New York State Bar Association Tax Section

Report on Certain Legislative Proposals Relating to the Section 163(j) Earnings Stripping Rules

September 12, 2003

Report No. 1037

NEW YORK STATE BAR ASSOCIATION TAX SECTION REPORT ON CERTAIN PROPOSALS THAT WOULD REVISE THE SECTION 163(J) EARNINGS STRIPPING RULES[1]

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1. Introduction and Summary Conclusions

This report sets forth the comments of the New York State Bar Association Tax Section in respect of proposals that would modify the "earnings stripping rules" contained in section 163(j) of the Internal Revenue Code of 1986, as amended (the "Code"). The proposals addressed include certain provisions of the Bush Administration's Fiscal Year 2004 Revenue Proposals (the "Bush Proposal") as well as section 2001 of H.R. 2896, the "American Jobs Creation Act of 2003" introduced by Ways and Means Committee Chairman Thomas on July 25, 2003 (the "Thomas Bill," and together with the Bush Proposal, the "Proposals").[2] The report also addresses the proposal to liberalize the guarantee provisions of section 163(j) contained in section 255 of the Promote Growth and Jobs in the USA (PRO GROW USA) Act of 2003 introduced by Senator Orrin Hatch on July 28, 2003 (the "Hatch Bill").

The earnings stripping rules are designed to limit the ability of corporations with U.S. operations owned by certain tax-exempt persons (in particular, treaty-benefited foreign persons) to reduce their U.S. tax liability through interest paid to tax-exempt affiliates (or interest paid to an unrelated party in circumstances where a related foreign person or tax-exempt party guarantees the debt). In general, the current earnings stripping rules apply only if the payor's debt-to-equity ratio exceeds 1.5 to 1 and the payor's net interest expense exceeds the sum of 50% of its "adjusted taxable income" (generally taxable income computed without regard to deductions for net interest expense, net operating losses, and depreciation, amortization and depletion) plus a three-year carryforward of excess limitation. If that is the case the lesser of such excess net interest expense or the tainted ("disqualified") interest is disallowed as a deduction for the current year (subject to unlimited carryforward).

The Proposals would significantly expand the current earnings stripping rules by deleting or modifying the existing debt-to-equity safe harbor, modifying the substantially adjusted taxable income percentage limit, and (in the case of the Bush Proposal) adding a new interest disallowance rule that would apply in circumstances where the U.S. subsidiaries of a foreign parent are more highly leveraged than the overall worldwide corporate group. In addition, carryovers would be curtailed.

This report focuses on the technical, administrative and policy issues raised by the Proposals. The principal conclusions of this report may be summarized as follows:

1. We recommend retention of a safe harbor. We generally would favor the debt-to-assets safe harbor set forth in the Bush Proposal (as the asset categories may be further refined) but using, at the taxpayer's election, U.S. tax basis, U.S. GAAP book value, or fair market value.

2. We recommend against adoption of a worldwide leverage test as was proposed in the Bush Proposal and original Thomas proposal. In our view, such a test would be extremely difficult for taxpayers to apply and for the Internal Revenue Service to audit.

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[2] The Thomas Bill revises an earlier Thomas proposal set forth in section 201 of H.R. 5095, the "American Competitiveness and Corporate Accountability Act of 2002."

3. We recommend that proposed reductions in the percent limit for purposes of the adjusted taxable income test take into account, among other factors, that the resulting amount allowed should be consistent with arm's length principles.

4. We recommend that if the carryforward of disallowed interest is limited, that the limit be the same length of time as for net operating losses, i.e., 20 years.

5. We recommend that, especially in connection with the proposed tightening of the earnings stripping rules, it would be appropriate to reconsider to what extent section 163(j) should continue to apply to loans guaranteed by affiliates. In this regard, we believe in particular that a tailored approach such as the Hatch proposal deserves serious consideration.

2. Description of the Proposed Changes to Section 163(j)

a. Bush Proposal

The Bush Proposal, while not currently the subject of any pending legislation, merits extended discussion in its own right, in view of both the fact that it apparently continues to reflect the preferred approach of the Bush Administration and because it incorporates certain creative, albeit provocative concepts intended to better target earnings stripping. The Bush Proposal would make the following changes to section 163(j).

i. <u>Modification of the existing 1.5-to-1 debt-to-equity ratio safe harbor.</u>

The current uniform fixed debt-to-equity safe harbor would be replaced by an approach that takes into account the types of assets owned by the corporation and the leverage typically associated with such types of assets.[3] The proposed safe harbor would be determined based on a series of debt-to-asset ratios identified for broad asset classes. The safe harbor would permit a level of indebtedness (the "safe harbor amount") based on the value of the corporation's assets in each identified class. Our understanding is that tax basis would serve as a proxy for value for this purpose. This is the same as under the existing safe harbor.

Under this approach, a corporation would categorize its assets into the identified classes (as set forth in the table below). The corporation first would determine its safe harbor amount by multiplying the value of its assets in each asset class by the debt-to-asset ratio for such class, and then totaling such amounts. The corporation would be subject to the limitations of section 163(j) only if its actual indebtedness exceeded this safe harbor amount.

The applicable asset classes and related debt-to-asset ratios are set forth below:

[3] The description of the Bush Proposal relies on the Treasury Department's General Explanations of the Administration's Fiscal Year 2004 Revenue Proposals (February 2003), reprinted in Highlights & Documents, Feb. 4, 2003, 1361, 1397-98

Asset Class	Debt-to-Asset Ratio
Cash, Cash Equivalents, Government Securities	.98
Municipal Bonds, Publicly Traded Debt Securities, Receivables	.95
Publicly Traded Equities, Mortgages and Other Real Estate Loans, Other Corporate Debt and Third Party Loans	.90
Trade Receivables and Other Current Assets	.85
Inventory	.80
Land, Depreciable Assets, Other Investments, Loans to Shareholders	.70
Intangible Assets	.50

Equity investments in foreign related parties (other than investments in subsidiaries) would not be taken into account for this purpose.

ii. Disallowance of deduction for disqualified interest.

The Bush Proposal would disallow a deduction for "disqualified interest" (defined as under current law) paid or accrued by a U.S. corporation[4] if (1) the debt-to-asset ratio exceeds the safe harbor amount and (2) either (A) the lesser of the amount of such disqualified interest or the total net interest expense of the U.S. corporation exceeds 35% of the adjusted taxable income of the U.S. corporation (any such excess being potentially nondeductible under this "adjusted taxable income test"), or (B) the U.S. corporation is a member of a worldwide affiliated group and the interest is attributable to debt of the U.S. corporation that causes its debt-to-assets ratio to exceed both the debt-to-assets ratio of the worldwide affiliated group and the safe harbor amount (interest on such excess debt being potentially nondeductible under this "worldwide leverage test"). The amount of interest deduction actually disallowed would be the greater of the amounts determined under the adjusted taxable income test or the worldwide leverage test. Under the worldwide leverage test, the disallowance would be of gross, rather than net, interest expense.

For purposes of the worldwide leverage test, debt-to-asset ratios would be determined by valuing assets at their U.S. tax basis and treating all corporations in the worldwide affiliated group as one corporation. Under a special rule, however, all financial institutions that are members of the same worldwide affiliated group would be treated as a separate affiliated

[4] For this purpose, all members of a U.S. affiliated group, within the meaning of section 1504(a) would be treated as a single U.S. corporation, as under existing section 163(j)(6)(C). Also, as under existing section 163(j), the Bush Proposal would in principle apply to U.S. branches of foreign corporations. Regulations implementing such application have not yet been issued under existing law.

group, and therefore as a separate single corporation for purposes of the calculation. To the extent that a U.S. corporation has a debt-to-assets ratio that exceeds the debt-to-assets ratio of the worldwide affiliated group, the disproportion would be attributed first to any debt owed to, or guaranteed by, a related foreign person.

iii. Carryforwards curtailed.

The unlimited carryforward of disallowed interest expense provided in existing section 163(j)(1)(B) would be reduced to five years, and the three-year carryforward of "excess limitation" provided in existing section 163(j)(2)(B)(ii) would be eliminated. In addition, the carryforward of disallowed interest expense would be permitted to reduce the taxable income of the U.S. corporation for any carryforward year only to the extent that 35% of taxable income in that year exceeds the corporation's net interest expense for that year and the worldwide limitation is not applicable in that year. Further, a carryforward would be allowed for interest expense that is disallowed under the adjusted taxable income limitation only to the extent that such interest expense exceeds interest expense that would have been disallowed under the worldwide limitation (taking into account the allowance of interest expense on the safe harbor amount for purposes of the worldwide limitation). Stated differently, no carryforward would be permitted for interest disallowed under the worldwide limit.

iv. Example.

The operation of the Bush Proposal may be illustrated by the following example. Assume:

- U.S. group's adjusted taxable income ("ATI") is 70.
- U.S. group has 400 gross assets and 300 (3:4 blended debt-to-assets ratio)[5] liabilities, including 250 "related party indebtedness" ("RPI"), with 9% interest rate on RPI, so "disqualified interest" ("DQI") of 22.5.
- Total net interest expense is 27.
- Worldwide affiliated group (including U.S. group) has gross assets of 1200 and total unrelated party debt of 600 (1:2 debt-to-assets ratio).

Disallowed interest would be calculated as follows:

- "Disproportionate indebtedness" ("DI") = U.S. indebtedness – (U.S. assets/worldwide assets) x (worldwide unrelated debt) = 300 – (400/1200) x (600) = 100.
- "Disproportionate domestic related party indebtedness percentage" ("DDRPIP") = DI/RPI = 100/250 = 40%.

[5] Assume most assets by value consist of intangible assets and depreciable assets, with the consequence that the safe harbor is not met.

- "Excess domestic disqualified interest" ("EDDI") = DDRPIP x DQI = 40% x 22.5 = 9.0. This amount is permanently disallowed under the worldwide limitation.

- ATI limitation = lesser of DQI = 22.5, or net interest expense – 35% x ATI = 27 – 35% x 70 = 2.5.

- Total disallowed interest = EDDI or ATI limitation, whichever is greater; here, 9.0; 13.5 of DQI is allowed.

- Carryover of excess disallowance under ATI limitation over disallowance under worldwide limitation; 2.5 – 9 = 0.

v. <u>Effective date.</u>

The proposed changes would apply generally for taxable years beginning in 2004.

b. Thomas Bill

The Thomas Bill, which is currently pending in Congress, would make the following changes to section 163(j).

i. <u>Eliminate existing 1.5-to-1 safe harbor.</u>

The Thomas Bill would eliminate the existing safe harbor and not replace it with any other safe harbor.

ii. <u>Disallowance of deduction for disqualified interest.</u>

With respect to interest on debt owed to a tax-exempt related party, the Thomas Bill would reduce the current law 50% limit under the adjusted taxable income test to 35% for taxable years beginning in 2004 and 25% thereafter. (For purposes of the discussion below the 25% limit for taxable years beginning after 2004 generally is assumed to be applicable.) In the case of interest that is disqualified interest by reason of a guarantee, however, the limit would remain at 50%.

If a taxpayer has incurred both unrelated party debt guaranteed by a tax-exempt related party and tax-exempt related party debt, the amount of disqualified interest that would be disallowed would be the sum of (i) the excess, if any, of the taxpayer's total net interest expense over 50% of the taxpayer's adjusted taxable income, and (ii) the excess, if any, of the taxpayer's disqualified interest from related party loans (or, if less, the taxpayer's total net interest expense), over 25% of the taxpayer's adjusted taxable income.[6] Under a special disallowance limit, however, the disallowance under the previous sentence would not reduce the deduction for

[6] In effect, this part of the maximum disallowance formula would allow the taxpayer a deduction for interest on debt guaranteed by a related party plus interest on related party debt plus other interest (net of interest income), up to in total the 50% of adjusted taxable income limit, but the amount of such deductible interest expense is then reduced dollar for dollar by any interest on related party debt that exceeds the 25% limit applicable to that debt.

interest below the sum of the amount of interest includible in the gross income of the taxpayer for such taxable year and an amount equal to 25% of adjusted taxable income.[7]

The operation of the proposal may be illustrated by a few examples,[8] as follows.

Example 1 illustrates how unrelated party nonguaranteed debt affects the calculation, as well as the effect of related party debt in excess of 25% of adjusted taxable income: there is a disallowance for the 5 by which total debt exceeds the 50% limit plus disallowance for the 5 by which related party debt exceeds the 25% limit. Example 1A shows that the result is the same in this fact pattern if guaranteed debt generating disqualified interest is substituted for unrelated nonguaranteed debt. Example 1B shows how if related party debt is reduced so as not exceed the 25% limit, and replaced by related party guaranteed debt, the difference results in additional deductible interest. In other words, once interest expense on total debt exceeds the 50% limit, every dollar of related party debt above the 25% limit results in a double disallowance of the interest, once under the 50% limit and once under the 25% limit.

	Example 1	Example 1A	Example 1B
Adjusted taxable income	100	100	100
Interest on related party loan	30	30	25
Interest on loan guaranteed by related party	0	25	30
Net interest expense (income) on other loans	25	0	0
Disallowed interest expense/carryover	10	10	5

Example 2 shows that if guaranteed debt and related party debt each equal 25% of adjusted taxable income, the maximum amount of each is achieved without a disallowance. As the comparison between Example 2 and 2A indicates, moving amounts from guaranteed debt to related party debt does not affect the amount of disqualified interest provided the total related party interest does not exceed the 25% limit. Once the 25% limit for related party debt is reached, whether unrelated party debt is guaranteed or not is irrelevant to the total deduction allowed, as the comparison between Examples 2 and 2B illustrates.

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[7] This formula reflects a correction to the language of the Thomas Bill as introduced. Staff, Joint Committee on Taxation, Technical Explanation of H.R. 2896, The "American Jobs Creation Act of 2003," August 13, 2003 (JCX-72-03), reprinted in Highlights & Documents, August 14, 2003, 2033, 2063-64 (hereafter "JCT Technical Explanation"). The original language would have resulted in a lesser amount of disallowed interest than under current law in certain situations in which there is relatively a large amount of non-related party interest.

[8] The JCT Technical Explanation contains certain other examples.

	Example 2	Example 2A	Example 2B
Adjusted taxable income	100	100	100
Interest on related party loan	25	0	25
Interest on loan guaranteed by related party	25	50	0
Net interest expense (income) on other loans	0	0	25
Disallowed interest expense/carryover	0	0	0

Example 3 illustrates how net interest income reduces the disallowance (assume 50 gross interest income and 25 unrelated party nonguaranteed interest expense).

	Example 3
Adjusted taxable income	100
Interest on related party loan	30
Interest on loan guaranteed by related party	20
Net interest expense (income) on other loans	(25)
Disallowed interest expense/carryover	0

Had there been less than 25 net interest income, all or part of the 5 excess related party interest expense would have been disallowed, since in that case the corporation's net interest expense (here, 25) would exceed 25% of adjusted taxable income.[9] This demonstrates how, even if the 50% limit for net interest expense is not exceeded, gross interest income is applied first against interest other than related party interest and only to the extent that other interest is reduced to zero is any remaining interest income available to offset related party interest expense for purposes of the 25% limit.

Examples 4 and 4A illustrate the effect of the special disallowance limit (assume 60 gross interest expense in each case).

[9] See proposed section 163(j)(a)(2)(B), 163(j)(a)(1)(B). This result would be consistent with the special disallowance limit. For example, if gross interest income were 45 instead of 50, the allowable interest expense of 70 (assuming disallowance of 5) would exceed 45, the sum of gross interest income plus 25% of adjusted taxable income.

	Example 4	Example 4A
Adjusted taxable income	100	100
Interest on related party loan	55	55
Interest on loan guaranteed by related party	0	0
Net interest expense (income) on other loans	5	(5)
Disallowed interest expense/carryover	35	25

In Example 4, apart from the special disallowance limit, 40 would have been disallowed (i.e., 10 excess interest expense plus 30 excess related party interest expense) and hence only 20 interest expense would have been allowed. The special disallowance limit, however, would require that not less than 25% of adjusted taxable income (here, 25) be allowed. Example 4A illustrates the operation of the special disallowance limit where the facts are the same except that there is gross interest income of 10 (and as before, gross interest expense of 60): under the special disallowance limit, the amount of total interest expense allowed must be at least the sum of gross interest income plus 25% of adjusted taxable income (here, 35).

