REPORT# 533

TAX SECTION

New York State Bar Association

Report on Proposed Disallowance of Deductions

June 24, 1986

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The Honorable Dan Rostenkowski
2232 Rayburn Building
Washington, DC 20515

Dear Representative Rostenkowski:

I enclose a report on the proposal in the Senate amendments to H.R. 3838 that would partially disallow deductions for interest paid to certain related foreign parties. The report, which concludes that the proposal is unsound and should not be adopted, also contains a number of specific comments on the proposal.

The Tax Section would be pleased to be of further assistance to you in connection with this matter.

Sincerely,

Richard G. Cohen
Chairman

Enclosure
cc: The Hon. John J. Duncan) with
Robert J. Leonard, Esq.) enclosure

NEW YORK STATE BAR ASSOCIATION TAX SECTION

COMMITTEE ON U.S. ACTIVITIES OF FOREIGN TAXPAYERS

Report on the Proposed Disallowance of Deductions for Interest Paid to Certain Related Foreign Parties

Section 984 of the Senate amendments to H.R. 3838(the “senate Bill”) would disallow certain interest paid by United States persons to related foreign persons that are exempt from U.S. tax on the interest.* Insofar as the exemption results from exemptions from or reductions in United States withholding taxes pursuant to income tax treaties, we believe that the proposal is unsound and should be rejected by the Conference Committee.

I. SUMMARY OF PROPOSAL

Section 984 of the Senate Bill would amend Code Section 163 to disallow deductions for certain interest paid by U.S. persons to “related tax-exempt parties”. The disallowance would apply to the extent that net interest deductions otherwise available to the borrower exceed 50% of its taxable income, as recomputed by adding back all interest payments and net operating loss deductions.

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* This report was prepared by John A. Corry. Helpful comments were received from Renato Beghe, William L. Burke, Herbert L. Camp and Richard G. Cohen.

For this purpose, the Senate Bill would treat as “exempt” not only U.S. entities such as employee benefit trusts and charitable organizations but also any related person that is a foreign corporation if no United States tax is imposed on interest paid by the taxpayer to such person, such as by reason of a tax treaty exemption. If a treaty reduces the rate of U.S. tax on interest paid to a foreign person, the payment would be deemed exempt in the same proportion that the treaty's rate reduction from the 30% rate bears to the 30% rate. Payments of interest to a foreign person would be subject to these rules even though such person is taxable on such interest in its country of domicile.*

This provision results from the Finance Committee’s

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* The Senate Finance Committee Report (p. 426) states that because interest received by a Netherlands Antilles finance subsidiary of a U.S. person will normally be paid by it as interest to unrelated persons except for the “spread” retained by it, which will be currently subject to U.S. tax under the Subpart F rules of the Code, such payments would not be disallowed under this provision. If the Netherlands Antilles finance subsidiary is owned by a foreign corporation, the Senate Bill presumably would apply, although it is possible that the recently agreed upon but yet to be released revision of the United States income tax treaty with the Netherlands Antilles may remove the withholding tax exemption (at least in the case of newly issued obligations) so that the question in that context would at least eventually become academic.

concern that unlimited deductions for all interest paid to related exempt entities permits significant erosions of the tax base in situations where the Finance Committee believes that an economic unit is contracting “with itself at the expense of the government” (Committee Report, p. 424). The Finance Committee states that the uncertainties of present law regarding debt-equity questions may allow taxpayers to take aggressive positions that inappropriately erode the U.S. tax base and that case law dealing with the debt-equity question may not be adequate to address this concern. The Committee concluded that, rather than adopting debt-equity rules limited to “earnings-stripping cases”, it is preferable to tie this limitation to taxable income which, in the Committee's opinion, “goes to the heart of the earnings stripping question”.

The Bill permits carry forwards of disallowed interest deductions. However, the Finance Committee concludes, without explanation, that carry backs are inappropriate.

The Finance Committee concludes that the proposal would not violate provisions of U.S. income tax treaties that prevent discrimination against foreign-owned U.S. businesses because it also applies to interest paid to tax-exempt related U.S. entities. The Committee adds that, in any event, it does not intend that any contrary treaty provision should “defeat its purpose in enacting this limitation.”

II. GENERAL DISCUSSION OF PROPOSAL

To the extent that the proposal treats as "exempt" interest that is not fully subject to U.S. tax by reason of a specific treaty provision, we believe that it is unsound and should not be adopted.

