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Leveraging Earnings-Stripping Regs for Foreign Investments: Maximizing Tax Savings, Minimizing IRS Scrutiny

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Today's faculty features:

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Leveraging Earnings-Stripping Regs for Foreign Investments: Maximizing Tax Savings, Minimizing IRS Scrutiny

Feb. 6, 2014

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Today's Program

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REVIEW OF MATERIAL TERMS OF SECT. 163(j) AND THE PROPOSED REGULATIONS

History & Purpose Of Sect. 163(j)

- Sect. 163(j) was enacted by the Omnibus Budget Reconciliation Act of 1989.
  - Intended to prevent perceived erosion of the U.S. tax base by means of excessive deductions for interest paid by a taxable corporation to a tax-exempt (or partially tax-exempt) related person
- Proposed regulations were issued in 1991 but never finalized.
  - In the absence of final or temporary regulations on a particular issue, the IRS will generally look to proposed regulations to determine its position

Sect.163(j): The Basics

- Sect. 163(j) may limit deductions for any "**disqualified interest**" paid or accrued during the taxable year (e.g., interest paid to a "**related person**" that is not subject to U.S. tax)
- Amount disallowed will not exceed the "**excess interest expense**"
- Sect. 163(j) applies only if the ratio of debt-to-equity for the taxable year exceeds 1.5 to 1 (the "**debt-to-equity safe harbor"**)

Key Terms

- “Disqualified interest”
- “Related person”
- “Excess interest expense”
- Debt-to-equity safe harbor

“Disqualified Interest”

- Any interest paid to a “**related person**” if no U.S. tax is imposed on such interest
- Any interest paid to a third party subject to a “**disqualified guarantee**” when no U.S. “gross basis tax” is imposed on such interest
- Any interest paid by a “taxable REIT subsidiary” to a real estate investment trust (REIT)

Definition Of "Related"

- Any relationship described in sections 267(b) or 707(b)(1), including:
  - Two corporations that are members of the same "controlled group" (i.e., (1) parent with at least a 50% direct or indirect ownership by vote or value in a subsidiary or (2) five or fewer individuals own, directly or indirectly, more than 50% of two corporations by vote or value)
  - A corporation and a partnership, if the same persons own more than 50% of the value of the outstanding stock of the corporation and more than 50% of the capital or profits interests in the partnership
  - A partnership and a person owning more than 50% of the capital or profits interest in the partnership
  - Two partnerships in which the same persons own, directly or indirectly, more than 50% of the capital interests or profits interests

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Related Party: Partnerships

- Special rules for partnerships
  - Interest accrued or paid to a partnership that is a “related party” is not “disqualified interest” if less than 10% of the profits and capital interest in the partnership are held by persons not subject to U.S. tax (except to the extent the interest is allocable to a partner that is a “related party”)
  - When a partner benefits from a foreign tax treaty, the partner’s interest in the partnership is treated in part as tax-exempt interest

Related Party: Interest Subject To Tax

- Interest paid to a “related party” is disqualified only if the interest is not subject to U.S. tax
  - Interest paid to a related foreign person will not be disqualified interest if it is subject to full 30% withholding tax

- Pass-through entities
  - Determined at the partner level
  - Similar rules for pass-through entities other than partnerships

Interest Subject To Tax (Cont.)

- If a “related person” is a non-U.S. person entitled to treaty benefits, then only a portion of the interest is treated as not subject to tax

- Amount of interest that is treated as not subject to tax is based on the proportion of:
  - (1) Rate of tax on the interest income, as reduced by the treaty; to
  - (2) Rate of tax on the interest income not reduced by the treaty

Disqualified Guarantees

- Interest paid to a third party will be "disqualified interest" if there is a "disqualified guarantee"

- Any "guarantee" by a "related person" that is made by:
  - A tax-exempt, or
  - A foreign person

  if the interest is not subject to a U.S. gross basis tax

  - Exceptions
    - Interest on debt would have been subject to tax on a net basis if paid to the guarantor
    - Taxpayer owns a "controlling interest" (at least 80% by vote and value) in the guarantor

Definition Of “Guarantee”

- Guarantee is defined broadly and includes any arrangement in which a person assures, on a conditional or unconditional basis, the payment of another’s obligation
  - Commitment to make a capital contribution
  - “Comfort letters,” even if not legally enforceable
  - Contingencies ignored

What Is "Excess Interest Expense"?

