carried forward for five years (after which it would expire), and the proposal would have eliminated the excess limitation carryforward under present law. Finally, the Thomas bill would also have added a new "super disallowance" rule that would apply where a US corporation is a member of a worldwide affiliated group that has "excess domestic disqualified interest" for the taxable year. Such interest deductions would have been immediately and permanently disallowed. Under the proposed rules, "excess domestic disqualified interest" would exist to the extent that the US subsidiary was more highly leveraged than the worldwide corporate group.

Foreign investors might have been tempted to breath a sigh of relief when the last session of Congress ended without the enactment of the Thomas bill. The current Congress continues, however, and thus the possibility of an interest-stripping amendment is still real. On the bright side, a new legislative proposal would liberalize one aspect of the interest-stripping limitations.

Houghton Bill

Under present law, interest that is paid on indebtedness to an unrelated third party may be subject to disallowance under section 163(j) if there is a "disqualified guarantee" of such indebtedness. A disqualified guarantee is generally any guarantee made by a related person that is a tax-exempt entity or a foreign person.[5] The term "guarantee" is defined to include "any arrangement under which a person (directly or indirectly through an entity or otherwise) assures, on a conditional or unconditional basis, the payment of another person's obligation under any indebtedness."[6] The legislative history of section 163(j) indicates that Congress intended that the term guarantee be interpreted in its broadest sense to include not just a traditional guarantee, but also any arrangement, such as a "comfort letter," that provides any credit support for indebtedness, whether or not the arrangement results in a legally enforceable obligation.[7]

Congressman Amory Houghton Jr. recently introduced a new bill, HR 285 (the "Houghton bill"),[8] which would except from disqualified guarantees "a guarantee by a foreign person, [if] the taxpayer establishes to the satisfaction of the [Internal Revenue Service] that the taxpayer could have borrowed substantially the same principal amount from an unrelated person without the guarantee." The Internal Revenue Service (IRS) would have the authority to reject such a position by the taxpayer where the borrowing would have to be on terms "substantially dissimilar" to those of the actual loan. Thus, for example, if a taxpayer can show that it would have been able to obtain a loan from a bank for the same principal amount without the guarantee, but the guarantee was offered to the lender in exchange for an interest rate reduction of 40 basis points, then the guarantee would not be a disqualified guarantee. If, however, the 40-basis point-rate differential obtained through the guarantee were considered to be so material as to result in debt with "substantially dissimilar" terms, the IRS could treat the guarantee as a disqualified guarantee. As the foregoing example illustrates, the value to taxpayers of the proposed exception will largely depend on how the substantially dissimilar standard is interpreted and applied by the IRS. Treasury regulations issued in a different context provide that a modification of the terms of an existing debt instrument that results in a yield differential of more than the greater of ¼ of one percent (25

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5 Code section 163(j)(6)(D)(i).

6 Code section 163(j)(6)(D)(iii).

7 United States, House of Representatives, Committee on Ways and Means, *Fiscal Year 1994 Budget Reconciliation Recommendations of the Committee on Ways and* Means, report no. 103-11 (Washington, DC: US Government Printing Office, May 18, 1993).

8 Fairness, Simplification and Competitiveness for American Business Act of 2003, HR 285, 108th Cong., 1st sess., introduced on January 8, 2003.

basis points) and five percent of the instrument's current yield is deemed for federal income tax purposes to result in a new debt instrument that differs materially from the original debt instrument (and the taxpayer is deemed to have exchanged the old debt instrument for a new debt instrument in a potentially taxable transaction).[9] The fact that such a small difference in yield is considered to result in a "material difference," however, does not mean that the resulting debt instrument would necessarily be considered "substantially dissimilar" under the standard in the Houghton bill proposal.[10]

Bush Budget Proposal

Unfortunately, President Bush's fiscal year 2004 budget proposal, which was submitted to Congress on February 3, 2003 ("the Bush proposal"),[11] includes most of the proposed changes to the earnings-stripping rules that were included in the Thomas bill. However, the Bush proposal would modify rather than eliminate the debt-to-equity ratio safe harbor. Specifically, the Bush proposal would retain the safe harbor, but in an expanded form. Under the Bush proposal, the debt-to-equity ratio threshold would take into account the types of assets owned by the corporation and its leverage, which in the view of the Bush administration is typically associated with various broad asset classes. Thus, instead of a fixed debt-to-equity ratio, the safe harbor would be determined on the basis of a series of debt-to-asset ratios identified for these specified asset classes. The new safe harbor would permit a level of indebtedness based on the value of the corporation's assets in each asset class. The applicable asset classes and debt-to-asset ratios are as follows:

[9] Treas. reg. section 1.1001-3(e)(2).
[10] Some recent proposals to codify the substance-over-form principle of US tax law would require transactions to have a material economic effect in order to be taken into account for tax purposes. Query whether and how such a rule would be coordinated with the material difference standard of Treas. reg. §1.1001-3 and/or other existing de minimis rules.
[11] United States, Executive Office of the President, Office of Management and Budget, Fiscal Year 2004 Budget, transmitted to Congress on February 3, 2003.

Asset class	Debt-to-asset ratio
Cash, cash equivalents, and government securities	0.98
Municipal bonds, publicly traded debt securities, and receivables	0.95
Publicly traded equities, mortgages and other real estate loans, other corporate debt, and third party loans	0.90
Trade receivables and other current assets	0.85
Inventory	0.80
Land, depreciable assets, other investments, and loans to shareholders	0.70
Intangible assets	0.50

By comparison, the present law's 1.5 : 1 debt-to-equity ratio is equivalent to a 0.60 debt-to-asset ratio. It is evident that the Bush proposal would be a substantial liberalization for most taxpayers. The 0.70 ratio that applies to real estate, however, is still somewhat lower than the ratio that would be permitted by a typical first mortgage lender, and is significantly lower than the 0.90 or higher ratio sought by many investors for purely commercial reasons, in the absence of tax considerations, in order to maximize their return on equity.

The Bush proposal does not detail exactly how the debt-to-asset ratios would be determined where the corporation holds stock of other corporations, but the proposal includes a cryptic statement that "equity investments in foreign related parties (other than investments in subsidiaries) would not be taken into account" for the purposes of determining the debt-to-asset ratios. Under present law, affiliated US corporations (that is, corporations connected by 80 percent ownership by vote and value to a common parent)[12] are supposed to be treated as a single corporation for the purposes of determining the debt-to-equity ratio, and stock in non-affiliated or foreign corporations is treated in the same manner as any other asset of the corporation.[13] The Bush proposal would, however, require consideration of how any stock owned by the corporation is to be treated for the purposes of determining the appropriate debt-to-asset ratio. One possible meaning of the statement quoted above is that unless the related parties qualify as "subsidiaries," the proposal would prevent the stock from being taken into account in determining the safe harbor. If this is in fact the intention of the proposal, it might be viewed as an anti-abuse rule designed to prevent foreign shareholders from "stuffing" the US corporation with affiliate stock in order to increase its

[12] The proposed Treasury regulations issued under section 163(j) provide that certain constructive ownership rules are taken into account in determining ownership for this purpose. prop. reg. section 1.163(j)-5(a)(3).

[13] The basis of any stock in a non-affiliated 10-percent-owned corporation is, however, adjusted by taking into account earnings and profits of the 10-percent-owned corporation in a manner similar to that provided in Treas. reg. section 1.861-12T(c)(2). prop. reg. section 1.163(j)-4(c)(2).

permissible debt without bringing the underlying assets into the US tax base. More likely, however, the statement means to require the taxpayer to include such stock in its general intangible-assets basket, potentially resulting in the lowest possible ratio for the stock. Under this interpretation, if the foreign corporation is a "subsidiary" of the taxpayer, then a lookthrough rule would perhaps apply to permit a higher debt-to-asset ratio based on the foreign corporation's underlying assets. This approach would be consistent with the approach taken by the Treasury in the interest-sourcing rules that apply to the foreign tax credit and other purposes; these rules provide a lookthrough rule for the purposes of characterizing the stock of a controlled foreign corporation.[14]

The Bush proposal includes the "super disallowance rule" contained in the Thomas bill proposal, which compares the leverage of the US corporations in the group with the leverage existing in the worldwide group and disallows any deduction for interest attributable to the excess US indebtedness. Unlike the current excess interest limitation, which merely defers interest deductions, interest disallowed under the super disallowance rule would be permanently disallowed. In general, the new rules 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 Bush proposal would modify the super disallowance rule in one important respect, however. Under the Bush proposal, the debt-to-asset ratio safe harbor would trump the super disallowance rule, and the amount of debt treated as excess US indebtedness would not exceed the amount by which the US corporation's indebtedness exceeds its safe harbor amount. Thus, if a US corporation's assets consist primarily of publicly traded equities, it will not be subject to the super disallowance rule if its debt-to-asset ratio is less than 0.90, even if the worldwide group's debt-to-asset ratio is much lower.

