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Rules Against Earnings Stripping: Wrong Answer to Corporate Inversions

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Introduction

The tax-driven expatriation of US corporations is a troubling phenomenon. In a "corporate inversion," a new foreign corporation, typically located in a low-tax or no-tax country, replaces the existing US parent corporation of a multinational enterprise (MNE). The US corporation then becomes a subsidiary of the new foreign parent. Since the US tax treatment of an MNE operating in the United States is significantly less favorable when the top-tier parent corporation is a domestic rather than a foreign corporation, the inversion transaction averts a substantial amount of US tax.[1] Inversions have attracted adverse attention from tax specialists, media, the US Treasury Department, and Congress. In the wake of September 11, it seemed downright unpatriotic for US firms to invert as a way of skimping on their tax payments.

In June 2002, Congressman Bill Thomas (R-CA), chairman of the House Ways and Means Committee, with the support of the Treasury Department, proposed comprehensive international tax legislation designed, among other things, to thwart corporate inversions. A key component of Thomas's solution was to significantly tighten the "earnings stripping" rules under Section 163(j) of the Internal Revenue Code (IRC). The Bush administration included a similar proposal in its fiscal 2004 budget, released in February 2003.

Corporate inversions have attracted adverse attention from tax specialists, media, the US Treasury Department, and Congress. In the wake of September 11, it seemed downright unpatriotic for US firms to invert as a way of skimping on their tax payments.

To understand the debate surrounding the earnings stripping rules, we first review the tax motivation for corporate inversions and the fundamental tensions inherent in the "classic" US tax system (separate taxation of corporations and individuals). We then turn to earnings stripping, starting with the 2002 Preliminary Report on Tax Policy Implications of Corporate Inversion Transactions (hereafter Treasury Report 2002). Earnings stripping is said to occur when a US subsidiary pays an excessive amount of interest to a related foreign corporation.

Corporate Inversion Transactions

As an academic possibility, corporate inversions were analyzed as early as the mid-1970s (Kramer and Hufbauer 1975), but actual transactions were relatively rare until the mid-1990s. The last few years have seen a marked increase in their frequency, size, and profile (Treasury Report 2002).

Basic Structure. Inversion transactions can be accomplished in various forms, with no real change in the operational activities of the corporate group. In the most common form, known as "stock inversion," the shareholders of a US parent corporation exchange their shares for those of a newly formed foreign corporation incorporated in a tax haven jurisdiction such as Bermuda. The tax haven jurisdiction does not have an income tax treaty with the United States. Then the foreign parent corporation sets up a foreign subsidiary in a third country that does have an income tax treaty with the United States, typically Barbados or Luxembourg (the treaty jurisdiction). The income tax treaty usually eliminates withholding tax on the payment of royalties or interest from the United States to the treaty jurisdiction. Interest and royalties paid by the erstwhile US parent corporation (now a US subsidiary) to the treaty jurisdiction subsidiary, and then on to the new foreign parent, are no longer subject to US tax.[2]

Earnings stripping is said to occur when an excessive portion of the corporate earnings of a US subsidiary is paid out as interest to the foreign parent corporation (or one of its foreign subsidiaries) and claimed as a deduction against the corporate income of the US subsidiary.

Other forms of inversion involve asset inversion (i.e., the actual transfer of assets from a US corporation to a newly formed foreign corporation) and various combinations of asset inversion and stock inversion.

Tax Benefits. Inversions usually yield substantial tax benefits for the inverted corporate group.[3] First, corporate inversion may shelter US-source income from US tax by diverting taxable income from the newly minted US subsidiary to the treaty jurisdiction subsidiary. The income tax treaty usually eliminates any withholding tax on the payment of royalties and interest from the United States to the treaty jurisdiction. Once the funds are paid out, they become a deductible expense to the US subsidiary, and the receipts by the treaty jurisdiction subsidiary are no longer subject to US tax. Thereafter, the money can be paid to the parent corporation located in the tax haven jurisdiction. This shifts interest or royalty payments from the US corporate pocket to a related foreign corporate pocket, resulting in an overall reduction of the US corporate tax base.[4]

Second, corporate inversion may shelter foreign-source income from US tax. The United States, unlike most countries, taxes the *worldwide* income of its citizens and residents, including corporate residents. Thus a US-based MNE is subject to US tax on its foreign-source income, although double taxation is mitigated through the foreign tax credit system. By contrast, a foreign-based MNE is not subject to US tax on its foreign-source income.[5] Thus, when a US-based MNE inverts and then reorganizes its foreign operations as subsidiaries of the new top-tier foreign parent corporation, the restructuring can eliminate the application of US international tax rules to the foreign operations of the MNE. If the new foreign parent is incorporated in a country that does not tax worldwide income (almost always the case), the third-country foreign operations are subject to tax only in the countries where they do business. Moreover, the inverted MNE can now establish new foreign operations that are no longer subject to the anti-deferral regime of Subpart F.[6]