Example 5 illustrates that, as under existing section 163(j), only the deduction of disqualified interest may be disallowed under section 163(j)(1)(A), which may be a lesser amount than the maximum disallowance permitted under section 163(j)(1)(B).

	Example 5
Adjusted taxable income	100
Interest on related party loan	50
Interest on loan guaranteed by related party	0
Net interest expense (income) on other loans	30
Disallowed interest expense/carryover	50

Because there is only 50 disqualified interest, the cap of 55 is irrelevant, and 50 is disallowed.

Unlike the Bush Proposal (and the original Thomas proposal), the Thomas Bill would not provide for a worldwide limitation.

iii. Carryforwards curtailed.

The unlimited carryforward of interest under existing section 163(j) would be reduced to 10 years, and the three-year carryforward of "excess limitation" would be eliminated. The 10-year carry forward would be applied separately to disqualified interest from related party loans and disqualified interest from loans guaranteed by a related party. For this purpose, interest disallowed would be considered to first be from related party loans and only any excess amount to be from guaranteed debt. The effect of this ordering rule would be that related party interest that is disallowed would be usable in a carryforward year only to the extent that, after taking into account disqualified interest from guaranteed debt (current year and carried forward) there still would be limitation. A rule that simply would permit disqualified interest from the earlier year to be used first would result in less possibility of an expiration of the carryforward.

iv. Taxable REIT subsidiaries.

Existing law would be retained for interest paid or accrued by a taxable REIT subsidiary of a REIT to the REIT, but relocated to section 856 of the Code.

v. Effective Date.

The Thomas Bill would apply generally to taxable years beginning after December 31, 2003.[10] For purposes of the 10-year carryover rule, amounts that may be carried to a taxable year beginning after December 31, 2003 would be treated as having been disallowed for the most recent taxable year beginning prior to 2004 (thus allowing full 10-year carryover period for all such amounts).

c. Hatch Guarantee Proposal

i. Certain guarantees excepted from section 163(j).

The Hatch Bill's guarantee proposal would add an additional exception to the definition of a "disqualified guarantee" to cover a situation in which the taxpayer establishes to the satisfaction of the Secretary that the taxpayer could have borrowed substantially the same principal amount from an unrelated person without the guarantee. The discretion of the Secretary to reject a taxpayer's showing would be subject to the gloss that, "to the extent provided in regulations, the Secretary may reject a showing that a taxpayer could have borrowed substantially the same principal amount if such borrowing is on terms substantially dissimilar to those of the actual loan."

[10] In addition, the changes would apply to taxable years ending after March 4, 2003 (with application of the 25% limit from the start, without phase-in) in the case of any corporation that is either a "surrogate foreign corporation" or an "expatriated entity," each as defined in the provisions of the Thomas Bill dealing with corporate expatriations (or as would be defined in those provisions if such terms applied to all post-1996 expatriations). Under section 2002 of the Thomas Bill, a "surrogate foreign corporation" is defined as a foreign corporation that completes an acquisition of substantially all of the assets (directly or indirectly) of a domestic corporation or partnership (an "expatriated entity") after March 4, 2003 if the former owners of the acquired entity own 60% or more (by vote or value) of the foreign corporation and the foreign corporation is not an "inverted domestic corporation" (unless, on before March 4, 2003, the foreign corporation acquired more than half of the U.S. entity's properties).

ii. Effective Date.

The Hatch proposal would apply to "guarantees issued on and [sic] after the date of the enactment of the Act."

3. Technical Comments on Bush Proposal

a. Comments on Proposed Changes to Safe Harbor

i. The safe harbor will be a de facto limit for many taxpayers.

The amount of interest disallowed under the Bush Proposal is the greater of the amounts determined under the adjusted taxable income test and the worldwide leverage test. Further (for the reason mentioned in part 3.c below), most taxpayers with substantial foreign operations, as a practical matter, would not be able to determine the amount limited under the worldwide leverage test. For these two reasons, as a practical matter in many cases all disqualified interest would be disallowed unless the taxpayer satisfies the safe harbor test. Accordingly, the safe harbor would be the only relevant determination for many taxpayers.

ii. The appropriateness of the changes to the safe harbor.

The rationale for changes to the safe harbor is that the current "one size fits all" safe harbor fails to tailor the safe harbor to different industries with different asset mixes. According to the Treasury General Explanation of the Bush Proposal, "certain businesses can be highly leveraged because their assets are very liquid, such as financial securities. The revised safe harbor based on asset classes would serve to better focus the application of the section 163(j) limits so that the rules, after tightening, would apply only to companies with unusually high levels of indebtedness when compared with other companies that have a similar mix of assets."

We agree with the premise that a "one size-fits all" approach of current law is too blunt, and we endorse the Treasury Department's effort to move to a system of safe harbors that better reflect commercial realities. We believe, however, that the Bush Proposal's safe harbor as formulated fails to achieve that objective.

The principal shortcoming of the Bush Proposal's safe harbor is its perpetuation of existing-law rules relying solely on tax basis to measure the values in each asset class (and its extension of those rules into the new worldwide leverage test, discussed below). In commercial lending transactions, the borrower's tax basis in its assets is irrelevant. Lenders generally look to the capacity of the borrower's assets to generate cash to service debt. Even in asset-based financings (a subset of the commercial financing market), tax basis is not a pertinent consideration. Asset-based lenders concentrate on the value of their collateral and its marketability, not on tax basis. Most taxpayers, for example, have a zero basis in self-created intangibles such as patents, trademarks, software code and know how. In the case of many companies, particularly in technology or service industries, these zero basis assets are their most valuable assets, with the capacity to generate billions of dollars of cash flow. Ascribing a zero value to such assets in the context of asset-based financing is not consistent with commercial reality. Conversely, ascribing a high value to certain assets with a high tax basis is also not

consistent with commercial lending practices. For example, publicly traded debt securities of issuers that are near insolvency cannot be leveraged at anything close to 90% of tax basis.

We recognize that the use of tax basis in connection with the safe harbor is required under current section 163(j) and thus is a problem under the current law. The issue is acute, however, in the context of the Bush Proposal because, as discussed above, the safe harbor will be the only relevant determination for many taxpayers. Unless the use of market valuation is permitted, we believe that the Bush proposal will add significant complexity to the rules without, in most cases, a concomitant benefit in the form of greater precision in measuring a company's ability to borrow at arm's-length.

We understand that Treasury may be concerned that a fair market value alternative could permit taxpayers to seek inflated appraisals or otherwise claim amounts that are excessive. We believe that these issues could be adequately addressed through procedural requirements and on audit. Cf. Rev. Proc. 2003-37 (use of fair market values for purposes of Treas. Regs. §1.861-9T(g)). Targeted penalty provisions could also be brought to bear. Cf. Code §6662(e).

We recommend that the Administration consider altering the proposed safe harbor to give taxpayers a choice of determining values using fair market value, U.S. GAAP book value or tax basis. Certain taxpayers would prefer the convenience and relative stability and predictability[11] of performing the safe harbor calculation using tax basis or GAAP book value, while other taxpayers (principally those with depreciated, but still valuable, assets and with self-created assets that have a zero basis) would be able to opt for a safe harbor that more readily reflects commercial reality. For those taxpayers that already prepare U.S. GAAP financials or for whom preparation of such financials would be practical, an election to use U.S. GAAP figures to compute the safe harbor ratio would be welcome.[12] In particular, GAAP purchase accounting would result in treatment equivalent to the use of fair value following acquisition of a corporation even where a section 338(h)(10) (or section 338) election is not made, and without the complications and inconsistencies of the fixed stock write-off method under Prop. Reg. §1.163(j)-5(e). Further, under GAAP book value, certain intangibles including, in particular, goodwill would not have to be written off unless impaired.

So long as the taxpayer is not permitted to change the election (absent IRS approval), it is hard to see how the Government's interests would be harmed. While there would be some increase in complexity as a result of use of other than tax basis, we believe this would be outweighed by the benefit, particularly considering that use of other than tax basis would be voluntary with the taxpayer. Precedents for an election of valuation alternatives can be found in certain other areas in which taxpayers have had to look to the amount of assets held abroad, in particular the interest allocation and apportionment rules of Treas. Regs. §1.861-9T, permitting taxpayers to so elect for interest expense sourcing purposes, the interest allocation and

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[11] Fluctuations in fair market value could result in a lower (or higher) allocable amount of interest expense than would have been allowed at the time the debt was incurred.

[12] In the case of certain regulated entities that do not use GAAP accounting, we recommend that statutory accounts be permitted to be used under such circumstances as GAAP accounts would be permitted to be used.

apportionment rules of Treas. Regs. §1.882-5, where foreign taxpayers may so elect for determining deductible interest, and the determination of United States real property holding company status under Treas. Regs. §1.897-2(b).

Further, in order to deal with the zero value of self-created intangibles under a tax basis (or generally GAAP) valuation method, it may be appropriate to permit certain deductible expenses (including but not limited to R&D expenses and all expenses to develop a tradename or trademark) to be capitalized for purposes of the debt-to-assets ratio.

Another issue with the Bush Proposal is that the table of debt-to-asset ratios appears to be insufficiently reflective of commercial realities and perhaps insufficiently refined. For example, the trademarks of world-famous consumer brands, which are given a 50% leverage ratio, would appear to us to be much more readily leverageable than a receivable from some barely solvent shareholder, which would be given a 70% leverage ratio. As a second example, we believe, based on our experience, that the 90% ratio for loans by financial institutions is too low.

iii. Technical issues with the proposed safe harbor

The safe harbor under the Bush Proposal raises a host of technical issues.

1. Will there be a reduction in assets for excluded liabilities and if so how will it be allocated among asset categories? Under current law, short-term liabilities (generally payables of under 90 days) are not counted as "debt" for purposes of the safe harbor but do reduce equity.[13] There is no need under current law to allocate the reduction to specific categories. Under the Bush Proposal, because there are separate categories that include current assets, the purpose of excluding short-term payables from debt, with a corresponding reduction in assets, may no longer exist. If, however, such exclusion and reduction were retained, specific allocation would be necessary. Presumably, such a reduction would be allocated first to "trade receivables and other current assets," and any remaining amount pro rata among the remaining categories.

2. When will the determination of the safe harbor be made? Under current law, it is made on the last day of the year. A similar one-time determination would lend itself to some possibility of manipulation in the case of the Bush Proposal. For example, a company contemplating an investment in new equipment would be well advised to retain its cash and make the investment on January 1 rather than in late December. Similarly, companies would be well advised to convert receivables into cash and to delay payment of payables in anticipation of the determination date. While a quarterly determination (similar to the one used under the PFIC and investment in U.S. property rules) would be more accurate, this would substantially increase the compliance burden. We believe that the incentive and ease of manipulation in this context is substantially less than in the

[13] Such items were thought to potentially distort the measurement of net equity due to cyclical fluctuations.

context of those other rules and that ultimately the greater accuracy of quarterly measurements would not outweigh the resulting complexity.

3. Would branches, simply or together with related U.S. corporations, be subject to the adjusted taxable income limitation and/or the worldwide leverage limitation? Compare IRC §163(j)(8)(C); Prop. Reg. §1.163(j)-8. If so, how would the safe harbor limitation in the worldwide leverage test (and that test generally) be coordinated with the fixed (7%) ratio and actual ratio computations under Treas. Regs. §1.882-5? (See part 3.c.v below.)

4. More guidance should be provided regarding the definition of the various asset categories. Should the asset categories and their applicable ratios as set forth in the statute be permitted to be supplemented by the Treasury Department and the Internal Revenue Service?

5. We assume the proposal to be that, for includible subsidiaries, the consolidation principles of Prop. Reg. §1.163(j)-5(d) generally would apply. We assume that investments in nonconsolidated subsidiaries would be included at adjusted tax basis as under Prop. Reg. §1.163(j)-3(c)(2) or, if an option to use GAAP and/or fair market values is permitted as we suggest, then at those values.

6. We also assume that, if a tax basis approach to valuation is taken, some adjustment analogous to the fixed stock write-off method of Prop. Reg. §1.163(j)-5(e) is intended to be permitted.[14] We note that, in the context of the proposed safe harbor with different ratios for various asset classes, a look-through to the underlying assets of the corporation would be appropriate, in order to avoid arbitrary distinctions in the permitted ratio between a stock purchase with a section 338(h)(10) election and one without. Further, the 96-month amortization required under the fixed stock write-off method means that the relief provided often would be less than if assets with a substantial portion of 15-year goodwill had been acquired. In any event, we do not believe that this method, applicable only to acquisitions, is an adequate alternative to the broader fair market value and GAAP book value elections we suggest above.

7. Would the treatment of investments in partnerships follow the approach of Prop. Regs. §1.163(j)-3(b)(3) (liabilities taken into account as per section 752) and Prop. Regs. §1.163(j)-3(c)(4) (partnership treated as entity for asset calculation), or would there be a look-through rule in respect of their assets and liabilities and if so at what ownership threshold? Given the different ratios for various asset classes, a look-through rule would be appropriate for an interest in an entity taxable as a partnership if such interest either is a general partner or managing member interest or represents more than, e.g., a 10 percent interest in either partnership profits or partnership capital.

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[14] In this regard, we refer to our comments in a prior report on the proposed regulations. New York State Bar Association Tax Section, report of Ad Hoc Subcommittee on U.S. Activities of Foreign Taxpayers on Regulations Proposed under Section 163(j), October 24, 1991, 91 TNT 225-36.

8. The proposal suggests that equity investments in foreign related parties (other than subsidiaries) are not taken into account. We understand that the concern relates to inflated asset amounts through stock investments in parent corporations, like the so-called "hook" stock employed in certain corporate inversion transactions. We believe that an exception in this regard should be tailored narrowly to reflect the cases perceived to be abusive but avoid overinclusiveness. For example, a significant albeit minority shareholding in an operating joint venture should not be disregarded under this rule.

9. Since repos and securities loans are marked to market on a daily basis for purposes of determining the amount of liquid collateral that must be posted, both sides of the transaction perhaps should be included in the Cash Equivalents category rather than in the 90% category (which would apply if a repo is treated as a secured loan for this purpose). Alternatively, the repo lender would be viewed as holding the higher rated of the security sold (plus any cash collateral posted) or the obligation to repurchase. The repo borrower should be treated as holding the security sold plus any cash collateral posted. Should the repo (lender) and "reverse repo" (borrower) positions be netted for this purpose?

10. What are the proper asset categories for other financial instruments, including futures and forward contracts, swaps, options and other derivatives on debt and equity securities, market index instruments, derivatives on currencies and commodities, and precious metals?

11. Does the same ratio apply regardless of whether a debt or equity security is held for sale to customers (confirmation should be provided that the Inventory category (80%) does not apply to financial assets), held to maturity, held as part of a trading vs. investment book, hedged or not, subject to a repo, reverse repo, securities loan or securities borrowing, required to be marked-to-market under a collateral arrangement with a counterparty, etc.?

12. Does the same category apply to all receivables (e.g., for a financial institution, dividends, interest, substitute payments, sale proceeds, swap and other derivatives payments)?

13. How are other assets to be classified? E.g., (i) the lease portfolios of leasing businesses, (ii) cash and securities that are segregated by broker-dealers and other financial institutions in compliance with regulatory requirements or are held in segregated customer accounts, (iii) assets of insurance companies, including those held in special and variable accounts and various categories of receivables, and (iv) assets held through various types of off-balance sheet finance vehicles and other securitization devices.

14. If (in particular) a fair market value alternative is adopted, consideration should be given to treating obligations that are not liabilities for tax purposes but

economically are liabilities as offsets against asset value (e.g., the short position of the writer of a call option that is in the money).[15]

b. Comments on Proposed Changes to 50% Adjusted Taxable Income Test

The Proposals would retain the definition of "adjusted taxable income" provided in existing section 163(j)(6)(A), including the add-back for depreciation, amortization and depletion set forth in section 163(j)(6)(A)(i)(III). The Treasury Department had proposed to eliminate this addback in its preliminary report on corporate inversion transactions and in its subsequent Congressional testimony.[16] The Bush Proposal, like the Treasury Report, would reduce the 50% limit to 35%; the Thomas Bill would further reduce the limit to 25% for taxable years beginning after 2004.