- The excess of:
  - Corporation's "**net interest expense**" over
  - The sum of (a) 50% of the "**adjusted taxable income**" of the corporation and (b) any "**excess limitation"** carryforward

What Is “Net Interest Expense”? (Cont.)

- “Net interest expense” is the excess of interest paid or accrued over the amount of interest includable in gross income
  - Usual tax accrual rules apply, including market discount and bond premium
  - Look-through rule for partnerships: Partners include distributive shares of income and expense

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What Is “Adjusted Taxable Income”?

- An approximation for cash flow

- Taxable income, without regard to:
  - Net interest expense
  - Net operating losses and net capital losses
  - Depreciation, depletion and amortization deductions

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What Is "Adjusted Taxable Income"? (Cont.)

- Prop. Reg. Sect. 1.163(j)-2(f) increases adjusted taxable income for:
  - Charitable deduction carryforwards
  - Tax-exempt interest
  - Dividends-received deductions
  - Increases in accounts payable and decreases in accounts receivable
  - Increases in the LIFO reserves

“Excess Limitation” Carryforward

- If a corporation has excess limitation (i.e., the excess of 50% of adjusted taxable income over net interest expense), the excess limitation can be carried forward to the following three years and will increase the disqualified interest that can be absorbed in a future year
  - If Sect. 163(j) applies to a year, look back to prior years for “excess limitation”

Excess Limitation Carryforward Example

- A, a domestic corporation, is wholly owned by F, a foreign corporation. In Year 1, A had:
  - $100 of adjusted taxable income
  - $60 of interest expense, none of which was paid to F
  - $20 of interest income.

- In Year 1, A has an excess limitation carryforward of $10
  - The excess of 50% of adjusted taxable income ($50) over net interest expense ($40)

Example (Cont.)

- During Year 2, A has:
  - $100 of adjusted taxable income, including:
    - $20 of interest income
    - $110 of interest expense, including $60 of “disqualified interest” paid to F

- A has “excess interest expense” of $30, calculated as follows:
  - Net interest expense ($90) minus
    - 50% of its adjusted taxable income ($50), and
    - 2010 excess limitation carryforward ($10)
  - = $30 of excess interest expense

- Accordingly, $30 of the $60 of disqualified interest paid to F is disallowed.

Disqualified Interest Expense Carryforward

- Interest disqualified in one year will be carried forward, as disqualified interest and will be available if there is “excess limitation” in any subsequent year
  - Disallowed interest expense carryforward is deductible in a subsequent year, regardless of whether the corporation satisfies the debt-to-equity safe harbor in that year, to the extent of the excess limitation for that year

When Does "Debt-To-Equity" Safe Harbor Apply?

- The ratio of debt-to-equity as of the close of the taxable year exceeds 1.5 to 1
- "Indebtedness"
  - Prop. Reg. Sect. 1.163(j)-3(b)(1) defines "debt" as "liabilities in accordance with tax principles"; "liabilities" is generally broader than "indebtedness"
  - Exceptions
    - Accrued operating expenses, taxes payable and accounts payable, but only for first 90 days of existence and provided no interest accrual
    - Inventory financing (used to buy inventory, secured by such inventory, due on sale of the inventory)

Definition Of "Indebtedness"

- Look-through rule for partnerships: Partner treated as having incurred liabilities equal to its share of partnership liabilities under Sect. 752
- Financial entities may have difficulty passing test because they have high levels of debt as part of their business

What Is "Equity"?

- Equity is the **adjusted tax basis** (not GAAP value or fair market value) of all of the corporation's assets less its "liabilities"
  - Difficult for corporations with self-created intangibles or other assets with a zero basis
  - Consider buying assets rather than leasing to increase the amount of "equity"
  - Partnership interests: No look-through; tax basis in partnership interest (increased by allocated liabilities)

When Tested?