Fundamental Tensions

Before delving into the details of rules designed to curtail earnings stripping, it is worth reflecting on the fundamental tensions at play. In the "classic" US tax system—separate taxation of corporations and individuals—individual bondholders and shareholders are normally taxed on their interest and dividend receipts. However, corporate interest payments are a deductible expense, but dividend payments are not. The classic structure means that dividends are taxed twice—first as corporate earnings and then as shareholder income—whereas interest payments are taxed only once.[7] This dis-

Table 1. Interest paid by US entities to foreign persons, and withholding taxes collected by the IRS (2001) (in billions of dollars)

FDI-related interest payments	
Paid by US parent firms to their foreign affiliates	4.1
Paid by US subsidiary firms to their foreign affiliates	24.8
Other private interest payments	
Bond interest payments	56.1
Bank interest payments	42.0
Interest paid by nonbank financial firms	38.0
US government interest payments	80.7
Total interest paid	245.7
Total interest payments reported for US withholding tax purposes [a]	126.6
Total US withholding tax collected on interest payments [a]	4.2
Effective withholding tax rates	
On reported interest (percent)	3.4
On total interest (percent)	1.7

Note: The term “persons” includes corporations, partnerships, governments, trusts, etc., as well as individuals.

a. Extrapolated from withholding tax returns for 1999.

Sources: *Survey of Current Business*, April 2003, and IRS Statistics of Income, September 2002.

tinction provides a tax incentive for corporations to finance their operations with debt rather than equity capital.

For obvious tax reasons, the Internal Revenue Service (IRS) prefers lower debt-equity ratios, whereas most corporations prefer higher debt-equity ratios. Prudential considerations keep the majority of the corporations from going overboard on debt finance. A higher debt-equity ratio means lower credit rating, higher interest rates, and greater risk of bankruptcy. For closely held corporations (including US subsidiaries), where shareholders and creditors are aligned (for example, the parent corporation may be both shareholder and creditor), the prudential disciplines are less forceful. These situations give rise to troublesome cases under the classic US tax system, and the law gives no clear guidance as to when the legal form of a debt instrument should be ignored for tax purposes and instead re-characterized as equity. In 1969, Congress enacted Section 385, which gave the US Treasury authority to distinguish between debt and equity, looking behind the legal form of security instruments, but no regulations have ever been promulgated. In the absence of a regulatory definition, in litigated cases courts have examined a variety of factors to distinguish between debt and equity, taking into consideration all the facts and circumstances. The fundamental tension between debt and equity finance is thus resolved case by case.

A second fundamental tension arises in the international context when a foreign parent corporation controls a US subsidiary. US tax rules differ for US corporate members and foreign corporate members of an MNE group. All the US members of an affiliated corporate group must file a consolidated US tax return. In the consolidated return, intragroup purchases and sales, and intragroup payments of dividends, interest, and royalties normally “net out,” with no tax consequences. In this context, the IRS has less reason to be concerned about intragroup transfer prices or interest payments. Purchases by one group member from another, or interest payments from one to another, simply appear as offsetting items in the consolidated corporate tax return. However, foreign corporations are generally not required (or permitted) to join in a consolidated return, whatever the extent of intragroup ownership. Hence, the IRS is very concerned about transfer prices between US members and foreign members of the same MNE. The IRS is also concerned about interest payments from the US subsidiary to its foreign affiliates. Clearly these payments leave the US tax net, costing revenue in comparison with a hypothetical financial structure where the US subsidiary was capitalized with equity rather than debt.

The Treasury Report recommends a two-pronged approach to reduce the tax incentives. The first prong is aimed at tax motives associated with sheltering foreign-source income from US tax. The second prong is aimed at supposed tax loopholes that enable inverted corporations to shelter US-source income.

At first impression, it might seem reasonable for Congress to change the law to ensure that the IRS gets its one tax bite out of corporate interest payments that cross the US border. But the existing US tax structure is peppered with exceptions to the "one tax bite" concept. Table 1 provides a useful overview.