Although the Committee Report states that such interest income "may or may not be subject to foreign tax" (p. 425), in our experience in most cases such interest is subject to foreign income taxes imposed by the payee's country of residence. The United States does not enter into income tax treaties that reduce or eliminate United States tax on U.S. source income unless such income is generally taxable by the other treaty party. One of the two primary purposes for adopting income tax conventions is to avoid double taxation of income earned in one country by a resident of the other country.* Because such interest is generally taxable to treaty country recipients, it is the tax treaty negotiating policy of the United States, as evidenced in the June 16, 1981 U.S. Model Income Tax convention, that non-effectively connected U.S. source interest payments will be exempt from U.S. tax when paid to another treaty party resident.

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* Thus, the preamble to the June 16, 1981 U.S. Model Income Tax Convention states that the convention is "for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and capital."

Thus, in the normal case, although a treaty party may be exempt from U.S. tax on U.S. source income, its overall tax status is very different from that of a U.S. stockholder that is also exempt. The U.S. stockholder will pay no tax of any kind on such income, whereas the foreign person usually pays taxes on such income, albeit to a foreign government rather than the United States Government. It is therefore a clear misnomer to refer to the foreign taxpayer as “exempt”. Although it might be appropriate to apply the interest disallowance rules in the exceptional case of foreign taxpayers that are exempt from tax on such income in both the United States and their countries of residence, such disallowance should not apply to the usual situation of a taxable recipient. Moreover, we believe that the appropriate method of addressing the problem posed by such exempt foreign taxpayers is by treaty amendment rather than by an amendment to the Internal Revenue Code which, for the reasons discussed below, would be inconsistent with many tax treaty antidiscrimination provisions.

The Finance Committee’s concern that the uncertainties of present law may allow taxpayers to take aggressive positions in the debt-equity area is probably well founded, but it applies equally to U.S. corporations that are closely held by taxable U.S. persons. Apart from the nominal dividends received exclusion (which both H.R. 3838 and the Senate Bill would repeal), individual stockholders of closely held U.S. corporations are taxable at the same rate on dividends and interest that such corporations pay to them. Such corporations thus have the same ability and incentive to “strip earnings” through interest payments in lieu of dividend distributions so as to reduce their U.S. tax liability as do U.S. corporations owned by foreign shareholders. Indeed, the fact that most U.S. corporations are owned by U.S. persons rather than foreign corporations causes the revenue loss in the case of U.S.-owned domestic corporations to be much greater than the revenue loss in the case of foreign-owned domestic corporations. Hence, there is no policy reason to adopt a rule that discriminates against foreign-owned U.S. corporations. Particularly if the disallowance is to be determined on the basis of taxable income, it should be applied, if at all, to both taxable and tax exempt related persons.

The double taxation concerns that have invariably led to treaty reductions of or exemptions from the statutory U.S. 30% tax on interest should not be circumvented in such a heavy-handed manner merely because interest is paid to a related person. The treaties themselves provide exceptions for excessive payments based on transactions that are not at arm's length. By penalizing all U.S. corporations owned by treaty residents, the proposed interest disallowance would vitiate well-established tax treaty policies of the United States and for that reason alone should be rejected by the Conference Committee.

The Senate Bill would also discriminate against U.S. corporations owned by treaty residents when compared to U.S. corporations owned by other foreign persons. Interest paid to a related person that is a treaty country resident on whom there is no 30% U.S. withholding tax would be nondeductible by the pay or and hence indirectly taxable to it under the Senate Bill at a 33% rate. This rate would be 3% greater than the 30% rate at which deductible interest paid to a non-treaty resident related party is taxed. This is an unsound result.

Apart from its policy defects, this proposal would violate two non-discrimination clauses that appear in the 1981 U.S. Model Income Tax Treaty, the 1977 OECD Model Income Tax Treaty and several tax treaties that the United States has entered into with foreign governments.*

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* It is also probable that the Senate proposal would violate several treaties of friendship, commerce and navigation (“FCN”). Some FCN non-discrimination provisions may even have broader scope than those of a tax treaty, perhaps giving the foreign entity the choice of the more favorable provision. See O'Brien, “The Non-Discrimination Article in Tax Treaties,” 10 Law & Polly in Int'l Bus. 545, 586-591 (1978).