We agree that retention of the addback is appropriate. The addback reflects the fact that depreciation, amortization and depletion amounts, as determined for tax purposes, may vary significantly from "economic" amounts due to the availability of accelerated tax deductions. Although the Treasury Department's testimony suggested that eliminating the addback would focus the adjusted taxable income test on a comparison of interest expense to net income (rather than cash flow), we do not believe that businesses normally evaluate their capacity for indebtedness by reference to net income, as determined with these tax deductions, as opposed to by reference to EBITDA or a variation thereof. Moreover, the availability of accelerated tax depreciation, amortization or depletion schedules can vary significantly across industries. Therefore, we believe that the existing definition of adjusted taxable income – which eliminates the effect of these deductions – is a better proxy for evaluating whether or not a company's interest expense is disproportionately high. While some reduction of cash flow for anticipated capital expenditures is appropriate and would be taken into account by an unrelated lender, for simplicity that factor is better reflected in the percent chosen for the overall adjusted taxable income limit.

The reduction of the 50% limit to 35%/25% does not raise any technical issues per se. We believe, however, that consideration should be given to whether, taking into account available empirical evidence, the reduced limit would restrict the ability of foreign-owned U.S. companies to incur related party indebtedness that are consistent with an arm's length standard.[17] This issue is discussed below in part 8.a of this report.

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[15] Compare the definition of "obligation" in Prop. Regs. §1.752-1(a)(1)(ii). Although the discrepancies would tend to be much less dramatic, similar issues might arise under a tax basis approach.

[16] Office of Tax Policy, Department of Treasury, Corporate Inversion Transactions: Tax Policy Implications (May 17, 2002), Doc 2002-12218, 2002 TNT 98-49 (hereinafter "Treasury Inversion Report"). Testimony of Acting Assistant Treasury Secretary for Tax Policy Pamela Olson before the House Committee on Ways and Means Hearing on Corporate Inversion Transactions, June 6, 2002.

[17] Further, in determining the limit, it should not be assumed that the U.S. government collects substantially more revenues from interest payments made by standalone domestic borrowers as opposed to borrowers owned by a foreign parent company. As recognized in the 1993 legislative history (H.R. Rep. No. 103-11, 103d Cong., 1st Sess. 249), almost all interest paid to banks and other financial intermediaries is paid out as deductible expense, with the interest ultimately paid to a recipient that is not subject to U.S. tax. Interest on instruments issued in the capital markets similarly gravitates towards exempt recipients.

c. Comments on Proposed Worldwide Leverage Test

i. Appropriateness of the worldwide leverage test.

We understand that a worldwide leverage test may be considered attractive in so far as worldwide leverage might, if assumptions are made as to similarity of businesses (by industry, stage of development, etc.), economic environments, and so forth, be considered indicative of the degree of leverage an enterprise would employ without the influence of tax considerations unique to a particular country. We believe, however, that such a test raises very serious issues, both in theory and in practice, that substantially outweigh the merits of such a test.

A fundamental conceptual issue presented by the worldwide leverage test is that it bears no meaningful relation to any test a third-party lender would apply to determine whether a U. S. affiliate of a multinational group is over-leveraged, which we believe should be a relevant comparison (as discussed below in part 8 of this report). Third-party lenders care about cash flow, debt service ratios, marketability of collateral and other similar items. They care, if at all, only in the most minor way whether a U.S. group has more or less relative leverage than the overall group of which it is a part.

There are numerous reasons why a U.S. group may have more relative debt than the worldwide group of which it is a part. Interest rates in the U.S. may be lower than outside the U.S., the U.S. group may have a business or assets that produce a more consistent and more stable flow of cash than the overall group's assets, the U. S. assets may be more readily saleable, or the U.S. group may produce earnings in a more stable currency than the rest of the group, or the non-U.S. business may have proportionately more leverage in the form of obligations that are not "debt" under U.S. federal income tax principles (such as derivatives or lease obligations). As discussed below, particularly striking instances of such discrepancies can arise in the case of financial institutions which may include, e.g., primary dealer in U.S. government securities, wholesale banking and insurance businesses.[18] The mere fact that a U.S. group may have more relative leverage than the worldwide group of which it is a part tells the third-party lender nothing meaningful about whether the U.S. group is inappropriately leveraged.

ii. Valuation of assets and indebtedness.

An even more significant issue presented by the worldwide leverage test is the fact that it would require foreign-owned multinational groups to restate their worldwide balance sheets in accordance with U.S. tax principles in order to compute their worldwide leverage ratios. This presents several obvious difficulties.

First, the foreign group would be required to determine the U.S. tax basis of each of its assets worldwide. Making such a determination, if even possible, would be a huge undertaking for any large foreign corporate group, requiring countless hours of work and substantial expense. At a minimum, many, if not all, foreign groups would require substantial –

[18] In theory, this issue would be alleviated to the extent a comparable line of business filter is applied before applying the worldwide leverage test. The resulting level of complexity, however, likely makes such a proposal inappropriate.

and costly – assistance from U.S. tax advisors in order to reconstruct U.S. tax bases. Even with such assistance, however, many would be unable to make precise determinations due to inadequate records of historical cost, recognition and nonrecognition transactions, currency exchange rates and other relevant data. Determining indebtedness in accordance with U.S. tax principles would raise some of the same concerns, due to the need for expert assistance in classifying relevant items as either debt or equity for U.S. tax purposes. Moreover, requiring that the Internal Revenue Service audit these asset and debt determinations would quickly overwhelm the resources of the International Division.

We believe, therefore, that any such requirements are not only impractical, but in many cases will be wholly unworkable. As discussed above, because the amount of interest disallowed is the greater of the amounts determined under the adjusted taxable income and worldwide leverage tests, the inability to calculate the worldwide leverage ratio means that all disqualified interest will be disallowed unless the taxpayer manages to satisfy the safe harbor test. The proposal runs counter to the consensus view among taxpayers and tax administrators alike that the tax laws must be made simpler and changes to the tax laws should avoid undue complexity.

One alternative to applying U.S. tax rules to value assets and liabilities would be to permit foreign corporate groups to use the asset and liability valuations reflected on their audited financial statements. This approach would require much less work on the part of foreign taxpayers, but raises its own issues – among them, differences in accounting principles across countries and the fact that definitions of assets and liabilities for book purposes may differ in significant ways from the definitions that apply for U.S. tax purposes. A second alternative, permitting use of fair market values, raises similar practical issues, such as the need to obtain asset appraisals and the reliability of those appraisals. These issues have been considered in other, more limited contexts, such as the computation of the "actual ratio" of a foreign corporation's worldwide liabilities to assets under Treas. Regs. §1.882-5(c),[19] and the apportionment of interest expense for purposes of determining foreign source income for purpose of crediting foreign taxes.[20] Use of book or fair market values in connection with the proposed worldwide leverage test would greatly expand the scope of these potential issues. On the other hand, if a worldwide leverage test is included in legislation, we believe it would be imperative to provide taxpayers, by election, an alternative to U.S. tax basis for purposes of asset valuation,

[19] As discussed further below, Treas. Regs. §1.882-5 generally determines the deductible interest expense of a U.S. branch of a foreign corporation in a three-step process. In the first step, the corporation determines its U.S. assets. In the second step, it determines its U.S.-connected liabilities by applying to its U.S. assets either its actual worldwide liabilities-to-assets ratio or an elective fixed ratio. In the third step, the corporation determines the interest paid on the U.S.-connected liabilities determined in the second step.

[20] The regulations under Code section 864(e) for the allocation and apportionment of interest expense of a U.S. affiliated group permit taxpayers to elect use of a fair market value method. Treas. Regs. §1.861-9T(g). See Rev. Proc. 2003-37.

and that taxpayers should be permitted to use at least the amounts used for local GAAP purposes. An election to use fair market value might also be considered.[21]

Finally, a mandatory limit based on a worldwide leverage ratio represents a departure from traditional arm's-length principles that may be inconsistent with U.S. treaty obligations (as discussed in part 8 of this report) and that may, regardless of the abstract legal merits, invite similar legislation by trading partners with less onerous earnings stripping regimes.[22] We think it unlikely that the U.S. government would appreciate the imposition of a similar requirement upon U.S.-based multinationals by a foreign government, and we believe that it would be unwise for the U.S. to impose a tax requirement on foreign-owned corporations that it would not tolerate if reciprocated.

iii. Treatment of "financial corporations."

In recognition of the fact that financial institutions are typically more highly leveraged than other types of businesses, the Proposals would treat all financial corporations (defined in the Thomas bill's proposed Code section 864(e)(6)(B)) that are members of the same worldwide affiliated group as a separate worldwide affiliated group. That separate group would then be treated as a single corporation for purposes of applying the worldwide leverage test. Proposed Code section 864(e)(6)(B) would define a "financial corporation" to mean any corporation if at least 80 percent of its gross income is income described in Code section 904(d)(2)(C)(ii) and the regulations thereunder – generally, income derived in a banking, insurance, financing or similar business – that is derived in transactions with unrelated persons.

We agree that it makes sense to distinguish between financial institutions and other types of businesses, but we believe that it is overly simplistic to assume that all financial institutions have roughly similar leverage ratios (or that all nonfinancial businesses do). In fact, there can be significant differences between the leverage ratios of securities firms, banks and insurance companies. Depending upon the mix of businesses in a particular group, a U.S. subsidiary could be either advantaged or disadvantaged by having its domestic leverage ratio compared to the worldwide leverage ratio of its parent group. For example, a U.S. subsidiary of a foreign banking group that is a wholesale securities dealer would typically have a much higher domestic leverage ratio than the worldwide leverage ratio of its parent group. Consequently, the securities subsidiary could be penalized under the Bush Proposal, notwithstanding that its domestic leverage ratio was comparable to that of other U.S. securities firms. Conversely, a U.S. insurance subsidiary might have a lower domestic leverage ratio than the worldwide leverage

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[21] While auditing the asset values of a U.S.-based group is clearly challenging for the Internal Revenue Service, auditing the fair market values of assets located abroad within a foreign-based group would be significantly more difficult.

[22] Although the "CFC netting rule" of Treas. Regs. §1.861-10(e) imposes an analogous requirement on U.S.-based multinational groups to determine both worldwide debt-to-asset ratios of the U.S. parent group and the related party debt-to-asset ratios of controlled foreign corporations, each in accordance with U.S. tax principles, we do not believe that this provides support for imposition of a worldwide leverage test on foreign–based multinationals. Determining these ratios in accordance with U.S. tax principles is much less burdensome for a U.S.-based multinational than for a foreign-based multinational. Moreover, since the "CFC netting rule" applies to determine the U.S. tax liability of U.S.-based multinational groups, it does not raise the same nondiscrimination issue under existing U.S. treaties.

ratio of its foreign securities group parent; as a result, the insurance subsidiary could escape limitation under the Bush Proposal even if it were more highly leveraged than other U.S. insurance companies. Moreover, artificial distinctions between leverage treated as "debt" for federal income tax purposes and other forms of leverage (such as derivatives) that are common and significant within financial groups will make the worldwide leverage test an arbitrary measure in many cases.

A related problem arises from the fact that certain types of securities businesses – such as the business of primary dealers in U.S. government securities, or a matched book repo business (which may or may not be conducted by a primary dealer)[23] -- operate with almost 100% leverage, so that a U.S. subsidiary engaged in such a business would almost certainly be penalized under the Bush Proposal if it had any related party debt. (In other words, the leverage ratio of such a subsidiary would nearly always be higher than the worldwide leverage ratio of its foreign parent group, simply by virtue of the business that it conducts.) The debt-to-asset ratio safe harbor as proposed would rarely if ever eliminate this issue.

In theory, it would be possible to refine the provisions of the Bush Proposal to make finer distinctions among different types of financial businesses. We believe that this would introduce additional complexities to a provision that is already unacceptably complex. On the other hand, if there is to be a worldwide limitation, we would support a separate test for financial institutions, modified to reflect the concerns expressed above.

iv. Net vs. gross interest expense.

We also note the potentially onerous consequences that would be presented to, in particular, financial institutions if, as proposed, a worldwide limitation is a limitation on gross, rather than net, interest expense. In view of the enormous leverage and thin margins typical of many financing businesses, the disallowance of a deduction for gross interest could have draconian results. In formulating the adjusted taxable income limitation, the determination was reached that interest expense incurred to earn interest income was not abusive. We do not believe that this rationale is less valid in the context of a worldwide limitation, or that mechanically there would be a problem in expressing the limitation in terms of net interest expense.

v. Interaction with Treas. Regs. §1.882-5.

Adoption of the worldwide leverage ratio test would also eliminate any benefit that a foreign corporation with a U.S. branch might otherwise derive from the election of a "fixed ratio" of worldwide liabilities to assets under existing Treas. Regs. §1.882-5(c).

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[23] A "matched book repo" consists of a securities repurchase transaction with one counterparty that is matched by a precisely offsetting reverse repurchase transaction, involving the same security, with a second counterparty. The profit to the intermediary is the spread between the repo and reverse repo rates.

More specifically, we note that, pursuant to regulations issued under section 163(j)(9)(C) (as such paragraph would be renumbered by the original Thomas Bill),[24] the limitations of amended section 163(j) may be applied to a U.S. branch of a foreign corporation by treating the U.S. branch as a separate entity. This would be consistent with existing Proposed Treas. Regs. §1.163(j)-8. As a consequence, the branch's "disqualified interest" expense would be disallowed to the extent that its debt-to-assets ratio, as computed under Treas. Regs. §1.882-5(c) is disproportionately high as compared with the debt-to-assets ratio of the foreign corporation's worldwide affiliated group and exceeds the safe harbor amount. For example, if a U.S. branch of a foreign bank had elected to use the 93% fixed ratio for purposes of Treas. Regs. §1.882-5(c),[25] and that ratio exceeded the actual worldwide leverage ratio of the foreign bank's affiliated group and the safe harbor amount, then "disqualified interest" expense attributable to the disproportionate debt (to the extent in excess of the safe harbor amount) resulting from use of the fixed ratio would be disallowed.[26]

The effect of applying the Proposals in this manner would be to eliminate all of the benefits that the fixed ratio election was intended to confer under Treas. Regs. §1.882-5 (assuming the new section 163(j) safe harbor test has not been met). The purpose of the fixed ratio election is to provide a safe harbor under which foreign banks and other foreign corporations can avoid the difficulties inherent in calculating an actual worldwide debt-to-assets ratio to determine the amount interest property attributable to their U.S. activities. The fixed ratio is set at a level that is designed to be lower than the average debt-to-assets ratio of a foreign bank or other type of foreign corporation, with the result that use of the fixed ratio is likely to result in a lower U.S. interest deduction than the branch would otherwise have been able to claim. The compensation, however, is that the foreign corporation can avoid both the time and expense involved in computing an actual worldwide ratio and, subsequently, the potential difficulties posed by an Internal Revenue Service audit of its calculations. (Likewise, a taxpayer's choice of the fixed ratio benefits the Internal Revenue Service by relieving the Service of the need to audit worldwide assets and liabilities.) Under the Proposals, however, a foreign corporation with a U.S. branch that is not within the safe harbor debt amount would be forced to compute a worldwide leverage ratio, in order to apply the earnings stripping limitations, whether or not it had elected the fixed ratio. Accordingly, there would be no benefit at all to electing a fixed ratio for purposes of Regs. §1.882-5 (except in those relatively few cases where the fixed ratio exceeds the actual ratio or the safe harbor test is met).

We do not recommend elimination of the fixed ratio as a solution to this problem. We believe that the fixed ratio serves a very useful purpose in minimizing compliance and audit

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[24] Section 163(j)(8)(C) currently provides that the Secretary of the Treasury shall prescribe such regulations as may be appropriate for the coordination of section 163(j) with Code section 884. The Thomas Bill would renumber section 163(j)(8) as section 163(j)(9).

