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Proposed Earnings-Stripping Rules May Affect Canadian Investments in the United States

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The US earnings-stripping rules may soon be tightened to severely restrict the amount of interest that may be deducted by US corporations with related foreign creditors and related foreign guarantors. Taxpayers and their advisers should be mindful of the proposed changes when structuring new investments into the United States.

The US administration's fiscal year 2008 revenue proposals[1] include a proposal ("the proposal") to significantly tighten the "earnings-stripping" limitations of Section 163(j) of the Internal Revenue Code.[2] These changes may have a significant impact on the ability of foreign investors to invest in the United States on a tax-efficient basis.

OVERVIEW OF US EARNINGS-STRIPPING RULES

Under section 163(j), a corporation generally is not entitled to a deduction for "disqualified interest" paid or accrued during the corporation's taxable year, provided that the amount disallowed will not exceed the corporation's "excess interest expense" for the year.[3]

Disqualified Interest

For the purposes of section 163(j), disqualified interest generally means:

1. any interest paid or accrued by the corporation (directly or indirectly) to a "related person" if no income tax is imposed with respect to such interest (herein referred to as "related-party tax-exempt interest");
2. any interest paid or accrued by the corporation with respect to any indebtedness to a person who is not a related person if (a) there is a "disqualified guarantee" of such indebtedness and (b) no "gross basis tax" is imposed with respect to such interest (herein referred to as "disqualified guarantee interest"); and
3. interest paid or accrued (directly or indirectly) by a taxable REIT subsidiary of a real estate investment trust ("REIT") to the REIT.[4]

The terms "related-party tax-exempt interest" and "disqualified guarantee interest" are explained below.

Related-party tax-exempt interest

As indicated above, related-party tax-exempt interest consists of any interest paid or accrued by the corporation (directly or indirectly) to a “related person” if no income tax is imposed with respect to such interest. Thus, interest paid or accrued to a related person will be treated as disqualified interest if the payee is tax-exempt or if the payee is a foreign person entitled to a complete exemption from withholding tax under a US income tax treaty (or the portfolio interest exemption).[5] If the payee is entitled to the benefits of a US income tax treaty that reduces but does not eliminate the withholding tax, a portion of the payment is treated as subject to tax based on the ratio of the withholding rate applicable under the tax treaty to the statutory withholding rate applicable under the Code; and the remainder of the payment is treated as tax-exempt.[6]

Any person who is related to the corporation under section 267(b) or 707(b)(1) generally is considered a “related person” for the purposes of section 163(j). Thus, for example, an individual is related to a corporation if the individual owns, directly or indirectly, more than 50 percent in value of the outstanding stock of the corporation.[7] Constructive ownership rules apply for the purpose of applying the related party rules.[8]

Disqualified Guarantee Interest

As stated above, disqualified guarantee interest consists of any interest paid or accrued by the corporation to a person who is not a related person if (1) there is a “disqualified guarantee” of such indebtedness and (2) no “gross basis tax” is imposed with respect to such interest. In general, a disqualified guarantee is any guarantee by a related person that is a tax-exempt entity or a foreign person.[9] A gross basis tax is any income tax “determined by reference to the gross amount of any item of income without any reduction for any deduction allowed by this subtitle.”[10] Thus, a gross basis tax includes a cross-border withholding tax, but not the regular income tax paid by a domestic taxpayer.

Consider the perhaps unexpected result in the following circumstance. If a corporation pays interest to an unrelated US bank (or a US branch of a foreign bank), but the interest is guaranteed by a related foreign person, the guarantee is considered a disqualified guarantee. The bank is subject to US tax on a *net* basis, but not a *gross* basis; so, by reason of the disqualified guarantee, the interest constitutes disqualified guarantee interest that is subject to the limitations of section 163(j).