The first of these clauses specifically addresses the effects of the Finance Committee provision:

> Except where [related parties engage in other than arm's-length transactions, resulting in excessive payments] interest, royalties, and other disbursements 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 they had been paid to a resident of the first-mentioned State.

1981 U.S. Model, Art. 24(4); OECD Model, Art. 24(5). There can be no doubt that the Senate proposal would conflict with this provision in those treaties containing it, especially considering the OECD comment that the provision "is designed to end a particular form of discrimination resulting from the fact that in certain countries the deduction of interest . . . allowed without restriction when the recipient is resident, is restricted or even prohibited when he is a non-resident." Perhaps more noteworthy is that not all treaties negotiated subsequent to 1981 contain this provision. The OECD comment states that "contracting States [may] modify this provision in bilateral conventions to avoid its use for tax avoidance purposes." With regard to just such a concern, the United States - Canada Income Tax Treaty, Art. XXV (8) allows for the continued operation of the Canadian "thin capitalization" withholding provisions and any subsequent provisions intended to ensure that non-residents do not enjoy more favorable tax treatment than residents. See U.S. Treasury Dept., Technical Explanation of the U.S. - Canada Income Tax Treaty, Art. XXV, reprinted in 1 Tax Treaties P 1317Q (CCH) (1981).

Predating the interest deductibility clause, and therefore present in many more treaties, is a nondiscrimination clause that pertains to resident entities related to non-residents. This clause provides:

> 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 which is other or more burdensome than the taxation and connected requirements to which other similar enterprises of the first-mentioned State are or may be subjected. (emphasis added).

1981 U.S. Model, Art. 24(5); OECD Model, Art.24(6). The Finance Committee apparently believes that the interest disallowance proposal would not violate this type of nondiscrimination provision because U.S. corporations Controlled by foreign entities are "similar enterprises" to U.S. corporations controlled by tax-exempt U.S. enterprises.

We disagree. The Committee's reasoning is circular in justifying the proposed discriminatory treatment by defining the similarity in this way. The purpose of this nondiscrimination provision "is to ensure equal treatment for taxpayers residing in the same State, and not to subject foreign capital, in the hands of the partners or shareholders, to identical treatment to that applied to domestic capital." OECD Model Treaty Commentary, Art. 24, para. 6.

Furthermore, defining similarity by reference to whether a related party must pay U.S. taxes contravenes Treasury Department policy. For example, the Technical Explanation for this provision in the U.S. - U.K. Income Tax Treaty compares enterprises "carrying on the same activities." U.S. Treasury Dept., Technical Explanation of the U.S. - U.K. Income Tax Treaty, reprinted in 3 Tax Treaties P 8103DD (CCH) (1977). The U.S. tax status of interest paid to related persons is obviously irrelevant in comparing the activities of such corporations.

Therefore, the proposed disallowance is inconsistent with and vitiates an important part of the tax treaty negotiating policy of the United States and also violates non-discrimination clauses of the type contained in the 1981 Model Treaty.*

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* Although the Senate Finance Committee Report (p. 429) merely states that if the tax violates any U.S. treaty obligations, the Committee "does not intend that any contrary provision defeat its purpose in enacting this limitation", we assume that this means that the Finance Committee intends that the deduction disallowance rule should override these treaty provisions. If, contrary to the recommendation contained in this report, the Conference Committee decides to retain this provision in the Senate Bill, we suggest that the Conference Committee report specifically state that such an override is intended.

The Treasury Department has previously stated, in response to H.R. 3838, that it opposes amendments to the Internal Revenue Code that override U.S. income tax treaty provisions. This is because such amendments could diminish the value of future treaty commitments from the United States and offer foreign treaty partners an excuse to unilaterally abrogate the provisions of non-tax treaties.[**] The Tax Section supports the general tax treaty policy of limiting double taxation through reciprocal withholding tax reductions and exemptions for interest in cases where the other treaty party is taxable on such income in its country of residence.

For the foregoing reasons, the Tax Section strongly opposes this provision insofar as it relates to interest payments to foreign corporations that are exempt or subject to reduced tax only by reason of treaty provisions.[*]

[**] See letter dated April 7, 1986 from Treasury Secretary Baker to Senate Finance Committee Chairman Packwood.