[25] Treas. Regs. §1.882-5(c) permits a foreign corporation either to compute its actual ratio of worldwide liabilities to assets in step two of the interest expense computation, or to elect a fixed ratio of worldwide liabilities to assets. The fixed ratio is 93% for banking institutions and 50% for all other types of corporations.

[26] Because "disqualified interest" expense includes interest paid on loans guaranteed by a related party, all of the branch's interest expense could be treated as disqualified interest, since all of the debt of the branch could be viewed as structurally guaranteed by the foreign parent (because the branch is part of the same legal entity).

burdens for both taxpayers and the government and ought to be retained. Another possible solution to the problem would be to exclude foreign corporations that are subject to Treas. Regs. §1.882-5 from the scope of the worldwide leverage test on the grounds that they are already subject to a proportionate leverage requirement under that regulation. This solution requires coordination, however, in cases where a foreign corporation has both a U.S. branch and U.S. subsidiaries (e.g., a foreign bank that has both a U.S. branch and a separate U.S. securities subsidiary).

In sum, the integration of section 163(j) and section 1.882-5 raises a number of technical and policy questions, and Treasury should be given authority to issue regulations, including exempting branches from section 163(j) and taking account of excess favorable attributes in the branch in applying section 163(j) to subsidiaries.

vi. Summary

The issues with the worldwide leverage test may be summarized as follows:

- The results reached are not likely to reflect commercial reality and are likely to be arbitrarily either overly generous or overly stingy.
- Regardless of the method of measuring asset value, the test would be extremely burdensome, and immeasurably so if asset value is required to be measured by U.S. tax basis. We fail to see how the complexity that would be introduced would be justified by any benefit from application of the rule.
- The test would require extensive adjustments and exceptions for certain kinds of taxpayers, notably financial institutions.
- To our knowledge, the test would be nearly unique among the approaches taken by our trading partners.[27]
- The problems raised by the worldwide limitation are not sufficiently cured by the debt-to-asset ratio safe harbor.

Rather than attempting to fix these and other significant problems outlined above, the worldwide leverage test should simply be removed from the Proposals.

d. Comments on Proposed Changes to Carryforwards

i. Carryover of disallowed interest expense.

The indefinite carryover of disallowed interest expense under existing section 163(j) was part of the statute as originally passed by the House in 1989. It reflects the facts that

[27] We understand that in New Zealand taxpayers may rely on worldwide group leverage to increase allowable deductions if it is higher than normally permitted maximum leverage. We understand that a legislative proposal to similar effect is being considered in the Netherlands.

business cycles exist, that individual business themselves grow over time and that individual businesses and industries have their ups and downs within larger cycles. These factors are taken into account by lenders in determining the amount and terms of loans. The adjusted taxable income limitation under section 163(j), which apparently was based on a cash flow test analogous to that which commercial lenders often use in sizing a loan, already brings the amount of potentially deductible interest to a range considered very generally to correspond to the amount of interest expense under a commercial arrangement. Thus, any additional limitation, such as a limitation on the carryforward, can only serve to reduce the amount of deductible interest expense below that level of interest expense otherwise deemed an appropriate limitation.

The justification on technical tax policy grounds for a limitation on the carryforward period is not entirely clear. We note a possible administrative desire to avoid in any context the need to review records that could go back indefinitely. Given the taxpayer recordkeeping and burden of proof requirements, however, it is not clear how compelling that reason is. In any event, the 1989 Congress did not find it compelling.

Be that as it may, given that current law provides for a 20-year limit on net operating loss carryovers generally under section 172, an argument for a shorter period on purely administrative grounds would seem weak.

The argument also might be made that if a taxpayer is not able to absorb a carryover of disallowed interest expense within, e.g., 5 years, that that alone indicates that the level of indebtedness was too high. However, that would be inconsistent with the recognition, in connection with the extension of the net operating loss carryforward from 15 years to 20 years, that the business of taxpayers can undergo very long-term periods of stagnation or even deterioration.

There might also be an objective to prevent taxpayers to "grow into" the ability to use disallowed interest expense. While that is a consideration, we believe that there are three reasons why that criterion should not be determinative. First, the debt in question must separately have passed muster as true debt, the criteria of which already address this concern. Second, there is no reason to impose a rule a primary effect of which is to force taxpayers to continuously refinance into additional indebtedness as the business grows. Third, it would be an extremely imprecise and blunt instrument, achieving arbitrary results.

The adjusted taxable income limit itself is based on annual accounting periods, as is appropriate and necessary within our system of annual tax accounting. A limit on carryforwards based on a certain number of annual accounting periods is inherently arbitrary and in no sense justified by the normal accounting period concept. It can have the negative effect of arbitrarily disallowing, permanently, deductions for interest expense of taxpayers solely because their business has not performed in accordance with expectations. On the other hand, for agile taxpayers, the limitation can to some extent be parried by creating additional debt. For these reasons, while an unlimited carryforward might be considered inappropriate, we have substantial reservations about a limitation shorter than what administrative considerations might dictate and so believe that a 20-year limit would be appropriate.

On a purely technical level we note that, under proposed section 163(j)(1)(C)(ii) disqualified interest that arises in a taxable year (year x+2) would have priority over disqualified interest that could be carried from a prior year (year x+1) just as disqualified interest from a year earlier than such prior year (year x) would have priority over year x+1. We believe the provision functions correctly to cause the earliest carryover amounts to be used first and to prevent the permitted period of use of disqualified interest from an earlier year from being extended (we read "taken into account" in this provision as synonymous with "treated as paid or accrued" in proposed section 163(j)(1)(C)(i)).

ii. Carryover of excess limitation.

In addition to the carryover of disallowed interest expense, current section 163(j) permits a carryover of excess limitation for up to three years. This provision was added by the Conference Committee in 1989 to narrow the situations in which interest expense is disallowed "not because the corporation is thinly capitalized, but because of year-to-year changes in profitability."[28] The Bush Proposal (and the Thomas Bill) would eliminate this carryforward.

Much of what is expressed above in connection with the carryover of disallowed interest expense concerning fluctuations in business fortunes and the importance of avoiding arbitrary results is relevant here as well. We note that this provision serves the same purpose as a carryback, but without the procedural requirement to file an amended return. Because, unlike, e.g., foreign tax credits or net operating losses, the section 163(j) interest expense rule is relatively self-contained, this approach with its obvious compliance and administrative benefits is feasible.

On the other hand, we note that the ability to carry forward excess limitation from a period preceding incurrence of particular debt to avoid disallowance of interest expense on such later-incurred debt may be a more beneficial result than is consistent with the general approach of section 163(j). Unlike tax attributes such as net operating losses, which cannot be readily created by the taxpayer, interest expense is relatively easy to generate. In certain other areas, Congress has felt it appropriate to limit the ability of taxpayers to carry attributes back, where an unfettered carryback right was considered potentially abusive. See, e.g., IRC §172(h), §381(b).

Leaving aside simplicity concerns, we believe the best result would be to allow the carryover of excess limitation in nonabusive situations. Taking into account the complications that such an approach would entail, we have no objection to a deletion of the carryforward of excess limitation.

4. Technical Comments on Thomas Bill

a. Comments on Proposed Elimination of Safe Harbor

The elimination of the safe harbor would not raise technical issues in a strict sense, but would call into question the compatibility of the provision with the arm's length

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[28] H.R. Conf. Rept. No. 101-386, 101st Cong., 1st Sess. 567 (1989) (1989 Conference Report").

standard. This issue is discussed in part 8.a below. A collateral consequence of a too-inclusive provision is broader than necessary compliance and administrative burdens.

b. Comments on Proposed Changes to Deduction for Disqualified Interest

We refer to our comments in 3.d above in respect of the Bush Proposal.

We also note that the Thomas Bill would provide for the new lower percent of adjusted gross income to apply only to related party loans as opposed to unrelated party loans guaranteed by a third party, for which the current 50% limit would be retained. Assuming that the distinction between related party loans and unrelated party loans guaranteed by a third party is valid and that the line between the two can be defended against possible abuse (issues that are discussed further in part 7 below), we believe the language of the Thomas Bill, as proposed to be corrected as described in the JCT Report, would apply the distinction on a technically correct basis. The interaction between the 50% limit applicable to guaranteed loans and the 25% limit applicable to related party loans would not result in the possibility that interest on related party loans would avoid the lower limit. We also note that the approach of not distinguishing among particular guaranteed loans has the important advantage of simplicity.

c. Comments on Proposed Changes to Carryforwards

We refer to our comments at 3.d above in respect of the Bush Proposal.

5. Technical Comments on Guarantee Proposal in Hatch Bill

The Hatch Bill - which contains no other provisions applicable to earnings stripping - contains a relief proposal in respect of loans guaranteed by related parties that is very different than the proposed special treatment in the Thomas Bill. The Hatch Bill would carve out interest on certain guaranteed loans generally from the earnings stripping limitations, while continuing to treat interest on guaranteed loans that do not qualify for the exemption the same as interest on related party debt. Because the Hatch Bill would retain the 50% limit generally, however, the treatment of such ineligible guaranteed interest in effect would be the same as under the Thomas Bill.

The basic test for exemption under the Hatch Bill is whether, in the case of a guarantee of a corporation's debt by a foreign person,[29] the taxpayer "could have borrowed substantially the same principal amount from an unrelated person without the guarantee." The taxpayer would have to establish this "to the satisfaction of the Secretary." However, "to the extent provided in regulations," the Secretary could reject the taxpayer's showing if the hypothetical borrowing would be "on terms substantially dissimilar to those of the actual loan." The intention seems to be to exempt interest on a loan to a taxpayer that is guaranteed by a related party from the section 163(j) limitations if the taxpayer could have borrowed approximately the same amount from one or more unrelated persons, at least if the economic (and possibly legal) terms are not substantially dissimilar, and to delegate a significant amount of

[29] The Hatch Bill would confine the exemption to guarantees by foreign persons, and not include guarantees by domestic tax-exempt entities.

discretion to the Secretary in articulating the scope of the exemption (at least by regulation). In addition to our more general comments on the merits of a possible exemption for interest on guaranteed loans (set forth in part 7 below), we have the following technical observations:

1. We question whether the provision is drafted in a manner that would accomplish what we assume is a basic objective, namely, to address situations in which unrelated lenders (as a matter of facilitating credit analysis) demand a guarantee by the rated entity in the group, which typically is the parent company, or demand a guarantee by the parent company to eliminate issues of actual or constructive shifts of value from the subsidiary in favor of other group members. We would suggest that either the statute or legislative history make clear that the requisite showing be permitted to focus on economic criteria of the borrowing entity and disregard any lender condition that the borrower or guarantor be a rated entity or that a group parent guarantee be required for any other general policy reason of the lender.

2. Although the draft language refers to a single unrelated lender, we believe that it should be made clear that multiple lenders for the amount would be satisfactory.[30]

3. The proposed language to be added by section 255(a)(4) of the Hatch Bill would limit comparable borrowings to those with terms not "substantially dissimilar."[31] We believe that the rationale behind the "substantially dissimilar" test is to allow the Secretary to limit the exception to situations in which the guarantee is not required for a substantially similar loan as a credit matter (e.g., that the subsidiary is not borrowing on a "junk" bond basis unless the guaranteed debt also is on that basis). Accordingly, the "terms" relevant for the comparison should be narrowed to certain economic terms. For example, the fact that a substantially different form of loan document might be required or that additional financial covenants might be required should not in our view be relevant.

4. We note that, generally, there would be a lower interest rate on a guaranteed loan than on a nonguaranteed loan. A lower interest rate in this context would mean less U.S. interest expense as compared with a third party nonguaranteed loan (though, of course, more than as compared with no loan at all). We believe that a higher interest rate (at least if within a safe harbor amount) should not be considered a factor contributing towards substantial dissimilarity.

5. Although the provision's basic rule would delegate broad discretion to the Secretary, the "substantially dissimilar" test would on its face permit the Secretary to reject a guaranteed loan on the basis of dissimilar terms only under regulations (which procedurally is quite restrictive). On the other hand, we note that section 7805(b)(3) provides adequate authority for retroactive regulations to prevent abuses in the event that regulations are not issued within 18 months.

[30] We note that the test is not that the taxpayer could have borrowed from the same persons.

[31] Compare Treas. Reg. §1.881-3(a)(4)(i) and §1.904-5(c)(4)(ii); Rev. Rul. 87-89.

6. The test set forth in the Hatch Bill would require a fact-intensive inquiry. While taxpayers likely would welcome the additional complexity of the provision in view of the fact that it would apply only where a benefit not currently allowed is sought by the taxpayer, we recognize that the provision would place further demands on the resources of the Internal Revenue Service, which must be counted as a significant negative. As we discuss in part 7.b, the complexity issue could be reduced to a meaningful extent through certain presumption or safe harbors, in particular, a presumption based on the presence or absence of a favorable opinion of a financial institution capable of making or arranging a financing of the type and size opined on.

6. Policy Issues

a. Background of the Proposals

The Proposals had their genesis in ongoing debate regarding U.S. corporations that "invert" or reincorporate outside the United States in order to reduce U.S. federal income taxes (so-called "inversion transactions"). In fact, the Bush Proposal follows closely the proposals advocated by the Treasury Department in its recent tentative report on corporate inversion transactions.[32] The Treasury Inversion Report suggests that the principal benefit of an inversion transaction is that it permits an inverting company to employ earnings stripping and other devices to reduce U.S. corporate-level tax on income from U.S. operations.

The Treasury Inversion Report generally advocates a cautious approach in dealing with inversion transactions based on the perception that legislation targeting inversion transactions specifically would raise significant competitiveness concerns. In particular, the Treasury Inversion Report suggested that a targeted approach to the inversion problem would fail to address the fundamental tax advantages of inversion transactions which can also be achieved by newly formed or existing foreign corporations that acquire existing U.S. companies or form new U.S. subsidiaries and employ debt-financing and other arrangements that have the effect of reducing the U.S. tax base.[33]

Thus, although the Proposals emanate from concerns regarding inversion transactions, the Proposals would operate in a broader context and would apply regardless of whether the relevant indebtedness upon which interest is paid is associated with an inversion or similar transaction. The rationale for this level of breadth seems to be a generalized concern that foreign owners of U.S. businesses are employing excessive leverage to reduce improperly U.S. taxation. The Proposals apparently respond to concerns raised by members of Congress and others in recent years, and reflected in the Treasury Inversion Report, that foreign persons investing in the United States may not be paying their fair share of U.S. tax, and may be avoiding

[32] Treasury Inversion Report, supra note 16.

[33] This view was echoed in the New York State Bar Association report on Outbound Inversion Transactions (May 24, 2002), which, while advocating enactment of anti-inversion legislation in modified form, also cautioned against an overly narrow approach to the inversion phenomena and suggested consideration of tightening of the earnings stripping rules as a possible component of a broad-based longer-term legislative solution to address inversion transactions.

tax on a worldwide basis, thus arguably resulting in unfair competition for U. S. business.[34] However, it should be noted that this is a highly controversial proposition, and various commentators have expressed concern that there has been little study or debate regarding the extent to which foreign owned U.S. businesses are able improperly to avoid U.S. taxes and have referred to evidence to the contrary.[35]

b. Underpinnings of Earnings Stripping Limitations

The classic earnings stripping problem is the potential for erosion of the source country's income base through deductible payments to foreign persons who are not subject to full source country taxation on the payments.[36] Obviously, in a literal sense any deductible payments will erode the U.S. tax base to the extent the income is not taxable (viz. taxable at two levels) by the United States. What is commonly considered tax base erosion, however, is whether the United States (or other source country) has "adequate" taxing jurisdiction over earnings generated by domestic entities or entities engaged in business domestically.[37] As discussed further below, the standard implied by "adequate" is one of arm's length.[38]

The cross-border problem can be addressed either through a withholding tax regime on the income[39] or through a limitation on deductions. The trend in recent years, however, has been to reduce or eliminate withholding taxes on deductible (and, very recently, nondeductible) payments rather than use withholding taxes to avoid earning stripping. As a consequence, increased attention has been paid to restrictions on deductions.

