REPORT #633

TAX SECTION

New York State Bar Association

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New York State Bar Association

October 17, 1989

The Honorable Lloyd Bentsen
Chairman, Senate Finance Committee
703 Hart Office Building
Washington, D.C. 20510

Dear Senator Bentsen:

Our report of September 19, 1989 on certain provisions of the Revenue Reconciliation Bill of 1989 as approved by the House Ways and Means Committee opposed the enactment of section 11210, which would amend section 163 of the Code to limit deductions for certain interest paid by corporations to related persons if no tax is imposed with respect to such interest. We are writing again to state our opposition to the provision particularly in view of the implications of the very broad interpretation of the Bill set forth in the House Ways and Means Committee Report.

Although the Bill by its terms disallows deductions only for interest paid to related persons, the House Ways and Means Committee Report indicates that the relevant regulations will disallow interest deductions for payments made to unrelated parties in certain instances "whenever such a loan is guaranteed by a foreign related party, or otherwise is not based <u>solely</u> on the credit of the U.S. corporation." (Emphasis supplied.) House Report at 102.

The Bill approved by the Senate last week does not include an earnings stripping provision and, for the reasons expressed in our earlier report, we urge the conference to agree to the Senate's position. Our previous conclusion on this issue is reinforced because the House report makes it clear that section 163(i) would: apply to many every day commercial transactions having no “dividend stripping” aspects whatsoever; be even more discriminatory against our foreign treaty partners than we had previously envisioned; seemingly apply wherever credit support is supplied, even by a taxable person, if the lender is tax exempt, a result which has nothing to do with dividend stripping; and add to the already serious problems of interpreting the Code and administering the tax system.

1. Section 163(i) Would Apply to Many Transactions Having No Dividend Stripping Aspects

To apply the earnings stripping rule whenever a credit by an unrelated lender is either guaranteed by a parent or otherwise not based “solely” on the credit of the borrowing subsidiary would effectively interdict a host of transactions regularly structured solely for commercial reasons without any “dividend stripping” motivation. Credit support of various types is regularly utilized by U.S. borrowers to obtain funds for use in their business at the lowest possible interest cost, to simplify loan covenants or to avoid public disclosure of results of U.S. operations. Such supports are very different from the back-to-back loans which the Service has ruled to have the same effect as a direct borrowing by an exempt stockholder. Unlike back-to-back loans, these forms of credit support are commonly utilized in normal day-to-day transactions and do not involve the parent effectively supplying the funds.
The bank or other lender in these situations is the real lender, as contrasted with a back-to-back loan, where the bank is essentially a conduit.[1]

[1] See Rev.Rul. 84-152, 1984-2 C.B. 81. Rev.Rul. 84-153 1984-2 C.B. 383 and Rev.Rul. 87-89, 1987-2 C.B. 195, which are based on the assumption that the nominal lender is acting as a conduit for the true lender. The conference report should make it clear that, in the context of the earnings stripping rules, back-to-back loans should not include loans to U.S. borrowers that are made on the same terms that would have been imposed even if the parent had not placed funds with the lender, e.g., where a U.S.office of a bank that lends to a U.S. corporation is unaware of a deposit that the foreign parent may have made with one of the bank's foreign branches.

Because of the draconian penalty that would result from extending the earnings stripping rules to all forms of credit support, U.S. subsidiary borrowers would in many cases be forced to borrow solely on the basis of their own credit at significantly higher interest rates. Apart from increasing default risks that are not dissimilar to those created by junk debt, payment of higher interest by taxable United States subsidiaries is likely, on balance, to reduce Federal tax revenues, since at least part of the interest is likely to find its way to unrelated tax exempt entities (domestic or foreign).

2. Discrimination Against Treaty Partners

The discriminatory aspects of the Bill have become even more apparent in light of the House report. Consider three United States subsidiaries each engaged in the same business and borrowing from United States taxable lenders on the same terms, one owned by a U.S. parent, the second by a U.K. corporation and the third by a non-treaty country parent. Interest paid by the first and third of these corporations would be unaffected by section 163(i) while deductions for interest paid by the subsidiary of the U.K. corporation would be disallowed in part. In short, the subsidiaries of the U.S. parent and the non-treaty parent would both be at an advantage over the subsidiary of the U.K. Corporation. Thus, U.K. corporations would, in effect, be punished for their country's adherence to a tax treaty with the United States.

3. Section 163(i) is Apparently Intended to Apply Where the Lender, but Not the Guarantor, Is Tax-Exempt

The discussion at page 104 of the House Report of a loan from an exempt Dutch bank seems to imply that section 163(i) would be applied whenever the lender is “tax exempt” even if the person supplying credit support is taxable. This interpretation has also been suggested by members of the Joint Committee Staff.

If so, section 163(i) would apply to many transactions that are completely domestically related, e.g., a borrowing by a U.S. corporation, 51% of whose stock is owned by a U.S. corporation or individual, from an unrelated U.S. exempt employee benefit trust (or an issuance of section 871(h) portfolio debt or a qualified private activity tax exempt bond) if the borrower's U.S. controlling shareholder provides any kind of credit support. We question that this result, which cannot be gleaned from the Bill's text, was understood by the members of the Ways and Means Committee. It is impossible to understand any reason for applying section 163(i) in these cases since no element of dividend stripping is present. The interest paid by the borrower would be fully deductible if paid by the controlling U.S. shareholder. Moreover, for reasons set forth below it will in many cases be next to impossible to determine whether section 163(i) is applicable in such cases because it will not be possible to know whether particular debt is held by a tax exempt person.