In 2001, US entities paid approximately $246 billion of interest to foreign persons (including corporations, partnerships, trusts, governments, and individuals). Of this amount, some $81 billion was paid on US Treasury debt. By law, US Treasury interest paid to foreign persons is free of US withholding tax. Interest paid to foreign persons by various private US entities totaled $165 billion. Nearly all bank interest paid to foreign persons is also free of withholding tax. Hence, only $123 billion was reported to the IRS. On this amount, $4.2 billion was paid in US withholding tax. The effective US tax rate on reported interest was 3.4 percent. The effective US tax rate on total interest paid to foreigners was only half that level, 1.7 percent.

To summarize tax reality as opposed to tax theory, about half of US interest payments to foreign persons is legally exempt from US withholding tax. The other half is taxed at the low effective rate of 3.4 percent. Rather than describing the current US tax system for international interest payments as "one tax bite," a more accurate description is "one tax taste."[8] There are strong policy reasons for a taste rather than a bite. Over the past three decades, treasury secretaries and Congresses alike have concluded that the benefits to the US economy of open, almost tax-free access to international capital markets substantially outweigh whatever revenue might be collected on tax payments to foreign persons. The question, therefore, is not whether to defend the one tax bite principle; it has long since been abandoned. The question is whether the principle should be selectively applied to interest paid by US subsidiaries to their foreign parents (or affiliates).

Treasury Report

In May 2002, the US Treasury issued a preliminary report on corporate inversion transactions. The Treasury Report (2002) observes that corporate inversions occur largely because of the tax savings available and recommends a two-pronged approach to reduce the tax incentives.[9]

The first prong is aimed at tax motives associated with sheltering *foreign-source* income from US tax (i.e., avoiding the anti-deferral regime of Subpart F and excluding foreign-source income completely from the US corporate tax base). As for this motive, the Treasury acknowledges that the US worldwide tax system has its faults.

H.R. 5095 proposed by Chairman Bill Thomas in 2002 would significantly tighten the earnings stripping rules set forth in Section 163(j). It defines two types of corporate inversion transactions and establishes different adverse tax consequences for each type.

The Treasury Report properly recognizes that corporate inversions stimulated by foreign-source-income motives reflect a deep-seated problem: the competitive tax disadvantage of US-based MNEs in comparison with foreign-based MNEs.[10] To address this problem, the report calls for a comprehensive reexamination of the US international tax system as it applies to the foreign-source income of US corporations.[11]

The second prong is aimed at supposed tax loopholes that enable inverted corporations to shelter *US-source* income. However, inversions are by no means the only way that US-source income can be sheltered from corporate tax. The Treasury Report recognizes that "it is important not to lose sight of the fact that in many cases the same types of tax reduction may be achieved through other means."[12]

The Bush administration proposal, designed by the Treasury Department, generally follows the provisions of H.R. 5095, except that it adds a new "safe harbor" test.

It goes on to argue that "because the opportunities for earnings stripping are not limited to inversion transactions but are present in cases where a U.S. business is structured from the outset with a foreign parent and in cases where a foreign corporation acquires a U.S. operating group, reconsideration of these rules should not be limited in application to inverted companies..."

Chairman Thomas

In June 2002, Bill Thomas (R-CA), chairman of the House Ways and Means Committee, with the support of the Treasury, introduced H.R. 5095.[13] The bill was centrally motivated by the foreign sales corporation (FSC) case.[14] In addition, Thomas included measures specifically designed to thwart corporate inversions:[15]

- First and foremost, the bill would significantly tighten the earnings stripping rules set forth in Section 163(j). The rules are designed to limit the deduction when interest is paid by a US subsidiary to a related foreign corporation.
- The bill imposes additional tax burdens on corporate inversions. It defines two types of corporate inversion transactions and establishes different adverse tax consequences for each type.[16]
- For inversion transactions involving at least 80 percent identity of stock ownership (i.e., when the former shareholders of the top-tier US corporation hold 80 percent or more of the stock of the new foreign parent), H.R. 5095 would deem the foreign parent to be a US corporation.[17] For tax purposes, this would effectively unwind the inversion transaction.
- For inversion transactions involving at least 60 percent but less then 80 percent identity of stock ownership, the corporate "toll taxes" imposed under existing law for establishing the inverted structure could not in turn be offset by other tax attributes such as net operating losses or foreign tax credits.
- The bill also imposes a 20 percent excise tax on the value of all stock options and stock-based compensation held by insiders, top executives, and directors of a company that inverts.