- Debt-to-equity ratio is tested as of the end of the year, but see the “anti-abuse” rules in Prop. Treas. Reg. Sect. 1.163(j)-3
  - Assets are disregarded if “the principal purpose” of acquisition was to reduced debt-to-equity ratio
  - Decreases in debt during last 90 days of the year are ignored if aggregate debt increased in first 90 days after the year
  - Certain transfers of assets between related parties during last 90 days of the year are disregarded

Prior “Reform” Proposals

- “Inversion” transactions (U.S. parent corporation of a U.S. multi-national group replaced with new foreign parent corporation) in the early 2000s brought increased attention to earnings stripping
- Many “reform” proposals were advanced in the early 2000s, although none were enacted
- The proposals generally would have made Sect. 163(j) less generous to taxpayers (e.g., eliminating the debt-to-equity safe harbor, reducing the threshold for excess interest expense from 50% of adjusted taxable income, limiting the carryforward period for disallowed interest, eliminating the excess limitation carryforward)

Prior “Reform” Proposals (Cont.)

- **American Jobs Creation Act of 2004**
  - Did not amend Sect. 163(j)
  - Addressed inversion transactions directly through new Sect. 7874 (which, depending on the level of overlapping ownership between old U.S. parent and new foreign parent, limits tax attributes or treats new foreign parent as a domestic corporation)
  - Treasury ordered a study of earnings stripping, transfer pricing and U.S. income tax treaties

Treasury 2007 Study On International Tax Issues

- “The earnings-stripping study did not find conclusive evidence of earnings stripping from foreign-controlled domestic corporations that had not been inverted. However, there is strong evidence that inverted corporations have engaged in earnings stripping”
  - Study concluded that additional information was needed

Form 8926: Disqualified Corporate Interest Expense Disallowed Under Section 163(j) And Related Information

- Required to be filed by any non-S corporation that paid or accrued “disqualified interest” during the current tax year or had a carryforward of “disqualified interest” from a previous tax year

- Form 8926 requires disclosure of the amount of disqualified interest and the identity of the recipient of the interest

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Current "Reform" Proposal

- Treasury's FY2014 revenue proposals including the following 163(j) proposal (only in regard to expatriated entities):
  - The debt-to-equity safe harbor would be eliminated
  - The 50 percent adjusted taxable income threshold for the limitation would be reduced to 25 percent
  - The carryforward for disallowed interest would be limited to ten years, and the carryforward of excess limitation would be eliminated
- An expatriated entity would be defined by applying the rules of section 7874 and the regulations thereunder as if section 7874 were applicable for taxable years beginning after July 10, 1989

Resources

- James E. Croker, Jr. and Henry J. Birnkrant, *Earnings-Stripping Prop. Regs Raise the Level of Complexity for Related-Party Debt*, 75 J. T'AXN 244 (1991)
- Marylouise Dionne & Timothy Throndson, *Highlights of the Proposed Earnings Stripping Regulations Under Sec. 163(j)*, 23 The Tax Advisor 53 (1992)
- James E. Croker, Jr. and Henry J. Birnkrant, *Inclusion of Guaranteed Loans Further Complicates Earnings-Stripping Provisions*, 80 J. T'AXN 30 (1994)

Resources (Cont.)

- New York State Bar Association, Tax Section, *Report on Certain Legislative Proposals Relating to the Section 163(j) Earnings-Stripping Rules* (Sept. 12, 2003), *available at* 2003 TNT 178-49
- Dep't of the Treasury, *Report to The Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties* (Nov. 28, 2007), *available at* 2007 TNT 230-167
- Dep't of the Treasury, *General Explanations of the Administration's Fiscal Year 2014 Revenue Proposals* (April 10, 2013), *available at* 2013 TNT 70-33

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Susan Conklin, PricewaterhouseCoopers

EARNINGS STRIPPING: COMPLIANCE ISSUES, PRACTICAL SCENARIOS

Speaker Background

Susan is an international tax director in the Washington National Tax Services office of PwC and is an integral part of the U.S. Firm's inbound solutions practice.