Various factors can affect the practical incidence of earnings stripping in a cross-border context. In addition to the presence or absence of a withholding tax and the percent thereof, these include whether the payee has a high degree of common equity ownership in the payor such that the payment can be said to represent largely or entirely a shift from one "pocket"

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[34] See, e.g., "Dorgan: Treasury Loses Trillions in Multinational Tax Loopholes," Tax Notes, Apr. 19, 1999, p. 358; Leblang, "International Double Nontaxation," Tax Notes, July 13, 1998, p. 255. See also "GAO Reports International U.S. Corporations Pay Little U.S. Income Tax," 1999 TNT 72-48 (Apr. 15, 1999); "Many Foreign Corporations Paid Little or No Income Taxes, GAO Finds," 93 TNT 142-22 (July 14, 1993); "Full Text: Unofficial Transcript of Governmental Affairs Hearing on Transfer Pricing," 93 TNT 78-60 (April 8, 1993).

[35] See, e.g., Blouin, Collins and Shackelford, "Does Acquisition by Non-U.S. Shareholders Cause U.S. Firms to Pay Less Tax," Paper Presented at International Seminar in Public Economic Conference at Berkeley, December 7-8, 2001.

[36] As noted below, corporate tax base erosion exists in the domestic context as well.

[37] 1989 Conference Report, supra, at 569.

[38] Id. at 568-69. As a policy matter, the tax system should not allow business enterprises unfettered discretion regarding the jurisdiction to which they pay taxes on business income.

[39] Compare the mandated unrelated business taxable income treatment of payments by a taxable subsidiary to its tax-exempt owner under section 512(b)(13).

to another,[40] whether the payee has voting control such that (within regulatory and corporate governance restrictions) it can dictate a particular financial arrangement, to what extent the income is taxable on a current basis by the payee's jurisdiction, and the nature of the financial arrangement (debt versus equity capitalization being particularly manipulable).[41]

Accordingly, rather than adopt a rule applicable to all cross-border deductible payments, Congress in section 163(j) confined the deductibility limitation to situations involving certain of the factors mentioned above, including, in particular, the extent to which there is a U.S. withholding tax collected, the degree of equity ownership or voting control of the payor by the payee, and payments of interest rather than other deductible items.[42] A number of other countries have provisions providing for restrictions on deductibility of related person interest payments.[43]

A similar issue is present in a domestic context (other than in the relatively infrequent cases when such payments are made from one taxable corporation to another). For example, notwithstanding the recent reduction in rates for qualified dividend income, the U.S. tax system remains one of two-tiered taxation. Payments of deductible amounts from a taxable corporation to domestic individuals, or funds owned by such individuals, erodes the corporate tax base. Payments to pension funds, endowments, public and private foundations, etc. erode the taxable base altogether. The former may be rationalized to some extent as an inherent structural exception to a strict double taxation system, though in the context of closely held companies it can border an elective self-help. The latter may be rationalized as achieving certain commonly accepted societal and governmental objectives (e.g., subsidizing pensions, charitable organizations, educational institutions, etc.).

In a cross-border context as well there are certain considerations that would argue for restraint in limiting deductions, including international norms represented by certain provisions in treaties. These are discussed below.

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[40] The 1989 Conference Report, supra, at 568, refers to allowing unlimited deductions for related party interest as permitting "an economic unit that consists of more than one legal entity to contract with itself at the expense of the government."

[41] As to this last, the 1989 Conference Report noted the fact that from a U.S. tax standpoint even unrelated capital providers may be indifferent as to whether the payment is interest or a dividend or may actually prefer interest (e.g., to avoid withholding tax). On the other hand, while not noted in the 1989 Conference Report, it is also the case that unrelated capital providers generally would prefer to hold debt from a commercial standpoint, and related capital providers often would prefer to receive dividends from the standpoint of their home country taxation.

[42] Congress opted to not recharacterize the nondeductible interest payments as dividends. Compare IRC §163(e)(5). (treating certain payments on "applicable high yield debt instruments" as dividends for certain limited purposes). IRC §163(l) (simply disallowing the deduction). Recharacterization would have resulted not only in disallowance of a deduction but, in many cases, in additional U.S. withholding tax. It also would have been inconsistent with the concept of carryforward of disallowed interest and excess limitation.

[43] Several jurisdictions, including Canada, France, the United Kingdom and Australia, were referred to in H. R. Rep. No. 101-247, 101st Cong., 1st Sess. 1245 (1989) ("1989 House Report"). Subsequently, various other countries have adopted provisions that address earnings stripping, including, e.g., Denmark, Germany, Japan, Korea and South Africa.

c. Policy Considerations Suggesting Moderation

i. Considerations of conforming to accepted norm of arm's length standard.

Earnings stripping is not a phenomenon unique to the United States. Every country that has an income tax and allows interest expense to be deducted against income is in an analogous position. A number of jurisdictions have enacted rules to prevent excessive earnings stripping. While the laws of a number of other developed countries have earnings stripping rules, they tend to be far narrower in application and operation than the rules contained in the Proposals.

As a general proposition, countries have respected the arm's length standard. This standard is the cornerstone of the approach to transfer-pricing and related party dealings that has been adopted and permitted by the United States. It is in fact the standard referenced by the Congress in 1989 in its articulation of what level of taxing jurisdiction over domestic corporate earnings is "adequate" rather than unacceptable base erosion.[44] We concur, and believe that the scope of section 163(j) ultimately must be defensible under arm's length principles.[45]

In considering which restrictions the United States should place on earnings stripping, the determination may appropriately take into account to what extent the United States should favor policies ceding taxing jurisdiction to the country in which income is derived (source country) as opposed to the country in which the income recipient is resident (resident country). Traditionally, and taking into account arm's length principles, the United States has favored policies that have protected the taxation right of the resident country rather than the source country.[46] Tightening the earnings stripping rules would go the other way.

ii. Considerations of possible retaliation.

A closely related tax policy concern is that U.S. rules governing inbound investment not be perceived as much more restrictive than the laws of our major trading partners. As noted above, the earnings stripping rules do not operate in a vacuum. Currently, U.S. multinationals are able to strip earnings liberally from the tax base of many foreign countries. There may be more at stake in this context even than the enactment and/or tightening of foreign provisions corresponding to section 163(j).

[44] 1989 Conference Report, supra, at 569.

[45] As discussed in part 8.b. below, we note that the concept of arm's length can accommodate a range of interpretations and can be reconciled with the policy objective described above at part 6.b, that taxpayers not have unfettered selectivity in which jurisdiction to pay taxes on business income.

[46] See, e.g., Office of Tax Policy, Department of Treasury, Selected Tax Policy Implications of Global Electronic Commerce (November 1996); Letter from Secretary of Treasury James A. Baker to Chairman of the House Committee on Ways and Means Daniel Rostenkowski dated August 1, 1986, 86 TNT 152-6 (rejecting initial earnings stripping proposals).

iii. Considerations of inbound investment.

Another concern is the ability for taxpayers to "migrate" businesses and jobs. Just as U.S. multinationals have been able to structure their operations so that the activity and functions, and hence, the profit, left in high-taxed jurisdictions generally is relatively small, so a reasonably expected behavioral change among non-U.S. taxpayers confronted by overly restrictive earnings stripping rules could be a reluctance to locate their non-routine profit activities in the United States. A possible alternative modus operandi would tend more towards low margin stripped down distributorships and contract manufacturers. It also could be expected that the prices foreign persons are willing to pay for existing U.S. businesses would be reduced. The existence and impact of such phenomena is appropriate for Treasury study.

iv. Tax treaty considerations.

As noted, the Proposals represent an increased departure from general arm's length pricing principles. For that reason, to a significantly greater extent than the original earnings stripping rules, the Proposals may stand in conflict with existing tax treaty obligations of the United States. A policy consideration in the past has been that income tax treaties not be overridden lightly. These issues are discussed in greater detail in part 8 of this report.

v. Considerations of overbreadth.

A further policy question regarding the Proposals is whether their approach is overly blunt in respect of the targeted abusive earnings stripping transactions. To the extent the Proposals broaden the reach of section 163(j), they increase the situations in which legitimate deductions are denied. In addition, as does existing section 163(j), the Proposals would operate broadly to deny interest deductions in the United States regardless of how the relevant interest payments are taxed in the jurisdiction of the foreign affiliate or other party that receives the interest (i.e., even if interest paid from the United States generates corresponding taxable income in another high tax jurisdiction). We note that an effect of this approach is a risk of double taxation.

vi. Considerations of complexity.

The extremely burdensome and possibly compliance-proof nature of the worldwide limitation of the Bush Proposal and the additional complexity of the multiple-ratio debt-to-asset safe-harbor is another major concern. Many in the tax bar have been engaged in ongoing efforts to reduce existing complexity in the tax system as well as questioning nonessential compounding of the problem. We have discussed this issue in greater detail as appropriate in part 3 of this report.

7. Guaranteed Loans

a. History of Section 163(j) Guarantee Provision

When Congress enacted section 163(j) as part of the 1989 Revenue Reconciliation Act, the statute did not address third-party loans guaranteed by related tax-exempt entities. Section 163(j)(7)(A), however, authorized anti-avoidance regulations. The 1989 House Report

indicated that the committee intended to treat interest payments from a loan to a U.S. corporation that is "guaranteed by a foreign related party, or otherwise is not based solely on the credit of the U.S. corporation," as disqualified interest.[47]

The 1989 House Report's proposed treatment of guarantees was criticized by commentators as overly broad and unworkable.[48] The 1989 Conference Report noted that arguments were made that "the House [R]eport's discussion of parent-guaranteed debt would potentially have made ordinary third-party financing transactions subject to the disallowance rule, in view of the common practice of having parents guarantee the debt of their subsidiaries in order to reduce the cost of third-party borrowings." Reflecting these concerns, the Conference Report stated:

> The conferees intend to clarify that the provision is not to be interpreted generally to subject third-party interest to disallowance under the rule whenever such a guarantee is given in the ordinary course. On the other hand, the conferees do not intend to preclude Treasury from disallowing interest on a guaranteed third-party debt, in appropriate circumstances where the use of guaranteed third-party debt is a device for avoiding the operation of the earnings stripping rules, just as Treasury is not precluded from disallowing interest on a back-to-back loan.

The Proposed Regulations issued under section 163(j) in June 1991 "reserved" on the treatment of guarantees and back-to-back loans.[49]

Despite the concerns expressed by the Conference Committee in 1989, the 1993 Revenue Reconciliation Act expanded section 163(j) to include guaranteed loans. For taxable years beginning after December 31, 1993, interest paid on a loan from an unrelated party is treated under the earnings stripping rules as interest paid to an exempt related party if: (1) no gross-basis tax is imposed on the interest; (2) a person related to the debtor guaranteed the loan; and (3) the related person that guaranteed the loan is either exempt from U.S. income tax or is a foreign person.[50] These guarantees are broadly defined as "disqualified guarantees."

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[47] H.R. Rep. No. 101-297, 101st Cong., 1st Sess. 1242, 1245 (1989) ("1989 House Report").

[48] See letter from William L. Burke on behalf of New York State Bar Association to Sen. Bensten (D. Tex.), reprinted in 45 Tax Notes 907 (Nov. 13, 1989). The letter listed the following potential detriments of the proposed guarantee provision: the provision would "apply to many everyday commercial transactions having no 'dividend stripping' aspects whatsoever; be even more discriminatory against our foreign treaty partners than …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."

[49] Prop. Treas. Regs. §163(j)-9. No administrative guidance has been promulgated in respect of the scope of the guarantee provision or back-to-back loans (through in respect of the latter both the preamble to the Proposed Regulations and the 1989 legislature history (1989 House Report, supra, at 1246) refer to the principles reflected in Revenue Rulings 84-152, 84-153, and 87-89).

[50] IRC §163(j)(3)(B) and §163(j)(6)(D). Regulatory authority is provided to except a guarantee by a foreign person to the extent the foreign person would have been subject to net basis tax on the interest or the taxpayer owns a controlling interest in the guarantor. IRC §163(j)(6)(D)(ii).

Several reasons for the 1993 legislation were articulated.[51] The House Ways and Means Committee noted a basic concern that borrowing from an unrelated party with an affiliate guarantee may be "borrowing on the credit" of the affiliate and a "substitute for" a direct loan from the affiliate that may have "little economic consequence" and with respect to the form of which both lenders and borrowers may be "indifferent." The Committee felt that the same "objective" standard should apply to guarantees as to direct loans. The Committee further reasoned that not respecting the borrowing as traceable to the domestic borrower was consistent with the nontracing approach taken with respect to the allocation and apportionment of interest expense, both in the case of foreign corporations conducting a U.S. trade or business (Treas. Regs. 1.882-5) and for foreign tax credit sourcing purposes (Treas. Regs. §1.861-9T). Finally, with respect to why an exception for borrowing from net basis U.S. taxpayers was not made, the Committee noted that taxation of the payee was not relevant to proper measurement of the obligor's income. Further, in this regard, a concern about possible conduit arrangements was noted, as well as a concern about base erosion (the latter because the unrelated financial intermediary might pay U.S. tax on relatively little of its gross interest income).[52]

Section 163(j)(6)(D)(iii) defines "guarantee" broadly 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," unless otherwise provided in regulations. The 1993 House Report stated that "guarantee" is to be interpreted broadly enough to include any form of credit support by a related party:

> This includes a commitment to make a capital contribution to the debtor or otherwise maintain its financial viability. It includes an arrangement reflected in a "comfort letter," regardless of whether the arrangement gives rise to a legally enforceable obligation. If a guarantee is contingent upon the occurrence of an event, the provision would apply as if the event had occurred.[53]

b. Observations

The guarantee provision was adopted as a backstop to the basic earnings stripping limitations on direct loans from foreign related parties. Although interest on the guaranteed debt is paid to an unrelated lender, the debt may in certain circumstances serve as a substitute for a direct loan from the foreign parent to the U.S. subsidiary, which itself would have been subject either to full (30%) U.S. withholding tax or to the earnings stripping provisions of section 163(j).

The provision, however, has drawn fire since its inception. Apart from possible concerns in certain situations under debt-equity and conduit principles, discussed below, a

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[51] H.R. Rep. No. 103-11, 103d Cong., 1st Sess. 249 ("1993 House Report").

[52] On the other hand, no such considerations are taken into account on the face of the statute if, e.g., a highly leveraged foreign affiliate receives interest effectively connected with a U.S. business (e.g., a U.S. branch of a foreign bank) from a direct loan to a U.S. affiliate. Under certain circumstances, however, the arrangement might be treated as a back-to-back loan, based on the legislative history. See note 49 supra.

[53] 1993 House Report, supra note 51, at 249.

guaranteed loan is less likely to pose the classic earnings stripping problem. The lender is an unrelated party, and a multinational group is not motivated to maximize the interest it pays to unrelated creditors. Further, a guaranteed loan from a financial intermediary does not increase base erosion as compared with a nonguaranteed loan from a financial intermediary. In fact, one of the principal motives behind guaranteed debt is to reduce the borrower's interest rate.

In a typical bank borrowing by a subsidiary in a group of related corporations, the lending syndicate requires as a matter of course a guarantee from the parent company. The reasons generally do not include a belief that the subsidiary cannot service the debt but rather, primarily, a desire to have the entity that has a credit rating from rating agencies be a guarantor, and in addition, a preference to have all available resources behind the borrowing and considerations of general institutional policy. Similarly, when debt is placed in the public markets or "qualified institutional buyer" markets, the underwriters typically require that the rated parent company be a guarantor or co-obligor as a condition to taking the paper to the market. From the standpoint of the borrowing group, the benefit is an acceptable cost of funds.

As discussed below, we believe that the guarantee provision under current law raises policy questions when the potential for abuse is compared with the intrusion on nonabusive commercial arrangements, and that it is appropriate to revisit the guarantee rule in connection with the proposed expansion of section 163(j) under the Proposals. Our belief in this regard was reached prior to release of the Thomas Bill and the Hatch Bill which would (in very different ways) address the guarantee provision, and accordingly, our views are expressed more generally than with respect to those particular proposals.

i. Debt-equity principles.