In the eyes of the Treasury and Congressman Thomas, the cutting edge of H.R. 5095 is the tightening of Section 163(j) to discourage earnings stripping. Written testimony of Acting Assistant Treasury Secretary Pamela Olson stated that revisions to the Section 163(j) rules are "needed immediately to eliminate what is referred to as the real "juice" in an inversion transaction."[18]

Earnings Stripping Rules Under Section 163(j)

Language is important, and labels often determine public policy. The phrase "earnings stripping" conveys a malignant tone. Like "tax loophole" or "tax haven," it connotes something that ought to be stopped. In this policy brief, we do not attempt a new and kinder label for the phenomenon, but we do argue that earnings stripping is not the malignant force suggested by the Treasury Report or H.R. 5095. To help understand the proposed amendments to Section 163(j) and the role of earnings stripping in the larger international economic picture, we first review the current rules on earnings stripping and then analyze the proposed changes.

Existing Law. Earnings stripping is said to occur when an excessive portion of the corporate earnings of a US subsidiary is paid out as interest to the foreign parent corporation (or one of its foreign subsidiaries) and claimed as a deduction against the corporate income of the US subsidiary. Before the enactment of Section 163(j) in 1989, the excessive interest payments would be taxed by the United States only at the treaty-withholding rate, which might be zero. The IRS could challenge the extent of related-party debt, but only on a case-by-case basis, as explained earlier. Section 163(j) changed the case-by-case approach for US subsidiaries of foreign corporations. Interest paid to a related foreign corporation was labeled disqualified

Table 2. FDI in the United States, associated employment, interest and dividends paid, and US withholding taxes (2001)

FDI stock at historical cost ($ billions)	1,321.1
FDI stock at market value ($ billions)	2,526.7
Average annual FDI inflows (1999–2001, $ billions)	236.2
Employment (nonbank employees, in thousands) [a]	5,562.5
Percent of US employment in nonbank private industry	5.6
Distributed earnings ($ billions)	20.4
US withholding tax ($ billions)	1.1
Interest paid to foreign affiliates ($ billions)	24.8
US withholding tax ($ billions)	0.1
Effective withholding tax rate (percent)	0.4%

a. Employment is for 2000.

Source: *Survey of Current Business*, August and September 2002.

interest,[19] and the deduction was denied if the US subsidiary's debt-equity ratio exceeded 1.5 to 1 (the so-called "safe harbor" test) *and* if the subsidiary's net interest expense exceeded 50 percent of its "adjusted taxable income" (ATI).[20] In other words, the US subsidiary had to flunk two tests before its related-party interest was disallowed. Disallowed interest could be carried forward indefinitely and claimed as a deduction when the subsidiary passed one or both tests.

H.R. 5095. The bill proposed by Chairman Thomas in 2002 would strengthen the earnings stripping restrictions in the current Section 163(j) by making the following amendments:

- Eliminate the current 1.5 to 1 debt-equity safe harbor altogether.
- Replace the 50 percent of ATI test with a 35 percent test.
- Add an *alternative* test, the excess-domestic-disqualified-interest test, based on the extent to which the US subsidiary's ratio of debt to assets exceeds the ratio for the worldwide affiliated group.[21]
- Calculate disallowed interest for the taxable year as the amount of disqualified interest (as defined in existing law) that is the greater of: (1) excess interest calculated under the new excess-domestic-disqualified-interest test; or (2) excess interest calculated under the 35 percent of ATI test.
- Tighten the carry-forward provisions to the disadvantage of the taxpayer: interest disallowed under the 35 percent of ATI test can be carried forward only to the extent it exceeds the interest disallowed under the excess-domestic-disqualified-interest test. Interest disallowed under the excess-domestic-disqualified-interest test, to the extent it exceeds the interest disallowed under the ATI test, is permanently disallowed—no carry forward is permitted. Finally, any disallowed interest eligible to be carried forward can only be carried forward for five years (not indefinitely, as under current law).

Treasury Budget Proposal. The Bush administration proposal (made in February 2003 in its fiscal 2004 budget), designed by the Treasury Department, generally follows the provisions of H.R. 5095, except that it adds a new "safe harbor" test. Under the Treasury's safe harbor, the current 1.5 to 1 debt-equity safe harbor would be replaced by a series of safe harbors determined by the leverage typically associated with the corporation's line of business. So long as the US subsidiary's debt was within the safe harbor, new Section 163(j) would not disallow related-party interest payments as a deductible expense. While revenue forecasts are hazardous, the Treasury projects that its proposal would increase US tax collections by a cumulative amount of $3.4 billion over 11 years. H.R. 5095 would increase tax collections substantially more, because it does not contain the safe harbors.

Problems Created by Tighter Rules

The revisions proposed by H.R. 5095 and the Treasury (even with its flexible safe harbor) raise serious policy issues, under four headings: investment chill, tax equity, compliance burdens, and international norms.