Susan has nearly 30 years of experience in advising foreign multinationals on complex U.S. federal income tax issues including compliance, legislative, regulatory and income tax treaty issues and restructuring. Susan's principal areas of expertise include the taxation of international transportation income, the taxation of U.S. real property interests, the taxation of foreign governments, U.S. trade or business and permanent establishment issues, the application of U.S. income tax treaties to foreign multinationals, branch profits taxes, and the application of anti-conduit and earnings stripping rules to inbound financing transactions. Susan also actively advises inbound companies and associations representing large foreign multinationals with respect to technical issues associated with their legislative and regulatory lobbying activities.

Compliance Issues And Practical Scenarios

I. Changing computational methodology is not a change in accounting method
II. Inconsistencies between statute and proposed regulations
III. Inconsistent treatment of partnership items
IV. Adjusted taxable losses
V. Allocation of items among members of affiliated groups
VI. "Surprise" disqualified guarantees

For many items, there are no easy answers. Each company must analyze its own situation and make its own determination regarding treatment of practical problems.

Changing Computational Methodology is Not a Change In Accounting Method

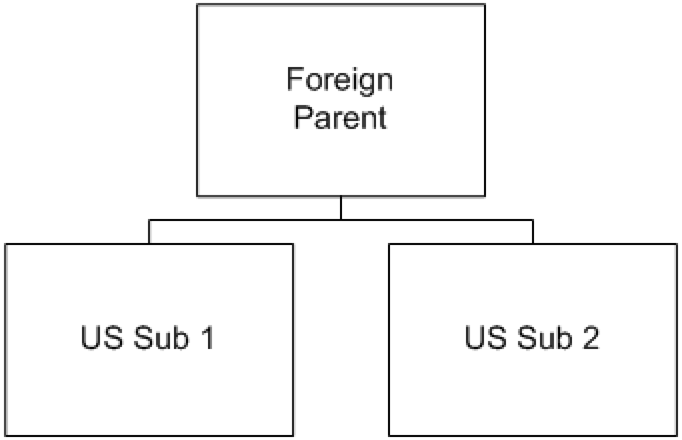
- Due to the limited nature of existing guidance, taxpayers may occasionally wish to change how they compute their Sec. 163(j) limitations, e.g., with respect to items not specifically described in either the statute or proposed regulations, or to use a methodology that differs from the proposed regulations.
- CCA 201202021 considered whether a change in the conclusion of whether a related party was a member of the affiliated group which resulted in full deductibility of interest expense and no limitation under Sec. 163(j) was a change in method of accounting.
- The CCA concluded "[b]ecause removing the 163(j) limitation can permanently change the taxpayer's lifetime income, the change is not merely a change in the timing of income and therefore is not a change in method of accounting."

Changing Computational Methodology is Not a Change In Accounting Method

- Other items that should be taken into account when considering whether to change computational methodologies:
  - Any change should remain consistent with the statute, even if it differs from the proposed regulations,
  - Any computational methodology or position should be "reasonable,"
  - Changing computational methodologies too frequently (e.g., every year), may be treated as evidence of a lack of reasonableness by the IRS; changes should preferably be made in years where there are significant business acquisitions, dispositions or other significant non-tax business reasons for making changes, and
  - All items carrying into the year of the change, including excess interest and excess limitations should use a consistent computational methodology. This may require recomputing several prior years' worth of 163(j) limitations.
  - The future impact of the changed methodology should be considered.

Inconsistencies Between Statute And Proposed Regs

- The principal inconsistency between the statute and proposed regulations is the definition of an affiliated group. Under the statute, the following two U.S. companies are not treated as members of an affiliated group (requiring separate Sect. 163(j) computations). Under the proposed regulations, they are members of the same affiliated group (requiring combined Sec. 163(j) computations).



Inconsistencies Between Statute And Proposed Regs (Cont.)