Even if this bizarre result was not intended and these credit support rules are to be applied only where both lender and related credit support provider are “tax exempt”, the rules could not be effectively applied, because in many cases, a borrower will not know whether or not the ultimate recipient of its interest payments is taxable or tax exempt.

For example, a lender or group of lenders that have privity of contract with a borrower, without the borrower's consent and even its knowledge, will often assign or sell participations in a loan to other financial institutions, some of which are likely to be tax residents of foreign countries that have treaties with the United States that exempt interest payments from withholding tax.[2] To protect its interest deductions, a borrower potentially subject to the earnings stripping rules would have to prohibit its lenders from making such assignments or participations, a limitation which would undoubtedly increase its interest costs, thus reducing its taxable income, and would prevent U.S. pension plans and other tax exempt entities from lending on a guaranteed basis.

Public offerings of guaranteed debt would raise even more acute problems if the lender's tax exempt status might bring section 163(i) into play. Many publicly held debt securities are registered in the name of Depositary Trust Company or its nominee. Their ultimate holders could include exempt employee benefit trusts and charitable organizations as well as foreign owners that are residents of treaty countries or that provide evidence of foreign ownership on Form W-8 and hence are eligible for the portfolio interest exemption provided under Code sections 871(h) and 881(c).[3] The issuer has no way of knowing

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[2] For tax purposes, the usual participation sale results in the participant being treated as receiving interest from the borrower rather than from the original lender. See, e.g., Rev. Rul. 81-251, 1981-2 C.B. 156.

[3] These certificates are provided to the U.S. withholding agent, i.e., the last U.S. person in the chain of payments, who will often be a U.S. bank or broker that has no connection with the issuer.

who actually owns the securities. Is the issuer to be denied interest deductions on the basis that all the debenture holders are exempt entities, even though this is unlikely to be the case?[4]

4. The Credit Support View in the House Report Will Not Improve Predictability or Administrability

Despite the apparent sweep of the suggestion in the House Report, we do not believe it will be possible for either the Internal Revenue Service or taxpayers to determine whether a loan is based “solely on the credit” of the U.S. corporation in many cases. Credit “support” can and does take many different forms in commercial practice and the parent/subsidiary relationship in its nature admits of infinite subtleties in the nature of support that one company draws from the other.[5]

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[4] Similarly, proposed Code Section 163(i)(5)(A) would provide flow through rules in the case of partnerships and other pass through entities, which the House Report states (at 103) are to include regulated investment companies and real estate investment trust. Are regulated investment companies and real estate investment trusts supposed to tell issuers of these guaranteed obligations the extent to which they have exempt shareholders, and how are they supposed to obtain this information, which they generally would not otherwise have? The practical effect of such a provision may well be that such entities will refuse to buy any guaranteed obligations of U.S. affiliates of foreign corporations that are treaty country residents.

[5] Illustrative of the situations that would need to be addressed would be whether and to what extent the following would result in interest deduction limitations: limited recourse guarantees (e.g., a guarantee of interest only for the first year or two or a guarantee of only a certain amount of deficiency after recourse to the subsidiary's assets); contingent guarantees (guarantees becoming effective mandatorily or as an option to a higher interest rate upon noncompliance with a loan covenant); subscription agreements under which the subsidiary may call upon the parent for an additional fixed capital contribution; nonbinding "keep well" or "comfort" letters; contracts for supply of goods and services by the subsidiary to the parent (ranging from strict "take-or-pay" arrangements to simply a history of purchases with an obvious commercial interest, but no legal obligation, for the parent to continue to purchase).

We also believe that the nature of the issues and uncertainty is such that any regulations implementing the House Report's credit support suggestion should be specified to be prospective only.

We therefore urge that section 163(i) be omitted from the Conference Committee Bill. If the section remains in the Bill it should be made abundantly clear in the Code itself that guarantees and other forms of credit support provided by a related foreign party should not cause the earnings stripping provision to apply except where, under the well recognized Plantation Patterns rule, the U.S. affiliate's obligation is treated for general tax purposes as the direct obligation of the foreign corporation.[6]

Yours very truly,

Wm. L. Burke, Chair

cc: H. Patrick Oglesby, Esq.
Chief Tax Counsel, Majority Office
Senate Finance Committee
205 Dirksen
Washington, D.C. 20510

Identical letter sent to the following:

The Honorable Bob Packwood
The Honorable Dan Rostenkowski
The Honorable Bill Archer
The Honorable Ronald A. Pearlman
The Honorable Kenneth W. Gideon

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[6] Plantation Patterns Inc. v. Commissioner, 462 F.2d 712 (5th Cir. 1972). Under that doctrine, a loan to a corporation that was guaranteed by a stockholder will be treated for tax purposes as the obligation of the stockholder rather than of the corporation if there is no reasonable expectation at the time the loan is made that it will be paid without resort to the guarantee. In other instances, a guarantee will be given no tax effect and the nominal borrower will be treated as the true borrower. See, e.g., Treas. Reg. § 1.861-2(a)(5) and Treas. Reg. § 1.862-l(a)(5). This is true even though a bank would not make a loan to the borrower on nearly as favorable terms were it not for the guarantee.