Investment Chill. If the earnings stripping amendments are enacted, foreign-based MNEs may reduce their inbound investments in the United States because of higher effective taxation. As table 2 shows, inward foreign direct investment (FDI) has been running about $250 billion annually. In 2001 (as in other recent years), interest payments have been running around $25 billion, somewhat more than distributed earnings (i.e., dividends). The effective US withholding rate on interest payments is under 1 percent. However, to the extent interest is disallowed under H.R. 5095 or the Treasury proposal, the effective US corporate tax rate would leap to around 35 percent at the federal level. The higher tax rate could easily put a chill on new inbound FDI.[23] In the short run, that would put downward pressure on the dollar in foreign exchange markets and upward pressure on US interest rates. In the long run, a reduction in inward FDI would deprive the US economy of the growth benefits of inward FDI (Graham and Krugman 1995).

Congress should exclude the earnings stripping provisions from H.R. 5095 altogether. It should leave intact the other measures advocated by Chairman Thomas—stiff "toll taxes" and reforms to US taxation of foreign-source income—to discourage corporate inversions.

Tax Equity. Foreign-based MNEs operating in the United States rightly argue that H.R. 5095 and the Treasury proposal discriminate against them as compared to US-based MNEs. Yet there is no factual justification for discrimination. Research studies conducted by Treasury officials and independent scholars find little or no evidence that foreign-based MNEs erode the US corporate tax base through the use of related-party debt to a greater extent than other US corporate taxpayers.[24]

Consideration of the credit market conditions facing US-based and foreign-based MNEs quickly shows the de facto nature of discrimination under the proposed changes to Section 163(j). US-based MNEs can rely on their high credit standing to borrow worldwide *directly or indirectly* from *unrelated* parties—banks, pension funds, insurance companies, and individual bondholders. The debt can be structured so that interest is deductible in the United States, whether or not it is taxed abroad. To take a very common example, US MNEs can borrow from commercial banks or the commercial paper market, and the interest income can be paid to foreign persons with little or no US tax. The IRS does not get a juicy tax bite from these payments; at most it gets a small tax taste. Moreover, US corporations are only subject to the "facts and circumstances" test to determine whether their debt is excessive.

US subsidiaries of foreign-based MNEs, seen as stand-alone borrowers, usually lack the high credit standing that would allow them to borrow worldwide *directly or indirectly* from *unrelated* parties.[25] The high credit standing is usually an attribute of the foreign parent, not the US subsidiary. The only way the US subsidiary can incur large amounts of debt at low interest rates is by borrowing from its foreign parent—which in turn borrows from the anonymous worldwide credit market. But related party debt quickly runs afoul of amended Section 163(j).[26] Unlike US-based MNEs, their foreign-based counterparts would be denied recourse to a "facts and circumstances" defense. In extreme cases, the excess-domestic-disqualified-interest test might deny interest deductions for corporations with no net interest expense (i.e., finance subsidiaries that had interest income in excess of interest expense) would be denied because they have disproportionate indebtedness and pay interest to related foreign corporations.

By discriminating against foreign-based MNEs, the new Section 163(j) would indirectly make US-based MNEs more tax-competitive. But it would do so by raising the tax burden on foreign-based MNEs. Therein lies a recipe for inviting retaliatory tax legislation abroad.

Compliance Burden. Compliance with the proposed excess-domestic-disqualified-interest test should be another source of concern. The proposed test requires a worldwide determination of MNE assets and liabilities. This procedure invites copycat reporting requirements abroad. Copycat reporting could eventually lead to a requirement of consolidated worldwide financial accounts for all members of an affiliated group, wherever located. That would be a major change in the international tax regime constructed over the past century. If consolidated worldwide accounts are a good idea, they deserve to be debated on their merits, not introduced piecemeal.

International Norms. The earnings stripping proposals seriously conflict with three international tax norms: the general proscription against double taxation, the widely accepted arm's length standard, and the nondiscrimination clauses in US tax treaties.

Double taxation. The proposed amendments to Section 163(j) would substantially increase the potential for double taxation. The reason is that the new carry-forward limitations change the cast of Section 163(j) from a mechanism to *defer* disallowed interest expenses, to a mechanism for *permanent* disallowance. By this device, interest expense could be disallowed in the United States but still taxed in a foreign jurisdiction. The US tax treaty network has no mechanism for correcting the resulting double taxation.

The Treasury should issue nondiscriminatory regulations under Section 385, applicable to all US corporations, to define and appropriately limit the use of excessive debt that abusively erodes the US corporate tax base.