Excess Interest Expense

As noted above, the amount of disqualified interest that may be disallowed under the earnings-stripping rules may not exceed the corporation’s “excess interest expense” for the year. Excess interest expense generally means the excess, if any, of (1) the corporation’s net interest expense over (2) 50 percent of its “adjusted taxable income” (“the 50 percent ATI threshold”) plus any “excess limitation carryforward,” as that term is described below.[11] For this purpose, adjusted taxable income means the taxable income of the corporation computed without regard to certain deductions including any deduction for net interest expense; any deduction for net operating losses; and any deduction for depreciation, amortization, or depletion.[12]

If 50 percent of the corporation’s adjusted taxable income in a given year exceeds its net interest expense, such excess is referred to as an “excess limitation.”[13] The excess limitation for any year constitutes an “excess limitation carryforward” to the first, second, and third succeeding years, provided that any excess limitation carryforward that is used to decrease excess interest expense in any year reduces the amount carried forward to any subsequent year.[14]

Debt-to-Equity Safe Harbour

The earnings-stripping rules currently do not apply to any corporation with a debt-to-equity ratio of not more than 1.5 to 1.[15] A corporation's debt-to-equity ratio is the ratio of (1) the corporation's total indebtedness to (2) "the sum of its money and all other assets" reduced (but not below zero) by such total indebtedness.[16] For this purpose, the amount taken into account with respect to any asset is its adjusted basis for the purposes of determining gain.[17]

Notwithstanding the administrable but stingy adjusted-basis rule,[18] careful taxpayers that require only a modest degree of leverage can, and do, plan into the debt-to-equity "safe harbour" to avoid the limitations (and headaches) of section 163(j).

Carryforward of Disallowed Interest Expense

Any interest disallowed under section 163(j) is treated as paid or accrued in the succeeding taxable year, and may be deducted in such succeeding year, subject to the further application of section 163(j) and any other applicable provision for deferring or disallowing interest expense. There is currently no limit on the number of years to which disallowed interest may be carried forward.

DESCRIPTION OF THE PROPOSAL

The proposal would significantly tighten the "earnings-stripping" limitations of section 163(j). These changes are described below.

Elimination of Safe Harbour

Most important, the proposal would eliminate the debt-to-equity safe harbour. Thus, all corporations, regardless of how modestly leveraged, would be subject to section 163(j).

Lower ATI Threshold

As explained below, a corporation's disqualified interest generally is disallowed only to the extent that the corporation has excess interest expense, and net interest expense is "excess" only to the extent that it exceeds the 50 percent ATI threshold. The proposal generally would replace the 50 percent ATI threshold with a stricter 25 percent threshold for disqualified interest other than disqualified guarantee interest.[19] The proposal would also eliminate the excess limitation carryforward. Therefore, the earnings-stripping rules would disallow considerably more interest than ever before, particularly in the case of corporations that have significant year-to-year changes in profitability.

Restricted Carryforward of Disallowed Interest

As stated above, any interest disallowed under section 163(j) is treated as paid or accrued in the succeeding taxable year, and may be carried forward indefinitely, subject to the further application of section 163(j) and any other applicable provision for deferring or disallowing interest expense. The proposal would restrict the carryforward period to 10 years. After 10 years, any interest carried forward under section 163(j) would be permanently disallowed.

Effective Date

The changes described above "would be effective on the date of enactment of the proposal." It is not clear what transitional relief, if any, would be given for existing structures or what rule would apply to interest expense arising in the taxable year in which the proposal is enacted.

COMMENTS AND PREDICTIONS

For taxpayers with established structures who planned on the basis of the existing provisions of the statute, changing the rules in the middle of the game would appear to be unfair, particularly since the proposed changes would extend the sweep of the earnings-stripping rules well beyond the supposedly thinly capitalized structures to which those rules originally were meant to apply. Taxpayers and their advisers should be mindful of the proposed changes when structuring new investments into the United States.

If adopted, the proposed changes would likely renew debate as to whether section 163(j) is consistent with the obligations of the United States under the nondiscrimination provisions of its income tax treaties. Under many US income tax treaties, the nondiscrimination article provides, among other things, that interest and other expenses paid by a resident of a contracting state to a resident of the other contracting state shall, for purposes of determining the taxable profits of the first-mentioned resident, be deductible under the same conditions as if they had been paid to a resident of the first-mentioned contracting state.

This is an issue that the House conference report addressed at length when section 163(j) was originally enacted in 1989.[20] As explained therein, one of the justifications advanced by the conferees for restricting the deductibility of interest paid to a related person entitled to the benefits of a US income tax treaty (when no such restriction would normally apply if the related person were domestic), is that interest deductions could properly be disallowed for thinly capitalized corporations, and that the 1.5-to-1 safe harbour represents a reasonable rule for measuring thin capitalization. This argument, which never seemed particularly persuasive, would appear to be off the table if the safe harbour is eliminated as proposed.