- The proposed regulations incorporate a rule based upon language in the legislative history that was not included in the statutory language.
- However, the statute *does* provide Treasury and the IRS with broad authority to provide “such regulations as may be appropriate to prevente the avoidance of the purposes” of Sec. 163(j).
- Because the regulations are presently only in proposed form, a taxpayer may choose to follow either either definition (though it should not change this choice from year to year).
- Taxpayers following the statutory rule will want to keep an eye out for temporary or final regulations to see if the definition under the proposed regulations becomes mandatory.

Inconsistencies Between Statute And Proposed Regs (Cont.)

- The use of the definition under the proposed regulations is problematic for some groups. Many large inbound multi-nationals have multiple U.S. consolidated groups that have entirely separate management and operations, making combined computations a practical impossibility.
- Combined computations for all entities under common ownership are made more difficult when entities use different taxable years.
- Acquisitions and dispositions of individual companies or sub-groups further complicate the abiity to compute Sec. 163(j) limitations, as well as excess interest or excess limitation carryovers.

• Form 8926 is based solely on the statute, not the proposed regulations, so difficulties may arise in completing the form.

Inconsistencies Between Statute And Proposed Regs (Cont.)

- Form instructions appear to indicate completion is required by all corporate taxpayers, even if they are not subject to Sec. 163(j).
- Most companies compute only a debt/equity ratio OR a limitation based on adjusted taxable income, but not both. The form requires the completion of both.
- Proper completion of the Form 8926 is thus subject to interpretation, with some questioning the authority of the Service to require its completion by any taxpayer.
  - Taxpayers questioning the need to complete the Form 8926 should consider that an IRS agent would request a copy of the Form during the course of an examination. It may be easier for IRS agents to follow the computations on the form than computations included on a separate spreadsheet.

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Inconsistent Treatment Of Partnership Items

- In computing adjusted taxable income, Prop. Reg. 1.163(j)-2 requires a partner to subtract the following items of or relating to a partnership:
  - Depreciation, amortization or depletion relating to a sale or disposition of property by a partnership (Prop. Reg. 1.163(j)-2(f)(3)(i)
  - Depreciation, amortization or depletion relating to a sale or disposition of a partnership interest (Prop. Reg. 1.163(j)-2(f)(3)(i))
- But, the proposed regulations make no mention of adding back annual depreciation, amortization or depletion deductions of a partnership (which would result in higher deductible interest in years preceding a disposition of an asset by a partnership or the partnership interest itself).

Inconsistent Treatment Of Partnership Items (Cont.)

- Query: Why do the proposed regulations only partly address assets subject to depreciation, amortization or depletion? What about other partnership items that fall within any of the other categories for additions/subtractions (e.g., tax-exempt income, changes in accounts receivable/payable)?
  - Although the purpose of the adjusted taxable income computation is to provide a means of approximating cash flow (excluding CAPEX, interest and federal income taxes), there are presently no "other additions" or "other subtractions" categories that would indicate that Treasury and the IRS thought it appropriate for a taxpayer to use discretion in making adjustments for other items.