Arm's length. The excess-domestic-disqualified-interest test is inconsistent with the arm's length standard, since it does not reflect whether an independent third party lender would have loaned the same amount to the US subsidiary under the same terms and conditions.[27] The arm's length principle is widely accepted for dividing the income and expenses of an MNE group between taxing jurisdictions. It is embodied in tax treaties based on the OECD Model Tax Treaty (OECD Model), the UN Model Tax Convention, as well as in domestic laws of many countries, including Section 482 of the IRC. It is considered a key component for avoiding international double taxation and thereby facilitating cross-border trade and investment.[28]

The OECD guidelines define the arm's length principle to be the "international standard that OECD member countries have agreed should be used for determining transfer prices for tax purposes." The most authoritative statement of the principle is found in paragraph 1 of Article 9 of the OECD Model, which requires that associated enterprises deal with each other on an arm's length basis, that is, on the same terms and conditions as would apply if the parties were not related.[29]

In the context of related-party loans, the implementation of the arm's length principle is articulated in a 1987 OECD Research Paper (OECD 1987), which applies Article 9 of the OECD Model Tax Treaty to situations in which a so-called debt instrument should be recharacterized as equity for tax purposes. The research paper suggests that the preferable approach to these "thin capitalization" situations is a "facts and circumstances" approach, and not a "fixed ratio" test (i.e., the approach embodied in Section 163(j)).[30]

The United States has traditionally advocated the arm's length standard. Repudiation of the arm's length standard with respect to related-party interest payments will invite erosion in other areas. This step should not be taken without deep consideration of its ramifications.[31]

Finally, the earnings stripping proposals conflict with nondiscrimination clauses included in many US tax treaties, including Article 24(3) of the US Model Treaty (which is based on Article 24(4) of the OECD Model).[32] These provisions generally commit the United States to give a deduction for interest paid by a US company to a treaty-partner resident to the same extent that such interest would be deductible if paid to a US resident.

The legislative history of Section 163(j) suggests that Congress was aware of the potential conflict between Section 163(j) and US treaty obligations. However, the legislation history reflects two alternative explanations why Congress believed Section 163(j) does not breach US treaty nondiscrimination requirements. The first explanation is based on a tortured interpretation of the phrase "under the same conditions" in the treaty nondiscrimination clause.[33] The second explanation focuses on the argument that current Section 163(j), as applied, is congruent with the arm's length standard for purposes of making thin capitalization determinations and thus should not be deemed to violate the treaty nondiscrimination provisions.

Congress should direct the Treasury to undertake a comprehensive study to determine whether the current practice of taxing international interest payments at a low effective rate (under 2 percent) remains in the national interest.

Even if these explanations were valid when Section 163(j) was first enacted (which we doubt),[34] they would have little force if the proposed amendments were enacted. The new Section 163(j) would clearly discriminate against interest payments to related foreign parties.

Recommendations

Proposals to amend Section 163(j) are stimulated by the perceived problem of corporate inversion transactions and a fear that inverting companies are loading up with debt to their new foreign affiliates, thereby eroding the US corporate tax base.

However, the proposals go far beyond dealing with tax-motivated inversion transactions. They apply across the board to all foreign-based MNEs operating in the United States. They pose a substantial risk of collateral damage to the US economy and US international tax principles that far outweigh any benefits.

We believe that prudent tax policy should avoid these risks and instead be based on the three recommendations:

• Congress should exclude the earnings stripping provisions from H.R. 5095 altogether. It should leave intact the other measures advocated by Chairman Thomas—stiff "toll taxes" and reforms to US taxation of foreign-source income—to discourage corporate inversions.

• The Treasury should issue nondiscriminatory regulations under Section 385, applicable to all US corporations, to define and appropriately limit the use of excessive debt that abusively erodes the US corporate tax base.

• Congress should direct the Treasury to undertake a comprehensive study to determine whether the current practice of taxing international interest payments at a low effective rate (under 2 percent) remains in the national interest. If so, the Treasury should say so. If not, the Treasury should submit a comprehensive proposal that deals with all avenues for tax exemption of interest payments—zero withholding on Treasury debt, zero withholding on bank interest, and zero withholding in tax treaties.