As a practical matter, the far stricter earnings-stripping rules may impel otherwise compliant taxpayers to structure loans from technically unrelated persons in order to avoid section 163(j). A few possibilities are discussed below.

Discretionary Trusts

One fertile ground for zealous tax planning lies in the area of discretionary trusts. As noted above, for the purposes of section 163(j), an individual is "related" to a corporation if he or she owns, directly or indirectly, more than 50 percent in value of the outstanding stock of the corporation. For this purpose, stock owned by a trust is considered to be owned "proportionately" by its beneficiaries ("trust attribution"),[21] and an individual is considered to own any stock owned, directly or indirectly, by members of his or her "family," that is, by his or her brothers, sisters, spouse, ancestors, and lineal descendants ("family attribution").[22]

In many cases, each beneficiary's "proportionate" interest in a trust can be determined on a straightforward actuarial basis. For example, if a trust pays all of its income to the settlor for life, with all trust income thereafter payable to the settlor's spouse for life, and the remainder passing thereafter to the children of the settlor and the settlor's spouse, the interests of each beneficiary can be determined on the basis of certain statistical assumptions.

This result arguably may be avoided if the trust is discretionary. For example, suppose that the settlor settles a trust with respect to which (1) the trustee has the discretion to pay trust income or corpus to *any* beneficiary and (2) the beneficiaries named in the trust instrument include the settlor, the settlor's spouse, the settlor's children, the settlor's siblings, and the settlor's nieces and nephews.

Under this arrangement, it is far more difficult to say what interest in the trust may be ascribed to any particular beneficiary. Suppose that the trust owns 100 percent of the stock of a domestic corporation ("USco") and that USco borrows funds from the settlor.[23] To determine whether interest paid by USco to the settlor is considered to be paid to a "related person," it is necessary to determine what percentage of the stock of USco is considered to be owned by the settlor. In this regard, note that any stock of USco considered to be owned by the settlor's spouse, children, or siblings pursuant to the trust attribution rule will be "attributed" to the settlor pursuant to the family attribution rule. Any stock considered to be owned by the settlor's nieces and nephews will not be attributed to the settlor, however, because a person's nieces and nephews are not considered part of his or her "family" for the purposes of section 163(j).

Because of the discretionary nature of the trust, USco may take the position that it is not possible to determine the interests of any trust beneficiary and, consequently, that the trust attribution rule cannot be applied. Accordingly, USco might argue that the settlor cannot be considered to own more than 50 percent of the stock of USco and that, as a result, interest paid by USco to the settlor is not related-party tax-exempt interest subject to disallowance under section 163(j).

Note that if all of the trust beneficiaries were members of the settlor's "family," it appears that the application of the trust attribution rule should not be relevant, because all of the shares of USco considered to be owned by the trust's other beneficiaries would in any event be attributed to the settlor under the family attribution rule. The inclusion of technically unrelated beneficiaries, such as the settlor's nieces and nephews, undercuts this argument, because it is not clear what portion, if any, of the trust income and/or corpus may be used to benefit the settlor and members of his or her "family."

Notably, the Treasury department and the Internal Revenue Service (IRS) have tried to have it both ways with respect to the treatment of discretionary trusts. In a private letter ruling dealing with "personal holding company" status (a status that taxpayers do not desire), the IRS took the view that ownership of stock held in a discretionary trust will be based on all of the facts and circumstances, including in particular any prior pattern of distributions.[24]

With respect to a reciprocal shipping exemption under section 883,[25] however, the Treasury department has issued regulations that reject the facts-and-circumstances and pattern-of-distributions approach. Under the section 883 regulations, a foreign corporation that seeks to satisfy the applicable ownership test by having "qualified shareholders" own more than 50 percent of its shares generally cannot attribute any shares held by a discretionary trust to beneficiaries of that trust.[26]

The Treasury department appears to have adopted the same position where a taxpayer must satisfy an ownership test to qualify for the benefits of a US income tax treaty. Under the limitation on benefits ("LOB") provision in article 22 of the US Model Income Tax Treaty,[27] for example, an entity that is a resident of one of the contracting states will qualify for treaty benefits if, among other requirements, persons who are residents of the same contracting state and who are entitled to the benefits of the treaty under certain provisions of article 22(2) own a 50-percent-or-greater interest in the entity.[28]