Adjusted Taxable Losses

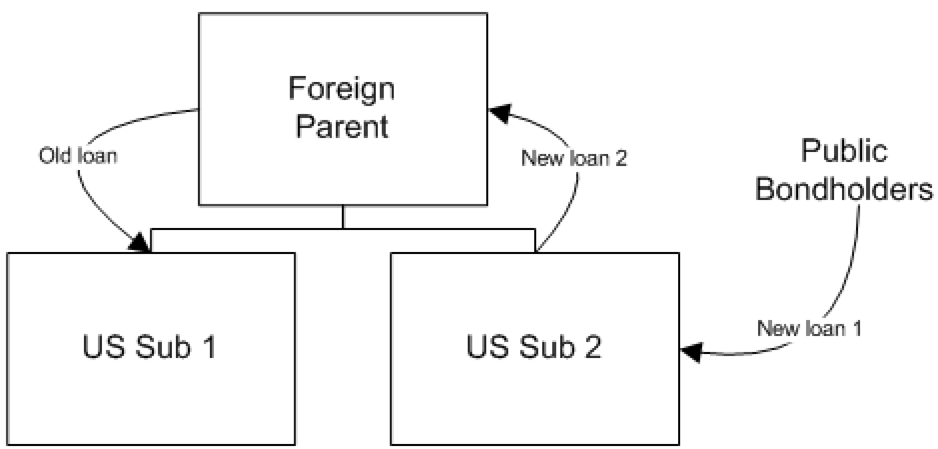
- The recent difficult economic environment has resulted in many companies incurring an adjusted taxable loss under Sec. 163(j).
- Prop. Reg. 1.163(j)–2(f)(4) provides that "the amount of an adjusted taxable loss reduces the excess limitation carryforward for the purpose of determining whether there is excess interest expense for a taxable year."
- BUT – the excess limitation carryforward is computed as follows:

50% of Adjusted Taxable Income
- Net Interest Expense
=Excess Limitation Carryforward

- Query: If an excess limitation carryforward is computed based on 50% of adjusted taxable income, then is it appropriate for an adjusted taxable loss to offset 100% of such a carryforward?

Allocations Among Affiliated Group Members

- Affiliated group member must generally compute a Sec. 163(j) limitation on a combined basis.
- The proposed regulations proscribe rules for the allocation of various items among affiliated group members (Prop. Reg.   1.163(j)-5), generally, based on the presumption that money within an affiliated group is fungible.
- In some cases, these allocations lead to unfavorable tax results.
- Consider the following fact pattern:



Allocations Among Affiliated Group Members (Cont.)

- (Cont.)
  - U.K. parent owns a U.S. consolidated group (US Sub 1) that is actively engaged in business and which has a loan from its U.K. parent.
  - U.K. parent wishes to access U.S. bond markets and has been advised to use a U.S. sub for this purpose.
  - U.K. parent sets up US Sub 2 solely for the purpose of obtaining financing on U.S. public markets.
  - Sub 2 obtains financing on U.S. markets and on-lends funds to its U.K. parent Because Sub 2 has no assets other than the receivable from its parent company, the public bonds are guaranteed by the U.K. parent.
  - U.K. parent uses funds entirely outside of the United States and can demonstrate under principles similar to the Treas. Reg. 1.881-3 anti-conduit regulations that no portion of these funds was used to finance its U.S. operating subsidiary.

Allocations Among Affiliated Group Members (Cont.)

- Both the US Sub 1 and US Sub 2 loans are considered to generate "disqualified interest," which is considered to be "exempt related person interest" under the proposed regulations.
- The proposed regulations generally require US Sub 1 and US Sub 2 to compute a 163(j) limitation on a combined basis and to allocate this combined computation between US Sub 1 and US Sub 2.
- Consequently, even though there is no relationship between the activities or loans of US Sub 1 and US Sub 2, and US Sub 2 has been structured under transfer pricing rules to always earn a small profit, which on a stand-alone basis would never result in a Sec. 163(j) limitation (because US Sub 2 would always have net interest income), the required allocations among affiliated group members under the proposed regs could result in US Sub 2 having disallowed interest expense under Sect. 163(j).

“Surprise” Disqualified Guarantees

- Taxpayers are strongly advised to carefully review all debt to determine whether a disqualified guarantee exists.
- The broad definition of a disqualified guarantee requires not only a review of the loan documents, but also discussions with persons who were involved with the negotiation of the original loan documents to ensure that:
  - No other documents (including e-mails) exist that could cause the loan in question to be treated as subject to a disqualified guarantee.
  - No verbal agreements were made that could cause the loan in question to be treated as subject to a disqualified guarantee.
- Further discussions often result in “surprise” disqualified guarantees, e.g.:
  - Mortgages and other secured loans guaranteed by a foreign parent company (e.g., as part of “standard operating policy”), or
  - A separate legal agreement not referenced in the original loan document between the parent company and the U.S. subsidiary’s lender contains a guarantee.

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