The following example illustrates how the interest-stripping proposal might apply in a typical case. Assume that a Canadian-income real estate investment trust (REIT) raises $100 million in a public offering of units to Canadian investors. Assume further that the REIT qualifies for US federal income tax purposes as a "unit investment trust" eligible for pass through treatment.[15] The REIT forms a US corporate subsidiary to which it contributes $50 million and the subsidiary purchases $500 million of US rental real estate. A first mortgage in the amount of $400 million is obtained by the subsidiary from an unrelated bank. The remaining $50 million required for the purchase is financed through a mezzanine loan made by the REIT to the US subsidiary. Assume that the subsidiary has no other assets. Under present law, interest paid by the subsidiary on the mezzanine debt should qualify for an exemption from US withholding tax under the portfolio interest exemption, assuming that no owner of the REIT to which the interest is allocable owns 10 percent or more of the REIT's outstanding units.

Analysis

The subsidiary has a debt-to-asset ratio of 0.90 ($450 million of debt and $500 million of assets). The debt-to-asset ratio of the worldwide group consisting of the REIT and its subsidiary, treating them as a single corporation, is 0.80 ($400 million of debt and $500 million of assets). Thus, up to $50 million of the subsidiary's debt could, unless the safe harbor applies, be treated as excess US indebtedness. The subsidiary's safe harbor ratio in the table shown above is 0.70, which would permit $350 million of indebtedness. The subsidiary's debt exceeds the safe harbor by $100 million, which is more than the

[14] Treas. reg. section 1.861-12(c)(3).

[15] An investment trust can avoid being treated as a business entity if it has a single class of ownership interests outstanding and if there is no power under the trust agreement to vary the investment of the interest holders. Treas. reg. section 301.7701-4(c)(1).

amount of potential excess US indebtedness. Therefore, none of the potential excess US indebtedness is protected by the safe harbor, and the subsidiary has $50 million of excess US indebtedness. Since the interest payable to the REIT on the $50 million mezzanine loan is exempt from US withholding tax, all of the interest on that loan would be treated as disqualified interest and would be permanently disallowed under the super disallowance rule.

As was the case in the Thomas bill, the Bush proposal's worldwide debt limitation would apply separately to the subgroup of financial institutions, if any, in a worldwide group. This rule is based on the theory that a higher level of leverage is appropriate for financial institutions and that it is unfair to compare the US financial institutions in a group with non-financial members of the worldwide group. This rule parallels the interest-sourcing rules of Code section 864(e). The interest-sourcing rules are relevant primarily in determining a corporation's US and foreign-source income in various specified categories, for the purposes of the foreign tax credit limitations, which prohibit foreign tax credits from offsetting the US tax imposed on the taxpayer's US-source income or on the taxpayer's income in a different category. Those rules also apportion debt on the basis of asset value and treat affiliated corporations as a single corporation, but treat the subgroup consisting of a group's financial institutions as a separate, single corporation.

Given the similar function of the proposed interest-stripping worldwide debt limitation (which effectively apportions US indebtedness to the assets of foreign affiliates) and the interest-sourcing apportionment rules, it is interesting to compare some of the features of these provisions. At the outset, it is worth noting that while these two sets of rules have a similar function, they operate in vastly different contexts. As noted above, the interest-sourcing rules are relevant primarily in determining a US taxpayer's foreign tax credit.[16] The foreign tax credit is designed for the specific purpose of eliminating double taxation of foreign-source income. The interest-stripping rules, on the other hand, are not concerned with double taxation at all. In fact, those rules will often cause the income of a taxpayer to be subject to effective double taxation by denying a deduction for interest paid to a related party, even where the interest is subject to income tax in the hands of the recipient under the laws of the recipient's jurisdiction.