A guaranteed loan may raise the question whether the loan is properly classified as equity under debt-equity principles, if considered on a stand-alone basis, without the guarantee. In cases where such reclassification applies (e.g., where an under-capitalized U.S. subsidiary is involved), the unrelated lender may be considered to have made the loan to the foreign shareholders, who in turn passed the funds to the U.S. subsidiary as a capital contribution. Payments by the U.S. subsidiary to the unrelated foreign party would serve to discharge obligations of the foreign shareholders to the unrelated lender and thus would be nondeductible disguised dividends generally subject to U.S. withholding tax.

The leading case dealing with recharacterization of guaranteed debt as equity is Plantation Patterns v. Commissioner.[54] The Plantation Patterns analysis is primarily a factual inquiry regarding who is the actual borrower. Where a corporation is undercapitalized and cannot reasonably be expected to meet its interest and principal obligations under a purported loan from an unrelated lender guaranteed by its shareholder, such that the lender ultimately looked to the shareholder guarantor for repayment, the guaranteed loan may be reclassified, for

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[54] Plantation Patterns, Inc. v. Commissioner, 462 F.2d 712 (5th Cir. 1972), cert. denied, 409 U.S. 1076 (1972). See also Casco Bank & Trust Co. v. United States, 544 F.2d 528 (1st Cir. 1976), cert. denied, 430 U.S. 907 (1977), and cases cited therein; In re Lane, 742 F.2d 1311 (11th Cir. 1984) (guaranties used as "substitutes for infusion of more capital").

tax purposes, as a loan to the shareholder followed by a contribution of capital by the shareholder to the corporation.[55]

This case law is applicable whether or not section 163(j) potentially applies to a loan. In our experience, in view of the potentially disastrous consequences of recharacterization in cross-border situations, most taxpayers structure their relevant financings so as to avoid serious risk of reclassification as equity. On the other hand, the fact that the obligation is likely classified as debt still leaves the question whether the amount of the debt is excessive from the standpoint of earnings stripping considerations.

ii. Conduit (accommodation party) principles.

A third party loan to a domestic subsidiary that is guaranteed by a tax-exempt affiliate potentially raises concerns of a nature similar to those underlying certain authorities addressing conduit financing arrangements. For example, if a financial institution makes a loan to a domestic corporation that is affiliated with a foreign person and the loan is guaranteed by such foreign affiliate, the situation can be analogized to the situation where the foreign person makes a deposit with the financial institution that in turn makes a loan to the domestic corporation. In fact, if the foreign person actually made a deposit, the arrangement might be treated as part of a back-to-back loan arrangement described in Rev. Rul. 87-89 (referred to in the legislative history to the 1989 Act[56] as a relevant standard) if the financial institution's loan would not have been made on substantially the same terms without the deposit. Additionally or alternatively, if there would be any right of setoff, the arrangement would be covered under the guarantee provision.[57] Whether an actual deposit exists or not, the unrelated lender may in certain circumstances be acting as a surrogate for the foreign affiliate in advancing funds to the U.S. subsidiary.

Treasury regulations issued in 1995 regarding conduit financing arrangements for withholding tax purposes also address the deposit situation. If a deposit and a loan are independent transactions such that the loan from the unrelated party would be made on substantially the same terms irrespective of the deposit, the loan to the U.S. subsidiary would be respected as made by the unrelated financial institution.[58] A similar test is incorporated in the guarantee proposal of the Hatch Bill (discussed below).

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[55] Plantation Patterns, Inc., 462 F.2d at 721-722. This case involved a quite egregious fact pattern, resulting in total recharacterization of the loan. It is not clear whether, in a less egregious case, partial reclassification (a bifurcated approach) would be taken.

[56] 1989 House Report, supra, at 1246.

[57] In theory, if one test is met, the other should be, and vice versa. The phrasing of the "substantially the same terms" test presumably was an attempt to determine from objective evidence whether there was a subjective intent to allow setoff (soft guarantee).

[58] Treas. Reg. §1.881-3(a)(4)(i). Accord, Rev. Rul. 87-89. Cf. Treas. Reg. §1.904-5(c)(4)(ii) (similar test under look-through rules for section 904(d) separate limitation categorization).

iii. Examples.

Two fact patterns may be considered in connection with a loan to a U.S. corporation by an unrelated party that is guaranteed by an affiliate of the US borrower.

> Case 1: Foreign affiliate ("FA") has funds on hand and instead of lending the funds directly to its U.S. affiliate ("US") deposits them in a financial institution ("Bank").[59]
>
> Case 2: FA does not have funds on hand (and so the arrangement represents a net borrowing to the group as a whole).

In case 1, the presumed concern is that the arrangement economically is a direct loan by FA to US and hence may result in a higher amount of debt at the level of US than if the loan were directly to US from Bank with no guarantee, for two reasons. First, the loan is based in part on FA's credit and so might be excessive in a debt-equity sense. This issue is referred to in the 1993 House Report.[60] Second, to the extent the ability to make a deposit with the lender can eliminate third party borrowing costs, the arrangement might be viewed as the economic equivalent of a direct loan and so as facilitating a shift of earnings from one pocket to another (via Bank as a conduit) in order to reduce the U.S. tax base (the "push-down" issue).

Case 2 might be viewed as if FA is in effect acting as an intermediate borrower and relender in respect of the Bank loan to US. Even viewing FA as a conduit, case 2 would have one of the issues of case 1, namely that FA's credit is available to support the loan and hence there is not a market constraint limiting the amount of the loan by reference to US's credit. Further, since whether to leverage is to some extent discretionary, case 2 might be viewed as if FA had incurred the debt for its non-US operations and freed up internal cash to lend to US, and in that somewhat stretched sense described as shifting earnings from one pocket to another.[61]

Of the two concerns above, the true borrower issue (debt in excess of borrowing capacity) is theoretically a valid concern. On the other hand, as noted above, taxpayers in a cross-border context typically are careful to not stray too close to the line, and it is questionable whether the debt-equity distinction, which looks to the outer limits of the enterprise's borrowing power, would alone justify a radically different, formulary approach (not tied to whether there actually is excessive borrowing) in the section 163(j) context than in other contexts.

With respect to the push-down issue (whether "too much" debt is being incurred by US vis-à-vis FA), construing case 1 as a deposit by FA and a lending by Bank to US

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[59] This might or might not be the same entity that lends to US but, if not, assume that the actual lender is guaranteed by FA.

[60] The 1993 House Report refers to an objective of preventing circumvention of section 163(j) "through the device of borrowing on the credit of persons whose assets are outside of U.S. taxing jurisdiction."

[61] The 1993 House Report itself refers to the flexibility of an affiliated group as to its sources and uses of funds and the fungibility of money. The 1993 House Report for that reason found the nontracing approach taken for allocation and apportionment of interest expense, both in the case of foreign corporations conducting a U.S. business and for U.S. foreign tax credit sourcing, to be instructive.

(essentially, Bank acting as a conduit) creates a situation analogous to the direct loan situation in which the FA-US group might be viewed as shifting funds from US to FA. The two situations, however, are economically very different. FA's advance to Bank generally would earn a lower rate than Bank's loan to US. This may occur because, e.g., Bank is a higher rated entity than FA and/or the advance to Bank is in the form of a short-term deposit, or simply because the Bank wishes to earn a spread. Also, since the interest expense of US would only be at the rate at which FA could borrow, assuming no guarantee fee is imposed, there would be no concealed dividend included in the interest expense.

Suppose, for example US would have to pay 8% (all percents are per annum) to borrow from an unrelated party without an FA guarantee but could borrow at 6% with an FA guarantee, and FA can earn 5% on a deposit with Bank. Assume US can benefit from a federal and state deduction at an effective rate of 40% but that all interest expense in question would be disallowed if section 163(j) applied. Assume further, for simplicity and to illustrate the most extreme case, FA is eligible for 0% withholding under a U.S. income tax treaty but is subject to no tax on income received.

In the absence of section 163(j), a direct loan would "earn" the group after tax 3.2% (US tax savings on 8% interest). A deposit by FA with Bank and loan by Bank to US at parent's borrowing rule would earn the group, in the absence of section 163(j), after-tax 1.4%, as follows: 5% on deposit minus 3.6% after-tax cost of US borrowing.

If section 163(j) applies, a direct loan of the funds by FA to US would leave the group flat (no income, no expense and no tax deduction). A guaranteed loan subject to section 163(j) would be even more costly. On the other hand, a loan from Bank to US without a guarantee (but assuming the same 5% return on the funds of FA) would earn the group 0.2% after-tax, as follows: 5% income on funds of FA minus 4.8% after-tax cost of loan from Bank to US.

The taxpayer in this case has the choice of having US borrow from an unrelated party and claiming a U.S. tax deduction for the interest expense, or subjecting itself to the consequence of section 163(j). On the facts above, it would choose the former, costing the US fisc 3.2%.[62] If section 163(j) were inapplicable to the guaranteed loan, the arrangement would cost the US fisc only 2.4%.[63] Thus, the effect of the guarantee provision in this example is a cost to the U.S. fisc of 1.2%.

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[62] The example assumes, as in fact the drafters of the guarantee provision have, that even if Bank is a U.S. financial institution, the small amount of spread and the nature of the funding sources would mean little or no U.S. tax collected on the interest income of Bank.

[63] If the fact that, in the absence of section 163(j) the amount of debt between FA and US would be higher (motivated perhaps by the greater benefit), the relative advantage to the U.S. fisc would be diminished. This would seem very unlikely, however, since there would be a benefit, especially as compared with equity funds, even with section 163(j).

If FA were required to pay tax at a 20% rate in its place of residence instead of 0% as assumed above, it would even more likely make the same choice.[64] Thus, the effect of section 163(j)'s application to a guarantee in this situation is actually revenue negative.

In a case 2 net traceable borrowing situation in its purest form (i.e., where the only effect of the arrangement from a section 163(j) standpoint is credit support for Bank's loan to US), in the absence of section 163(j) the arrangement would cost the group after-tax 3.6%; with section 163(j) applicable, it would cost the group 6%; whereas an unguaranteed loan would cost the group 4.8%. Again the result of section 163(j)'s applicability is reductive to the US fisc (3.2% vs. 2.4%), as the taxpayer would borrow directly on an unguaranteed basis rather than on a basis where section 163(j) would apply.

What the above examples illustrate is that, taking into account the effect of the guarantee provision on taxpayer behaviour, at least in certain circumstances that do not seem unusual, the provision may be reductive rather than accretive to the US fisc. The taxpayer would find it advantageous on an after-tax basis to borrow without a guarantee.

iv. Nondiscrimination.

As discussed in part 8.b below, the guarantee provision raises particular issues in connection with nondiscrimination provisions under bilateral income tax treaties. Of course, the provision may override many such provisions under the "later in time" rule and may be argued to have been accepted as valid by treaty partners in certain other cases.[65]

v. Comments on guarantee provision and proposed changes thereto.

We believe that the merits of the guarantee provision, when weighed against the situations in which it operates unfairly because of the non-tax commercial motivation of many guarantees, should be reevaluated.

As discussed above, we believe that the tax law outside of section 163(j) adequately addresses general concerns of debt versus equity classification. With respect to whether the amount of debt is excessive (push-down issue), we question whether the provision results in revenue gain rather than revenue loss to the U.S. fisc. Taking those considerations into account, the approach taken in the guarantee provision appears to be unnecessarily broad. For example, section 163(j)'s sweeping inclusion of all guarantees by a related foreign party, including guarantees of, e.g., all traded debt, seems unnecessary.

The Thomas Bill would favor related party guarantees over related party loans by allowing a substantially higher adjusted taxable income limit for the former. The approach apparently reflects the view that related party guarantees as a rule are less of a problem than

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[64] Bank's nonguaranteed loan to US would cost the group after-tax 0.8%, as follows: 4% after-tax income on FA's funds, minus 4.8% after-tax cost of loan. A direct loan by FA to US would cost the group 1.6% (i.e., 20% of the 8% rate on a no guaranteed loan to US).

[65] Such an argument might be made by the U.S. tax authorities on the basis that Treasury's Technical Explanation with respect to various treaties refers to section 163(j).

related party loans, but nevertheless not deserving of a total exemption. The rationale underlying this treatment has not been articulated.

The approach, however, is not without merit. First and foremost, it would be simple to administer, creating a black and white test (subject to a possible antiabuse rule, as discussed below). Further, the test would not permit open season to have any amount of debt guaranteed, since the limits of the debt-equity case law (e.g., the Plantation Patterns line of cases) would have an in terrorem effect. Finally, the approach would not eliminate the earnings-stripping restrictions but rather merely preserve the status quo for loans guaranteed by a related party. Accordingly, the approach can be understood as an administratively straightforward compromise.

We do note, however, that there would undoubtedly be attempts to restructure from direct loans into guaranteed loans in certain circumstances. We expect that these would tend to involve companies without a public debt rating, for reasons noted above. In any event, while infringing somewhat on the simplicity of the proposal, we believe that a narrow but effective antiabuse rule would be appropriate if the Thomas proposal were adopted.

The Hatch Bill would provide relief for guaranteed loans in fewer cases that the Thomas Bill, namely, only when the "independent borrowing" test could be met, but the relief provided would be complete exemption from section 163(j). On examination, we believe that this approach on balance would be preferable to that of the Thomas Bill. The approach of focusing on cases that are nonabusive and completely exempting them from section 163(j) obviously has much to commend. The flip side of the coin is that the cliff effect of an all or nothing approach would tend at the margins to create pressure given the factual nature of the test (but the cliff is fairly steep under the Thomas Bill as well, where the test is form-driven).

If the basic test is whether the taxpayer has the ability to borrow on substantially the same economic terms without the guarantee,[66] then, if that standard can in fact be applied, the concerns expressed in the 1993 House Report and recited above should be allayed. Assuming such a test were met, the taxpayer would by definition not be borrowing on the credit of the foreign affiliate. Further, if the guaranteed loan is on substantially the same economic basis as a nonguaranteed borrowing, it would be inappropriate as a matter of tax policy to treat the arrangement differently than a nonguaranteed loan to the taxpayer. Under such circumstances, a nonguaranteed loan, rather than a loan from the foreign affiliate, is the surrogate to be referenced in determining the appropriate tax treatment. Under such circumstances, if the taxpayer opted for a guaranteed loan, a significant reason would not be a U.S. tax advantage, as that could be obtained through a direct loan, which, as assumed, could have been secured on substantially the same terms.

The significant negative features of the Hatch proposal are that, first, it may not be so clearly determinable whether the test in fact is met and second, trying to determine whether

[66] This would be a stricter test than simply the ability to borrow without regard to the terms. The latter is the "true debt" test of Plantation Patterns and its progeny, and accordingly reciting it as a test simply would codify the debt-equity case law in this area.

the test is met could in many cases be time-consuming and resource-demanding.[67] These issues could be partially addressed through appropriate administrative or regulative guidelines and presumptions. For example, given that a major reason for a guarantee is that the guarantor often is a rated entity, and given that, for credit rating purposes there is an enormous difference between a direct loan and a guaranteed third party loan (such that the loans are by no means equivalent from the borrower's standpoint), the fact that the guarantor is rated could be made a positive factor and, conversely, the fact that the guarantor is not rated could be made a negative factor. Similarly, a favorable opinion from an appropriately qualified investment banking firm could create a favorable or even conclusive presumption that the taxpayer could have borrowed independently on substantially the same terms.[68] In any event, we believe that it would be feasible to administer a test of this sort.

8. Treaty Issues

a. Relevance of the Arm's Length Standard to the Proposals

The Proposals raise issues in respect of bilateral income tax treaty obligations similar to those raised in connection raised by existing section 163(j). Although the issues are similar the conclusions that may be drawn are not necessarily the same.

Section 163(j) is at ground zero in the tug-of-war that surrounds cross-border transactions. Its principal application is where the rate of interest withholding has been reduced by bilateral income tax treaty.[69] Hence, tax treaty implications are directly relevant to any serious consideration of the provision, as Treasury and Congress recognized in 1989.