The Treasury department's technical explanation to the 2006 US model income tax treaty appears to provide, subject to one narrow exception, that a taxpayer cannot satisfy this ownership test by attributing shares held in a discretionary trust to beneficiaries of the trust:

> A beneficiary's interest in a trust will not be considered to be owned by a person entitled to benefits under the other provisions of paragraph 2 if it is not possible to determine the beneficiary's actuarial interest. Consequently, if it is not possible to determine the actuarial interest of the beneficiaries in a trust, the ownership test under clause i) cannot be satisfied, unless all possible beneficiaries are persons entitled to benefits under the other subparagraphs of paragraph 2.[29]

The Treasury department's position on discretionary trusts for the purposes of section 883 and LOB requirements may embolden taxpayers to take the same position for the purposes of section 163(j). Taxpayers are not likely to prevail on this issue, particularly where there is a revealing pattern of distributions. In light of the ammunition provided by the Treasury department, however, a court may be reluctant to penalize taxpayers who take the same position advanced by the Treasury department for the purposes of other ownership tests.

Back-to-Back Loans

Alternatively, taxpayers may attempt to avoid the earnings-stripping rules through back-to-back loan arrangements. Suppose, for example, that the owner ("Owner") of a US corporation (USco) loans funds to his cousin ("Cousin") who then loans substantially the same amount to USco[30] Cousin is not technically related to Owner and, therefore, is not considered a related person with respect to USco If Cousin is respected as the lender for US federal income tax purposes,[31] then it appears that the earnings-stripping rules should not apply.[32]

CONCLUSION

If the proposal is enacted, the earnings-stripping rules of section 163(j) will be tightened considerably. Taxpayers and their advisers should be mindful of the proposed changes when structuring new investments into the United States.

Taxpayers and tax advisers who were inclined to work within the safe harbour or the 50 percent ATI threshold may now attempt to avoid the application of section 163(j) entirely through the use of discretionary trusts, back-to-back loans, and other devices for structuring loans from persons who are arguably not "related" to the borrowing corporation. And, once they convince themselves that they have succeeded, they may no longer see any reason not to strip out as much income as possible from the borrowing corporation, subject only to debt-equity considerations. Consequently, and ironically, the proposed efforts to tighten the rules of section 163(j) may in some instances result in greater earnings stripping than ever before.

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1 Contained in United States, Office of Management and Budget, *Budget of the United States Government: Fiscal Year 2008* (Washington, DC: Office of Management and Budget, 2007).

[2] 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.

[3] Section 163(j)(1)(A).

[4] Section 163(j)(3).

[5] Pursuant to the "portfolio interest exemption," if certain requirements are satisfied, payments of non-contingent interest to a foreign person will not be subject to US withholding tax, provided that the recipient is not a 10 percent shareholder of the payer. See sections 871(h) and 881(c). Where the payer is a domestic corporation, 10 percent shareholder status is based on voting power.

[6] Section 163(j)(5)(B). Thus, for example, if an interest payment of $90 is made to a Canadian resident entitled to a 10 percent withholding rate under article XI of the US-Canada income tax treaty, in lieu of the 30 percent statutory rate otherwise applicable under the Code, then one-third of the payment ($30) would be treated as subject to tax and the remaining two-thirds of the payment ($60) would be treated as tax-exempt. It is assumed in this example that the portfolio interest exemption does not apply. See the Convention Between the United States of America and Canada with Respect to Taxes on Income and on Capital, signed at Washington, DC on September 26, 1980, as amended by the protocols signed on June 14, 1983, March 28, 1984, March 17, 1995, and July 29, 1997.

[7] Section 267(b)(1). Similarly, two corporations are related for this purpose if they are members of the same "controlled group," as determined by applying a more than 50 percent ownership test, in lieu of the usual 80 percent test. Section 267(b)(3) and (f). The other related-party tests are also based on greater than 50 percent ownership.

[8] *See* section 267(c).

[9] Section 163(j)(6)(D)(i). For certain limited exceptions, see section 163(j)(6)(D)(ii).