One point of comparison between the interest-sourcing rules and the interest-stripping rules is that the interest-sourcing rules permit the taxpayer to elect whether to use book tax values or fair market values of assets in apportioning debt among assets. In contrast, the interest-stripping debt-to-equity ratio test under present law requires the taxpayer to use the tax basis of its assets in determining its equity. The Bush proposal does not specify whether, in applying the super disallowance rule, the value of the corporation's worldwide assets would be determined on the basis of the assets' tax book values or fair market values. Clearly, it would be extremely difficult, under US tax principles, for a corporation to determine the tax basis of its foreign affiliates' assets. Among other things, such a determination would require recomputing depreciation and amortization using US tax principles and reviewing the history of an asset's ownership to determine whether it was acquired in a transaction that was tax-free for US tax purposes and resulted in a substituted or carryover basis. Of course, it could be even more difficult for a corporation to determine the fair market value of its foreign affiliates' assets. These concerns have been raised by commentators as a serious objection to the worldwide debt-limitation proposal.

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[16] The interest-sourcing rules are also used to determine the allowable foreign tax credits for a foreign corporation that is engaged in a US trade or business. To determine the US effectively connected taxable income, however, the foreign corporation would generally use the approach set forth in Treas. reg. section 1.882-5. But see *Natl. Westminster Bank v. US*, 99-2 USTC 50,654 (Ct. Cl.) (separate-entity method applicable to determine the taxable income attributable to a permanent establishment under the US-UK income tax treaty trumps the interest-apportionment rules of Treas. reg. section 1.882-5).

Another point of comparison between the interest-sourcing rules and the interest-stripping rules is that under the interest-sourcing rules, present law does not include foreign affiliates. Similarly, the present-law interest-stripping debt-to-equity ratio does not include foreign affiliates. In contrast, the worldwide debt limitation does include foreign affiliates in the worldwide group. The inability of US corporations to use a worldwide apportionment method for interest-sourcing purposes can cause some odd results. For example, the US members of a group may be required to apportion debt to the stock of foreign affiliates owned by members of the group, even if the assets of the foreign affiliate are more highly leveraged than the assets of the US affiliates. The pending Houghton bill does permit taxpayers to elect a worldwide apportionment method for interest-sourcing purposes. The Bush proposal does not include any similar rule, but there are indications that the administration is sympathetic to worldwide apportionment for interest-sourcing purposes. In particular, in a speech made on November 14, 2002, Kenneth Van Dam, deputy secretary of the Treasury, criticized the distortions caused by the treatment of foreign affiliates under the interest-sourcing rules.[17]

The worldwide debt-limitation proposal has been criticized by US tax practitioners on several grounds. One frequent criticism is that it is inconsistent with an arm's-length standard, since a third-party lender would typically not care about the level of debt of other affiliates of the borrower. The Bush proposal mitigates this criticism somewhat by limiting the amount of debt treated as excess US indebtedness to the amount of debt in excess of the debt-to-asset safe harbor. Another objection, which applies to the interest-stripping rules generally, is that it discriminates against foreign shareholders. As discussed in our previous article on the Thomas bill, Congress rejected this complaint when the interest-stripping rules were first enacted, relying in part on the fact that the interest-stripping rules also apply to interest paid to tax-exempt US shareholders. Yet another objection that has been raised is that the worldwide debt limitation disallows gross interest deduction, as opposed to the excess interest limitation that disallows excess *net* interest. This could have harsh results for taxpayers that make leveraged investments in debt instruments, since such a taxpayer that runs afoul of the super disallowance rule could lose the ability to offset its interest income with its interest expense. In contrast, the interest-sourcing rules, which also allocate gross interest deductions, address this problem by allowing a direct allocation of interest expense in the case of qualified non-recourse indebtedness and indebtedness incurred in integrated financial transactions.[18]

Conclusion

The Thomas bill itself died in the last session of Congress, but many of its elements have been reintroduced in the Houghton bill, which is currently pending before the House Ways and Means Committee. The Thomas bill's interest-stripping proposals are not included in the Houghton bill, but they were adopted, with some modifications, by the Bush administration in its 2004 budget proposal. The Houghton bill would include one taxpayer-friendly change to the interest-stripping definition of a disqualified guarantee. The word in the Capitol is that 2003 is likely to be the Year of International Tax Reform. Look for at least some changes to the interest-stripping rules to be included in any major reform package that gets enacted.

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17 United States, Department of the Treasury, Office of Public Affairs, "US Taxation of International Business -- The need for Reform, Remarks by Kenneth W. Dam, Deputy Secretary Department of the Treasury, Delivered to the Tax Foundation's 65th National Conference, November 14, 2002, Washington, DC," PO-3624, November 14, 2002. Another point of comparison between the interest-stripping rules and interest-sourcing rules is the treatment of investment in the stock of foreign subsidiaries, discussed above.

18 Treas. reg. sections 1.861-10T(b) and (c).