The principal purpose of bilateral income tax treaties, generally set forth in the very name of the treaty, is avoiding double taxation. To that end and as discussed below, modern income tax treaties to which the United States is a party uniformly adopt an arm's length standard for certain related party dealings. Under Article 9 (Associated Enterprises) of the treaties, such dealings include the amount of debt as opposed to equity funding of a company.[70]

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[67] Such considerations apparently motivated Congress in 1993 to reject the approach that a guaranteed loan is treated as a direct loan if the guarantee arrangement involved a principal tax avoidance purpose.

[68] Note that the fact that the evidence would tend to include an expert opinions (judgment of a qualified independent party) does not mean that the test would be subjective rather than objective.

[69] In limited situations, it can also have relevance where interest withholding is eliminated under the portfolio interest exemption. See IRC §§871(h), 882(c). It generally would not be relevant to domestic tax-exempt entities that directly own an interest in the corporation (but would, as noted above, be relevant where the tax-exempt entity invests in a partnership that holds more than 50% of the corporation). See IRC §513(b)(13), as amended in 1997. See note 81 infra.

[70] Curiously, a similar approach is not followed with respect to the extent to which a taxpayer can determine to license intangibles for a royalty rather than contribute the intangibles, or provide expert services for a management fee rather than contribute the service providers and know-how. Whether cash is contributed or lent could be viewed analogously to whether an intangible is contributed or licensed. No doubt the fungibles of cash as compared with, e.g., an intangible, is a large part of the reason for a distinction.

In theory, if the arm's length standard is adhered to with respect to debt-equity issues in a treaty context, the results should be acceptable to the respective Contracting States.[71] Certain considerations may cause that to not always be the case:

- "arm's length" may encompass a wide range
- some Contracting States have lower tax rates than others
- some Contracting States have more effective CFC rules than others.

There is an argument that these considerations should not be relevant. To the extent that countries choose to enter into bilateral income tax treaties, they do so on the basis that cross-border investment flows should be encouraged much like domestic investment flows.[72]

To the extent, however, that such or similar factors are taken into account and cause a departure from arm's length standards, they are inconsistent with and stand in opposition to the objectives of the treaty.[73] The Proposals would move the fulcrum and suggest the need for a reappraisal. Section 163(j), as proposed to be amended, must be evaluated against the arm's length standard, i.e., at what point does the inconsistency become too great.[74] More specifically, the results that would be produced under the Proposals should be tested against arm's length results to avoid excessive divergence. The exercise should not consist merely of identifying certain principles that may be abstractly applied without regard to the actual results in typical situations. Accepting for present purposes the statement of the 1989 Conference Committee that existing section 163(j) represented an attempt to find an arm's length formula,[75] a change that results in greater disallowance would on its face seem suspect.[76]

At one level these concerns could be dismissed simply as involving treaty obligations that can be overridden. While that is true as a matter of law under the U.S. "later in time" rule, such action by definition involves a policy tradeoff that may have a variety of consequences that need to be considered. Further, the arm's length standard is an overriding principle of U.S. income law generally, wholly apart from treaty considerations. If that is not the standard that should be applied, then the standard of what is in essence an antiabuse provision would be established without guideposts defining abuse.

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[71] See, e.g., OECD Committee on Fiscal Affairs, Thin Capitalization Report (Paris 1987) at par. 72 (hereafter, "OECD Thin Capitalization Report").

[72] A similar but more far-reaching thesis underlies the EC freedom of establishment clause that has been the subject of recent litigation. See part 8.b v. below.

[73] This is the case even though actual double taxation may be controlled to some extent by behavioural changes.

[74] Accord, 1989 Conference Report, supra, at 568-69; OECD Thin Capitalization Report, supra, par. 79 ("[t]he lower the ratio of debt-to-equity permitted by [a fixed] rule, the more serious may be the danger of producing a result which is … inconsistent with the arm's length principle….").

[75] 1989 Conference Report, supra, at 568-69.

[76] Further, as noted above, it is not obvious that considerations of protecting the tax base would justify a limit for foreign enterprises that is lower than for domestic enterprises.

b. Nondiscrimination

The other, and related, limitations relevant to earnings stripping to which the United States and other Contracting States typically subject themselves in bilateral income tax treaties are expressed in the Nondiscrimination article of such treaties.

i. General.

Article 24(3) of the United States Model Income Tax Convention of September 20, 1996 ("U.S. Model Treaty") states in pertinent part as follows:

> Except where the provisions of paragraph 1 of Article 9 (Associated Enterprises), [or] paragraph 4 of Article 11 (Interest)…apply interest…paid by a resident of a Contracting State to a resident of the other Contracting State shall, for the purpose 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 State.[77]

The 1989 Conference Report argued that section 163(j) does not violate the nondiscrimination provisions of U. S. treaties. One reason given was that section 163(j) treats similarly situated persons similarly (even though no such concept of "similarly situated" appears in the treaty provision). For the purpose of determining which persons are similarly situated, the 1989 Conference Report used as the objects of comparison "persons who do or do not bear U.S. tax on interest income from U.S. corporations,"[78] i.e., domestic tax-exempt organizations. The 1989 Conference Report concluded that section 163(j) is therefore "consistent with the view that payments leaving U.S. taxing jurisdiction may in appropriate circumstances, consistent with treaties, be subject by the United States to tax that would not be imposed on a payment to a U.S. person." For this reason also, "the provision makes no distinction between foreign lenders on the basis of whether or not their interest income is subject to tax in their residence country."[79]

We do not know whether this rationale, which has been much criticized, is considered by some to remain valid. In any event, we note that the comparison called for by Article 24(3) is between the treatment of payments by a person that is a resident of one Contracting State (here, the United States) to, on the one hand, another person that is a resident of that Contracting State and, on the other hand, a person that is a resident of the other Contracting State. To require that such a resident of the other Contracting State also be in effect taxable as a resident of the United States with respect to the income in order to be eligible for protection under the provision is circular and renders the provision meaningless. It would be particularly ironic given that the reason for "inadequate" U.S. taxation is a reduction in withholding rate agreed to elsewhere in the treaty. Drawing such a distinction even in the

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[77] The same provision can be found in many U.S. income tax treaties. See, e.g., Convention for the Avoidance of Double Taxation, U.S.- France, 1994, art. 25(3)(a); Convention for the Avoidance of Double Taxation, U.S.- Germany, 1989, art. 24(3).

[78] 1989 Conference Report, supra, at 568.

[79] Id.

context of related parties is inconsistent with Article 24(3), which clearly applies to related as well as unrelated parties, as the cross-reference to Article 9 makes evident.[80]

Further, a typical resident under a treaty is a person liable for tax in a Contracting State on such person's income regardless of source. Thus, the comparison to a tax-exempt person seems unjustifiable as a matter of textual construction.[81] Moreover, in general, the interest income is subject to tax in the hands of the treaty recipient and in any event is within the taxing jurisdiction of the relevant treaty country. The fact that such tax is not U.S. tax is, in the context of a bilateral income tax treaty, irrelevant.[82]

A second reason that the 1989 Congress cited in support of the consistency of section 163(j) with U.S. treaty obligations is that the provision "sets forth standards for determining thin capitalization in an arm's length fashion."[83] While earnings stripping provisions may not be justified under Nondiscrimination articles on the basis that the interest income is not subject to U.S. tax, we agree that they may be justified on the basis, and to the extent, that they are holding taxpayers to an arm's length result. The cross-reference in Article 24(3) to Article 9 makes clear that divergence between treatment of a resident of a source Contracting State and a resident of the other Contracting State is permitted so long as it tends to reinforce or at least is not inconsistent with arm's length dealing. Stated differently, even if a Contracting State does not require adherence to strict arm's length rules in the case of wholly domestic transactions, the treaty will not prevent it from requiring such adherence in the case of transactions to which the treaty is relevant, but will not allow additional restrictions. Thus, nondiscrimination provisions permit interest deductions in excess of an arm's length amount to be disallowed.

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[80] In addition, Article 24(4) could be cited in support.

[81] See American Law Institute, Federal Income Tax Project, International Aspects of United States Income Taxation II, Proposals on United States Income Tax Treaties (1991), 281. Compare the Lankhorst-Hohorst case discussed at part 8.b.v.

[82] The 1989 premise that a U.S. tax-exempt organization is an appropriate basis for comparison suffers further given subsequent amendments to the unrelated business income tax provisions applicable to tax exempt organizations. Tax exempt organizations generally are subject to tax on interest income from a "controlled entity" under section 512(b)(13) of the Internal Revenue Code. The 80% threshold that originally applied to determine whether an entity is "controlled" for this purpose has, since the original enactment of section 163(j), been reduced to 50%. Accordingly, the threshold for being "related" for purposes of section 163(j) is now the same as the threshold for being "controlled" for purposes of section 512(b)(13) (although there are differences in the applicable attribution rules). Interest paid to a related tax exempt organization therefore would generally not be subject to the earnings stripping rules because the interest would be subject to unrelated business income tax. In general, therefore, U.S. residents subject to the earnings stripping rules are limited to tax-exempt organizations that are partners in a partnership that is at least 10% (by capital or profits interests) owned by such organizations (but which individually own less than or equal to 50%). See IRC §163(j)(4)(B); Prop. Regs. §1.163(j)-2(g)(4).

[83] 1989 Conference Report, supra, at 568-69. The Report noted that the "conferees understand that, on average, net interest payments can generally be expected to be well under the threshold set by the bill." Id.

In the context of thin capitalization, Article 9 would permit the tax authorities to address more than the interest rate. They also could address the capital structure and to what extent deductions should be allowed or interest treated as dividends.[84]

Similarly, Article 11(4) of the U.S. Model Treaty is an exception grounded in arm's length principles, specifically in the context of the reduced withholding rate on interest. Unlike Article 9, Article 11(4) seems to just affect the rate of interest, not the capital structure ("amount of the interest, having regard to the debt-claim for which it is paid").[85] There is a suggestion that the treatment of the payor also could be affected to the extent of the rate adjustment.[86]

As the treaty structural analysis confirms, the compatibility of section 163(j) with Article 24(3) would stand or fall by how it measures up against the arm's length principle. Exactly how that principle should be applied in determining the amount of allowable interest expense, however, is unclear. Whether an instrument is properly classified as debt or equity is determined in the first instance under the law of the source Contracting State,[87] though in theory it might itself be the subject of an arm' length examination even if the same standard is applied domestically as well as cross-border.[88] Assuming an instrument passes muster as debt under general domestic law principles, however, there must be faced the problem that, in applying the arm's length principle, the amount of debt as compared with equity between unrelated parties can be arbitrary and can reflect not just the ability to service debt but also the state of capital markets at the time, the preferences of the issuer, and so forth.

If the measure of arm's length is what amount of debt could be justified if the lender were an unrelated party with no interest contingent upon profit, no control rights and having normal rights of acceleration in the event of default, one would get one answer. This answer would be reached by applying the various debt-equity criteria applicable under U.S. (or either relevant Contracting State's) domestic law to determine whether the amount is debt rather than equity, and then capping the amount by reference to the limits (financial ratios and related acceleration rights) that reasonably would be expected between unrelated parties. The limit would measure what parties are likely to do if the issuer were to attempt to borrow the amount in question in the different debt markets typically tapped by public issuers and ultimately would

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[84] Treasury Technical Explanation, U.S. Model Treaty, commentary to Art. 9.

[85] Accord, OECD Thin Capitalization Report, supra, par. 85(b)(iii).

[86] See OECD Thin Capitalization Report, supra, par. 61.

[87] E.g., U.S. Model Treaty, art. 3(2).

[88] The OECD Thin Capitalization Report (par. 74-79 and 84(c)) states that "national rules on thin capitalisation" are subject to an arm's length standard when applied in a treaty context. The authors of that Report presumably were referring primarily to provisions that limit interest deductions specifically in a cross-border context, whether through a debt-equity ratio or otherwise, rather than to general debt-equity classification rules or rules limiting deductions for domestic as well as foreign taxable entities in certain cases. Of course, however, to take an extreme case, if a country were to simply deny interest expense as a deduction in the case of all taxpayers (e.g., by eliminating the concept of debt for tax purposes), arm's length deductions for interest expense nevertheless would be required to be allowed under a treaty under the principles of this Report to enterprises of another Contracting State.

justify the maximum amount those markets would tolerate. The reference markets could, if appropriate, be defined to exclude certain types of public securities that, in exchange for a higher yield, have reduced creditor rights. This approach thus would apply a multifactor arm's length test by looking at each individual transaction and focusing on the amount that could be borrowed by a corporation with the taxpayer's economic profile from defined categories of unrelated lenders.

If instead the test is what amount of leverage is typically (e.g., on average) found, then one would get a very different answer. Under this approach, an arm's length amount would be determined not by what would be allowed for an individual transaction but by a standard set for taxpayers generally. Such a standard, based on "normally observed patterns," rather than "whether unrelated parties may have entered into a transaction involving the same 'thinness' of capital," was expressly articulated by Congress as an appropriate approach to determining arm's length interest expense between related parties when current section 163(j) was enacted in 1989.[89]

Under this second approach to arm's length, it would be possible to apply either a multifactor analysis or a fixed formula. The OECD Thin Capitalization Report observed that, in the view of the majority of OECD countries, a fixed debt-equity ratio would be compatible with an arm's length standard if it is used as a safe harbor, and not as a maximum, and that otherwise, it "would undoubtedly be inconsistent with the arm's length principle."[90] Congress, of course, adopted a fixed formula in the form of the 50% adjusted taxable income limit in 1989 and a fixed debt-equity ratio as a safe harbor.

Assuming that a fixed ratio or percentage (or ratios or percentages) is a way of approximating arm's length results generally, we believe the formula should be sufficiently permissive to accommodate arm's length results for most taxpayers. That is, the formula should be set so that most fact patterns (not just the average fact pattern) passes muster, and only the "outliers" are affected.[91] To the extent it is not, it may be inconsistent with what U.S. courts have considered treaty-compliant in certain other contexts and hence could amount to a treaty override.[92] A debt-to-asset test, along the lines proposed, would make sense if expressed and applied on a basis that would (i) allow taxpayers to comply and (ii) approximate arm's length results. A choice of book values (appropriately defined) and fair market value, in addition to tax basis, would satisfy such requirements. Similarly, even assuming that nondeductibility of net

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[89] 1989 Conference Report, supra, at 569 ("use of the term 'arm's length' in this context does not mean that the tax treatment of a particular structure cannot be adjusted consistent with a treaty whenever it can be demonstrated that such a structure exists in a situation involving junk bonds and unrelated lenders and borrowers"). The 1989 Conference Report expressly distinguished "ordinary sales or licensing transactions," as to which the conferees thought the normal arm's length analysis was sufficiently protective of U.S. taxing jurisdiction.

[90] OECD Thin Capitalization Report, supra, par. 79.

[91] See also 1989 Conference Report, supra, at 569 (quoted supra at note 74).

[92] See North West Life Assurance Co. of Canada v. Comm'r, 107 T. C. 363 (1996); National Westminster Bank v. United States, 44 Fed. Cl. 120 (1999).

interest expense in excess of 50% of adjusted taxable income is not overly restrictive, that fact says nothing about whether a test based on 25% or even 35% would be too restrictive.

Whether a ceiling based on the leverage of the worldwide group would be justified under an arm's length standard is also open to question. First, the assumption behind the Proposals must be that the non-U.S. part of the group is a proxy for what level of third party debt should be expected for the U.S. business. Whether that is or is not the case, however, would seem to be quite unpredictable. The principal variables affecting the proper level of debt, including strength of cash flow, and nature of the assets, and industry and industry segment of the borrower, and regulatory rules, generally would differ between the U.S. group and the worldwide group. In general, such an approach also would be at odds with the practices of our trading partners, which may be thought of as an international norm. The closest analogue of which we are aware is the approach to interest allocation under the U.S. rules under Treas. Regs. §1.882-5, which, even though only a single corporation is involved, was the subject of complaints by other countries in prior years and in fact has been held to violate the Business Profits article of the 1975 U.S.-U.K. income tax treaty.[93] While the United States has won acknowledgement within the OECD that such an approach is an acceptable approach in the context of one or more permanent establishments of a single corporation,[94] extending the approach to affiliated corporations is a significant conceptual leap.

ii. Summary of the status of the Proposals as compared with existing law.