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Endnotes

[1] A corporation is treated as domestic if it is incorporated under the laws of the United States or any state. Firms incorporated under the laws of foreign countries are treated as foreign.
[2] Through new debt securities and the transfer of intangible assets, the treaty jurisdiction subsidiary becomes a creditor of the US subsidiary and, in addition, holds the patents, trademarks and copyrights used by the corporate group.
[3] For example, it was reported that Tyco Corporation saved more than $400 million in 2001 by reason of an inversion transaction that occurred in 1997.
[4] This piece of tax planning is possible because the foreign corporation (in the treaty jurisdiction) that receives the interest income is not a US-controlled foreign corporation. While the interest or royalty income is passive income, it is not subject to the anti-deferral rules of Subpart F of the IRC, because those rules only apply to a US-controlled foreign corporation.
[5] The United States taxes foreign corporations only on income that has a connection (nexus) to the United States—for example, income that is effectively connected with the conduct of a trade or business. The newly minted corporation in the treaty jurisdiction does not conduct trade or business in the United States; it only receives interest, dividends, and royalties from its US subsidiary.
[6] The purpose of Subpart F rules (Section 951 of the IRC) is to protect the integrity of the worldwide US tax system. Under the deferral principle, the income of a foreign subsidiary of a US parent corporation is generally not subject to US taxation until the income is distributed to the US parent. However, under the rules of Subpart F, a US parent is subject to immediate taxation on the passive income earned by its foreign subsidiaries located in tax haven countries. Thus, only active business income of foreign subsidiaries is generally subject to deferral.
[7] In 2003, President Bush proposed the total elimination of taxes on dividends received by resident US shareholders. If enacted, the Bush proposal would mean that dividends, like interest, are only taxed once. As of early May 2003, it appears that Congress may agree to tax dividends at a lower rate (15 percent) but not eliminate the tax entirely.
[8] Even interest paid to US persons is more often subject to a tax taste than a tax bite, as illustrated by 1999 data. The national income accounts indicate that individuals received $1,001 billion of interest income. Tax-exempt interest paid by states and municipalities to individuals, and reported on their returns, amounted to $52 billion. Taxable interest reported on individual tax returns was $176 billion. The obvious conclusion is that there is severe underreporting of taxable interest income on individual tax returns. Moreover, many individuals received interest payments via accumulated earnings in their pension funds, on which tax was deferred for many years. Tax deferred is tax partially forgiven, and total pension payments to individuals in 1999 amounted to $304 billion. (All figures are from the *Statistical Abstract of the United States* 2002.)
[9] In addition to these two prongs, the Treasury Report (2002) calls for a review of tax treaties to curtail treaty shopping abuses, another look at the toll taxes when assets (especially intangible assets) are transferred to a foreign corporation, and a new reporting requirement for inversion transactions.
[10] According to the Treasury Report (2002), "[t]he U.S. international tax rules can operate to impose a burden on U.S. based companies with foreign operations that is disproportionate to the tax burden imposed by our trading partners on the foreign operations of their companies. . . . Both the recent inversion activity and the increase in foreign acquisitions of U.S. MNCs are evidence that the competitive disadvantage caused by our international tax rules is a serious issue with significant consequences for U.S. businesses and the U.S. economy."
[11] The Treasury Report (2002) calls for reevaluation of the anti-deferral regime of Subpart F and of the foreign tax credit rules, and an examination of the merits of an exemption-based (territorial) tax system. Similar reforms were urged by Gary Clyde Hufbauer and Joanna M. van Rooij (1992).
[12] The Treasury Report (2002) refers to two specific transactions: the first is a start-up company predominantly owned by US persons but established as a subsidiary of a foreign corporation located in a tax haven; the second is a cross-border acquisition that results in all US operations being owned by a foreign corporation.
[13] American Competitiveness Act of 2002 (H.R. 5095, sometimes referred to as the Treasury proposal).
[14] See Hufbauer (2002). To compensate the business sector for the elimination of FSC benefits, Thomas proposed several international tax reforms that would reduce the corporate tax burden and narrow the competitive tax disadvantage faced by US-based MNEs.
[15] In addition to the enumerated measures, H.R. 5095 also calls for a Treasury study of treaty shop-

ping and other anti-abuse rules and it creates new reporting requirements.

[16] The adverse consequences apply only if the inverted corporation does not have substantial business activities in the foreign country in which it is organized when compared to the total business activities of the affiliated group. Certain partnership transactions are also covered in H.R. 5095.

[17] This part of the proposal would not apply to inversion transactions completed after March 20, 2005, and it is designed to give Congress and the Treasury time to "carefully and thoughtfully examine the effects of the bill on corporate behavior" (press release, Chairman Thomas, August 2, 2002).

[18] Olson's testimony was submitted to the Committee on Ways and Means on June 6, 2002.

[19] Disqualified Interest also includes interest paid to unrelated parties in circumstances where the related party guarantees the debt.

[20] ATI is taxable income computed without regard to deductions for net interest expense, net operating losses, and depreciation, amortization, and depletion. Under Section 163(j), so-called "excess limitations" (*i.e.*, any excess of the 50 percent limit over a company's net interest expense for a given year) can be carried forward three years.