[10] Section 163(j)(6)(E)(i).

[11] Section 163(j)(2)(B)(i).

[12] Section 163(j)(6)(A).

[13] Section 163 (j)(2)(B)(ii).

[14] Section 163 (j)(2)(B)(iii).

[15] Section 163(j)(2)(A).

[16] Section 163(j)(2)(C).

[17] Section 163(j)(2)(C)(i). In certain circumstances, a property's adjusted basis for the purposes of determining loss may differ from its adjusted basis for the purposes of determining gain.

[18] For example, corporations with valuable self-developed intangibles may find that the inability to measure assets by their fair market value results in a dramatically overstated debt-to-equity ratio.

[19] Query how the 50 percent ATI threshold and the 25 percent ATI threshold would interact in the case of a corporation with both related-party tax-exempt interest and disqualified guarantee interest.

[20] See HR Rep. no. 101-386, 101st Cong., 1st sess (1989), 564-70.

[21] Section 267(c)(1).

[22] Section 267(c)(2) and (4).

[23] Assume also that the interest qualifies for a complete exemption from US withholding tax under an applicable US income tax treaty.

[24] PLR 9024076, March 21, 1990.

[25] Pursuant to section 883, a foreign corporation is exempt from US federal income tax on gross income derived from the international operation of ships of aircraft, provided that (1) the foreign country under the laws of which the corporation is organized grants an "equivalent exemption" to US corporations and (2) the foreign corporation satisfies an ownership test (or certain exceptions apply). The ownership test will be satisfied if more than 50 percent of the shares of the foreign corporation are owned, directly or indirectly, by certain "qualified shareholders." Section 883(c)(1); Treas. Reg. section 1.883-4(a).

[26] Treas. Reg. section 1.883-4(c)(3)(i). A very limited exception applies only if "all potential beneficiaries" are qualified shareholders.

[27] Under most US income tax treaties, a person who wishes to qualify for the benefits of the treaty must be a resident of one of the contracting states and, in addition, must satisfy the requirements of an LOB article.

[28] Art. 22(2)(e) of United States, Treasury Department, United States Model Income Tax Convention of November 15, 2006. In addition to this ownership test, the entity must also satisfy a base erosion test. The base

erosion test is satisfied if less than 50 percent of the entity's gross income is used to erode the entity's tax base through deductible payments (other than arm's length payments in the ordinary course of business for services or tangible property) to persons who are not residents of either contracting state or who are not entitled to the benefits of the treaty under certain provisions of Art. 22(2).

[29] United States, Treasury Department, United States Model Technical Explanation Accompanying the United States Model Income Tax Convention of November 15, 2006. It is possible that this language was meant to apply solely for the purposes of determining whether the discretionary trust itself satisfies the ownership test of the LOB article, but the language is not so limited. Note that the technical explanations to a number of US income tax treaties include a statement to substantially the same effect.

[30] Assume also that both Owner and Cousin are entitled to a complete exemption from US withholding tax under an applicable US income tax treaty.

[31] Regarding the possibility that Cousin may not be respected as the lender, see, for example, *Aiken Industries, Inc. v. Commissioner*, 56 TC 925 (1971); *Del Commercial Properties, Inc. v. Commissioner*, 51 F.3d 210 (DC Cir. 2001), aff'g 78 TCM (CCH) 1183 (1999); cert. denied, 122 S.Ct. 903 (2002); Rev. rul. 84-152, 1984-2 CB 381, obsoleted by Rev. rul. 95-56, 1995-2 CB 322; Rev. rul. 84-153, 1984-2 CB 383, obsoleted by Rev. rul. 95-56, 1995-2 CB 322. For a discussion of *Del Commercial* and other authorities, *see* Peter A. Glicklich & Michael J. Miller, "Appeals Court Invalidates US-Netherlands Double-Dip Financing Structure," Selected US Tax Developments feature (2001) vol. 49 no. 4 *Canadian Tax Journal* 1076-86. Note also that certain regulations that govern conduit financing arrangements apply solely for withholding tax purposes; such regulations would not affect the identity of the lender for US federal income tax purposes.

[32] The legislative history to section 163(j) indicates that regulations may be adopted to prevent the use of back-to-back loans to avoid the earnings-stripping rules, but to date no such regulations have been issued.