The Thomas Bill's proposed elimination of a debt-to-equity ratio safe harbor would cause a major change in how section 163(j) should be evaluated from an arm's length and nondiscrimination standpoint. A reasonable debt-to-equity safe harbor would mean that the rules would apply only in relatively highly leveraged situations. In such situations, a government could justifiably question whether the debt is arm's length and, for administrative convenience, have a fixed rule.

The Bush Proposal, relatively speaking, potentially cuts a better figure than the Thomas Bill in so far as it has a safe harbor. It must be questioned, however, whether the safe harbor based on debt-to-asset ratios in the Bush Proposal would sufficiently blunt the challenges to arm's length principles posed by certain other changes proposed to be made under the Bush Proposal, in particular, the worldwide leverage ratio. The latter provision would deny a deduction for interest on indebtedness solely because the worldwide leverage ratio is higher than the leverage ratio for U.S. affiliates, without regard to the absolute level of the leverage. Further, for many taxpayers, it would be impracticable or even impossible to demonstrate worldwide leverage. Thus, inclusion of the worldwide leverage test would significantly weaken the case under arm's length principles and hence under nondiscrimination principles.

If the Bush Proposal as it continues to be considered retains a limitation based on the lesser of a worldwide leverage limitation or a cash flow test, or even if (like the Thomas Bill)

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[93] National Westminster Bank v. United States, 44 Fed. Cl. 120 (1999).

[94] See, e.g., OECD, Committee on Fiscal Affairs, Discussion Draft on the Attribution of Profits to Permanent Establishments, Feb. 8, 2001, revised and supplemented, March 4, 2003.

the limitation is based only on a cash flow test but at a significantly lower percent than the currently applicable 50%, the safe harbor would be critical. We suspect that debt-to-asset safe harbor based on tax basis only could not stand up to that role.

Theoretically, like the debt-to-equity ratio under current law, the proposed debt-to-asset ratios would serve as a threshold test limiting the application of the earnings-stripping rules to situations in which leverage is arguably high. Whether this approach in fact is a meaningful threshold, however, depends first on whether and under what circumstances taxpayers will be permitted to elect to use book values or fair market values of their assets in computing the relevant ratios for the safe harbor. While existing section 163(j) limits taxpayers to tax basis (in the case of domestic subsidiaries), the limitation based on 50% of cash flow means that taxpayers with valuable low basis assets generally do not have to rely on the safe harbor. Second, it depends on the extent to which the permitted debt-to-asset ratios are, at a minimum, not less than the norm for those found in arrangements between unrelated parties. While we are not in a position to form a judgment on the latter question, we do note that the lowest proposed ratio (corresponding to a debt-to-equity ratio of 1-to-1) would allow substantially less leverage than allowed under current law (or, in general, under the laws of our major trading partners).

Even assuming a reasonable safe harbor, if the test applicable where the safe harbor is exceeded is too strict, the safe harbor would in effect operate as a fixed limit, which may itself be inconsistent with arm's length principles, as the OECD Thin Capitalization Report observes.

iii. Application to guaranteed loans.

The 1993 revision to section 163(j) added the guarantee provision. In addition to Article 24(3), Article 24(4) of the U.S. Model Treaty, which in substantially similar form is continued in many U.S. treaties, is relevant in this respect.

> Enterprises of a Contracting State, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State, shall not be subjected in the first-mentioned State to any taxation or any requirement connected therewith that is more burdensome than the taxation and connected requirements to which other similar enterprises of the first-mentioned State are or may be subjected.

The 1993 House Report declared the changes to section 163(j) nondiscriminatory, stating that the provision does not distinguish between U.S. and foreign lenders, because "in either case, deductions can be denied or not depending on the presence or absence of a disqualifying guarantee."[95] The 1993 House Report also stated "different but comparable tax treatment that reflects the different circumstances of foreign-owned and domestic-owned

[95] 1993 House Report, supra, at 249.

businesses does not necessarily constitute discrimination against foreign-owned U.S. businesses."[96]

The Senate Finance Committee acknowledged the relevance of the foreign-controlled enterprise provision in its report accompanying the 1993 legislation.[97]

> The committee understands that the impact of this provision may fall heavily on foreign-based multinational enterprises. … The committee does not believe that the impact of the provision on foreign-owned entities conflicts with U.S. tax treaties.
>
> … . Some U.S. tax provisions under current law affect only foreign-owned U.S. businesses, but these provisions are designed solely to provide comparable treatment for these and other U.S. taxpayers in areas where the fact of foreign ownership interferes with the effective operation of domestic tax rules.

While the statement acknowledges the relevance and validity of the nondiscrimination principle, it works from the premise that departures from that principle are needed to permit the "effective operation of domestic law" without external interference. Accordingly, the report notes "the committee believes that the provision does not inappropriately subject similarly situated persons to dissimilar treatment."[98]

As in the case of direct loans, so in the case of guaranteed loans the rationale is based on the fact that the related party is not paying any U.S. tax on the interest income. As noted in part 7.a above, Congress considered the guarantee provision a backstop to the direct loan provisions, added in order to prevent abuses.

As discussed above, we do not believe that U.S. taxation per se is a relevant criterion under the treaty (and would be a particularly ironic focus, where there is a reduction in withholding tax by reason of a treaty concession). In addition, the fact that the guarantee provision also, in theory, applies to domestic tax-exempt entities providing loan guarantees does not justify its imposition on foreign related party guarantors.[99] Thus, we believe the provision would pass muster under Article 24(3) at most to the same extent as in the case if direct loans,

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[96] Id.

[97] Id.

[98] Id.

[99] Even if the fact that a foreign lender may not have to pay U.S. tax on interest received from U.S. corporations (and therefore, strictly from a U.S. domestic law perspective would be comparable to a U.S. tax-exempt entity on interest income) were relevant in the case of a direct loan (and we do not believe it is), it is less relevant here. If the guaranteed loan is properly the debt of the U.S. affiliate, the foreign related party that does no more than guarantee the loan receives no payments (actual or deemed) from the underlying debt it guaranteed, and tax-exempt status is beside the point. The section 163(j) guarantee provision in fact applies to loans made by lenders who may be subject to U.S. tax on the receipt of interest payments. If, however, the foreign affiliate places a deposit with the actual lender or otherwise engages in a back-to-back arrangement, then the situation would be analogous to a direct loan. See Treas. Reg. §1.881-3.

i.e., only to the extent the arrangement results in a borrowing that permits interest deductions in excess of an arm's length amount.

As noted above, Article 24(4) of the U.S. Model Treaty also is relevant to guaranteed loans. The question is whether the guarantee provision imposes on a foreign-owned enterprise more burdensome taxation (or a connected requirement) than is applicable to an "other similar" domestic enterprise. Implicit in this test is that the taxation or requirement has some connection with the foreign ownership.[100] A threshold issue is how direct and invariable that connection must be. In our view, the mere fact that there may be instances when the taxation or requirement is or in theory could be imposed on a U.S. corporation that is not foreign-owned (e.g., if a U.S. subsidiary's debt were guaranteed by a foreign sister company and both entities are owned by a U.S. parent company) does not defeat a connection if the connection is present in the substantial preponderance of cases. In the context of the guarantee provision, the connection is very close. As noted in part 7.b of this report, lenders look for a guarantee by the group parent, which is almost invariably the rated entity in the group. Instances of a guarantee instead by an affiliate that does not directly or indirectly control the U.S. subsidiary would be relatively remote. Under these circumstances, we believe that the requisite connection between the taxation and the foreign ownership is likely to be present.

A second issue is the meaning of "similar" enterprise. In the case of a foreign parent corporation that provides a guarantee in favor of its U.S. subsidiary, the comparison under Article 24(4) should be with the case of a taxable U.S. parent that provides a guarantee to its domestic subsidiary. The section 163(j) guarantee provision imposes additional limitations on the deductibility of interest payments made by a foreign owned U.S. corporation which as a matter of market practice must have its debt guaranteed by the group parent, as compared with a domestically owned U.S. corporation. To say the former is not a "similar enterprise" within the meaning of Article 24(4) because it is owned or controlled by a person that is not subject to U.S. tax as a resident, as does the 1993 legislative history, would be circular and would make the treaty provision meaningless.

The guarantee provision clearly results in a more burdensome taxation requirement. A non-U.S. multinational's U.S. operations would be obligated to borrow at a higher interest rate without a parent guarantee in order that its interest deduction would not be subject to the limitation, placing a non-U.S. multinational's U.S. operations at a competitive disadvantage to its U.S. competitors. Further, unlike Article 24(3), Article 24(4) does not on its face permit discrimination that is consistent with requiring arm's length dealing, though we would find if consistent with the intent of the provision to infer such an exception.

It follows from the above that the guarantee provision would seem to be inconsistent with the treaty proscription against imposing more burdensome requirements on domestic entities owned by residents of other Contracting States.

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[100] See Square D Co. v. Comm'r, 118 T.C. 299 (2002).

iv. U.S. court decisions.

Treaty non-discrimination provisions have only infrequently been addressed in U.S. courts. The taxpayer in a recent case was unsuccessful, though the grounds in that case did not fit easily into the language or purpose of the Nondiscrimination article and the decision in any event was based on the "later in time" rule. See American Air Liquide, Inc. v. Comm'r, 2002-2 USTC ¶ 50,628 (9th Cir. 2002), aff'g 116 T.C. 23 (2001) (prospective effective date of Treas. Regs. §1.904-4(b)(2), which in certain circumstances would permit royalties derived by a U.S. subsidiary of a foreign company in respect of licenses to that company to qualify as general limitation rather than passive income royalties but only for royalties paid or accrued more than 60 days after the final regulations are published in the Federal Register, upheld against claim that failure to allow retroactive treatment was a violation of the Nondiscrimination article of the United States-France income tax treaty). Similarly, taxpayers were unsuccessful in two recent cases challenging section 267(a)(3) under the Nondiscrimination article of the former (1967) treaty with France,[101] and temporary Treasury regulations under section 267(f) under the Nondiscrimination article of the former (1975) U.S.-United Kingdom treaty.[102] In both of these cases, the issue concerned the provision corresponding to Article 24(4) of the U.S. Model Treaty. In none of these cases was the nondiscrimination argument as strong as it would be in a typical case under section 163(j), at least if one of the Proposals is enacted (leaving aside the "later in time" rule, which would obviate any actual risk of a judicial defeat with respect to existing treaties, thus making the issue one of principle rather than revenue).

On the other hand, two courts in recent years have found attempts by U.S. tax authorities to apply formulary approaches to be invalid in the face of the Business Profits article in the relevant treaties. National Westminster Bank v. United States, 44 Fed. Cl. 120 (1999) (rejecting Treasury regulation §1.882-5 formulaic determination of U.S. branch liabilities based on allocation of part of worldwide liabilities); North West Life Assurance Co. of Canada v. Comm'r, 107 T.C. 363 (1996) (rejecting section 842(b) minimum deemed effectively connected income determined by formula based on data relating to domestic insurance companies generally). Both of these cases reflect a willingness of the U.S. courts to strike down provisions as inconsistent with U.S. income tax treaties when the applicable treaty provision looked to the standalone arm's length tax status of a branch but the U.S. domestic law sought to apply a formula based on external inputs. Although each treaty is unique and the expectations of the respective Contracting States in certain later treaties may have evolved, these decisions are at least relevant to the issue of how a U.S. court would view the application of the Proposals in the absence of the normal rules resolving treaty-statutory conflicts.

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[101] Square D Co. v. Comm'r, 118 T.C. 299 (2002). The courts concluded that the disallowance under section 267(a)(3) was not more burdensome that in the case of U.S. taxpayers because it is not by reason of the foreign residence of the owners of the payor but rather because the payees (which were the owners of the payor and certain affiliates) were foreign and the income was not effectively connected with a U.S. business. The 1967 U.S.-France treaty did not have a provision corresponding to Article 24(3) of the U.S. Model Treaty.

[102] Unionbancal Corp. v. Comm'r, 113 T.C. 309 (1999), aff'd, 2002-2 USTC §50,628 (9th Cir. 2002). The court reached the rather obvious conclusion that the disallowance of a loss realized by a U.S. taxpayer on a sale to its U.K. parent company under the temporary regulations had nothing to do with the foreign ownership of the taxpayer and hence was not more burdensome than in the case of a domestically owned enterprise.

Under the "later in time" rule, as a legal matter, enactment of the Proposals would trump any treaty-based claims in respect of existing treaties. Further, the Treasury could well obtain acknowledgement of the section 163(j) provisions in connection with all new treaties. The question remains, however, whether the process is the proper and optimal way for the United States to proceed in the face of conflicting treaty provisions which not only are obligations but which themselves are based on long-standing policy considerations.

v. Recent EC Developments.

A number of recent decisions of courts in the European Community ("EC") have found earnings stripping (as well as other) provisions of the tax laws of parties to the EC Treaty to be invalid as discriminatory under that treaty. In one recent case, the European Court of Justice ("ECJ") addressed the German earnings stripping provisions as applied to EC shareholders. We mention that case as illustrative of tax policies in a somewhat analogous context but also to distinguish it.

Lankhorst-Hohorst GmbH ("Lankhorst") was a German limited liability company that borrowed from its 100% indirect shareholder, a Netherlands company. Under German thin capitalization rules, interest paid to a foreign shareholder that is allocable to the portion of the financing exceeding specified debt-equity-ratios is treated as a constructive dividend and is disallowed as business expense deductions for corporate income tax purposes and subject to withholding tax of 25%. In its decision of December 12, 2002 ("Lankhorst-Hohorst"),[103] the ECJ interpreted the freedom of establishment clause of article 43 of the EC Treaty, which provides that nationals and companies of one member State, may freely engage in commercial activity and establish and conduct enterprises in any other Contracting State, and found the German thin capitalization rules to be inconsistent with on the basis that they discriminate against non-German shareholders. The ECJ reasoned that the German shareholders to which the rules also apply (domestic tax-exempt corporations) are special corporations, and therefore not an appropriate comparative group for the foreign shareholders. The appropriate comparative group was found to be all German shareholders, a group that generally is not subject to the thin capitalization rules.

Apart from the analogy of the court's rejection of tax-exempt entities as the relevant comparative group, we find the decision very distinguishable from the issues under section 163(j). As a result of the freedom of establishment clause, differences in tax systems (tax basis, tax rates, etc.) of the various EC member States is not a justification for special rules governing cross-border payments. The underlying premise is that, regardless of the tax regime in another member State, the taxation of payments to an enterprise of that State must be no more burdensome than the taxation of payments domestically. This fact that the taxation regimes of the member States are vastly different makes the case of relevance to the situation of bilateral income tax treaties. By entering into the EC Treaty the member States committed themselves to create a single economic union with the attendant freedoms.

The entry into a bilateral income tax treaty is a much less comprehensive commitment and does not involve anything like the creation of an economic union. Hence, the

[103] Case C-324/00, 12.12.02.

considerations underlying the interpretation of nondiscrimination provisions in a typical bilateral income tax treaty are not the same as those relevant in cases like Lankhorst-Hohorst.

On the other hand, the Administrative Court of Versailles has ruled that the French thin capitalization rules in section 212 of the French Tax Code are inconsistent with Article 24(3) of the former (1967) U.S.-France income tax treaty (which corresponds to Article 24(4) of the Model Treaty).[104] While France has reserved its right to apply section 212 notwithstanding Article 25(3) of the current (1994) U.S.-France income tax treaty (which corresponds to Article 24(3) of the U.S. Model Treaty),[105] that is only the case to the extent the application is consistent with the arm's length principles referenced in Article 9 of the treaty.

[104] TA Versailles 8 act. 2002 n° 96-3131 at 97-1755, 5e ch., Sté Silicon Graphics.

[105] The 1967 U.S.-France income tax treaty did not contain a paragraph corresponding to Article 24(3) of the U.S. Model Treaty.