[21] Under the new test, total assets of the US subsidiary are first divided by total assets of the worldwide group. That calculation yields a fraction. Debt of the US subsidiary is then defined as "disproportionate" to the extent that it exceeds the product of this fraction and the total external debt of the worldwide group.

[22] Under the Treasury budget proposal there are seven classes of assets with ratios ranging from 0.98 for cash and equivalents class to 0.5 for the intangibles class. The aggregate of the products of the value of the assets within each class times the applicable ratio for that class yields a number. If the total debt of the foreign-owned US corporation does not exceed this number (i.e., the safe harbor figure), section 163(j) would not apply. Although not specified in the Treasury's budget proposal, the Treasury has unofficially clarified that "value" of each class of asset for this purpose means its US tax basis.

[23] In this regard, the European Commission (2002) commented: "H.R. 5095 ... as currently drafted will affect the legitimate foreign subsidiaries in the US ... with the results that the earnings stripping rules would be even more onerous than current law. Such legislation, if passed into law, could negatively impact FDI into the US."

[24] Two research studies conducted by Treasury officials during the 1990s, using corporate tax files, found no clear evidence that foreign-controlled US corporations lower their US taxable income through the use of related-party debt more than US-controlled US corporations. See Grubert, Goodspeed, and Swenson (1993) and Grubert (1997). Independent research conducted in 2001 suggested that there is no evidence that taxable income declines more after a non-US shareholder acquires a US domiciled firm than after a US shareholder acquires a US-domiciled firm. See Blouin, Collins, and Shackelford 2001.

[25] The Treasury Report (2002) argues that "a corporate structure that involves a foreign parent corporation and US operating subsidiaries provides particular opportunities for reducing the US tax on the income earned from US operations. These opportunities are not available in the same way to corporate groups with a US parent corporation." In a literal sense the argument may be correct, but US operating subsidiaries of foreign-based MNEs have far more limited access to the credit markets than US operating subsidiaries of US-based MNEs. US operating subsidiaries of US-based MNEs can borrow worldwide, guaranteed by the parent firms, without running afoul of Section 163(j). This is not true of US operating subsidiaries of foreign-based MNEs.

[26] The current Section 163(j) already discriminates against foreign-based MNEs, but the amended Section 163(j) would make the discrimination considerably more severe.

[27] The excess-domestic-disqualified-interest test operates by mechanically calculating whether a US corporation is disproportionately leveraged relative to the corporate group as a whole. Among other problems, this approach unjustifiably assumes that the MNC group operates uniformly in terms of credit-market conditions worldwide.

[28] The application of this principle is guided by the OECD Transfer Pricing Guidelines for MNC Enterprises and Tax Administrations (OECD guidelines).

[29] Article 9 provides, "[when] conditions are made or imposed between ... two [associated] enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly."

[30] The legislative history of the current earnings stripping rules suggests that Congress viewed the 1.5 to 1 debt-to-equity safe harbor as broadly consistent with the capital structure of independent companies. Congress apparently believed that the safe-harbor would excuse many US corporations with typical capital structures from any

of the earnings stripping rules. In contrast, the proposed excess-domestic-disqualified-interest test clearly abandons any pretense at the arm's length standard in favor of a rigid formula that would disallow interest expense incurred in truly arm's length transactions. The Treasury proposal, to be sure, adds the flexible safe harbor discussed in the text. Conceivably the "right" safe harbor would be consistent with the arm's length standard, but the Treasury's tests seem wide off the mark. The Treasury has unofficially indicated that its safe-harbor tests would be based on the tax basis of the assets of the US corporate borrower rather than their fair market values. However, bankers who consider lending funds to an unrelated borrower generally evaluate their security in terms of fair market values and not the tax basis of assets. That is especially relevant to technology corporations where asset values largely consist of patents, trademarks, and copyrights. These are usually generated by the company itself and have a very low tax basis.

[31] The conceptual alternative to the arm's length standard is formula apportionment. Formula apportionment would dramatically change the taxation of all MNEs. If it is a good idea, it deserves to be debated as a concept, not introduced through the back door.

[32] Article 24(4) of the US Model Treaty provides in pertinent part that "interest ... paid by a resident of a Contracting State to a resident of the other Contracting State shall, for the purposes of determining the taxable profits of the first-mentioned resident, be deductible under the same conditions as if [the interest] had been paid to a resident of the first-mentioned State."

[33] The thrust of the explanation is that, in applying the nondiscrimination clauses of US tax treaties to Section 163(j), a comparison should be made between interest paid to a taxable US person, and not to a foreign lender based in a tax haven country.

[34] See Culbertson (2003).