[*] We assume that enactment of such a provision could lead foreign treaty partners to enact similar provisions relating to foreign subsidiaries of U.S. corporations on the basis that the United States stockholders in such companies are also “tax-exempt entities”.

SPECIFIC COMMENTS

1. Disallowing interest deductions in relation to a corporation’s taxable income often will bear little relationship to the perceived abuse. The disallowance will often be the same whether the taxpayer pays interest only to related parties or pays substantial amounts of interest (but not in excess of its recomputed taxable income) to taxable persons such as banks. Thus, assume that a foreign controlled U.S. corporation has recomputed taxable income of $20 million, that it pays $10 million of interest to unrelated banks and $1 million of interest to its foreign stockholder. The $1 million would be non-deductible. However, the same result would apply if all the interest were paid to its foreign stockholder. Further, the disallowance would apply whether or not the disallowed deduction related to indebtedness that clearly qualified as debt for tax purposes, e.g., nonsubordinated, not based on earnings or receipts and a very low debt-equity ratio, or whether it was only barely on the “safe side” of the debt-equity line, e.g., subordinated interest based to

some extent on earnings, and a high debt equity ratio. We therefore suggest that if interest paid to related foreign stockholders is to be disallowed at all, the disallowance should relate only to indebtedness that is equity-flavored.

2. Under the Senate Bill, a carry forward for disallowed interest would be provided but a carry back would not. The Committee Report states (p. 425) that the carry forward is intended to prevent inequitable results where interest is disallowed because of It a bad year in a business cyclet1 which “might reduce pre-interest deduction taxable income to the point where the limitation takes effect.” In that event, we believe that a taxpayer that would not have been subject to the limitation in prior years had the interest been paid at that time should be allowed a limited carry back deduction under rules similar to those provided for net operating loss deductions.

3. The Finance Committee Report (p. 427) states that whether a foreign entity is tax-exempt for purposes of this provision should be determined on an item of interest by item of interest basis. The Senate Bill itself is ambiguous on this point. We suggest that the point is sufficiently important that it should be resolved by the statutory language, rather than in the legislative history of the provision.

4. Under the Senate Bill, if interest is subject to a reduced tax treaty withholding rate, it will be treated as partially exempt and partially taxable. The entire amount of the portion that is treated as exempt would be nondeductible to the extent that total interest payments exceed 50% of the taxpayer's recomputed taxable income. It therefore appears that the example on page 427 of the Finance Committee Report is incorrect in applying this exempt characterization rule only to the interest in excess of 50% of the taxpayer's recomputed taxable income.* On the other hand, if the example represents the drafters' actual interpretation of this provision, the proposed statutory language should be modified to reflect that position.

5. The Bill requires the adoption of regulations that would treat back-to-back loans through unrelated parties like direct loans to related parties. The only example of such a transaction that appears in the Finance Committee

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* In the example, a U.S. corporation has recomputed taxable income of $100 and pays $80 of interest to its Swiss parent, which is subject to a 5% withholding tax. We believe that the proper result under the Senate Bill is that 5/6 of the $80 payment, or $64, is treated as exempt and that therefore the entire $30 by which the total $80 of interest exceeds 50% of recomputed taxable income would be disallowed as a deduction. The Committee Report therefore is incorrect in treating as exempt only 5/6 of the $30 excess, and thus disallowing only $25 of the taxpayer's interest deduction.

Report involves a U.S. corporation that borrows money from a Dutch bank that has borrowed money from a U.S. corporation's foreign parent. We suggest that, if the interest disallowance provision is included in the bill that is agreed upon by the Conference Committee, the Conference Committee Report should include additional examples of what are and what are not back-to-back loans to which this provision applies. Thus, a back-to-back situation might also include a loan to a U.S. subsidiary by a U.S. bank that was made on the basis of a deposit with the bank by a related offshore party. On the other hand, interest should not be disallowed in a case where the U.S. branch of a foreign bank lends to a U.S. corporation and the foreign parent puts money on deposit with the foreign branch of the foreign bank where there is no transfer of funds from the foreign branch of the bank to its U.S. branch and where the U.S. branch does not deduct for U.S. income tax purposes the deposit interest paid by the foreign branch.

6. If no effort is made to isolate the extent, if any, that interest paid to a “related tax-exempt entity” is included in a net operating loss, it may be possible for at least some taxpayers to achieve the result that the Senate Finance Committee believes is inappropriate by careful timing of interest expense. Thus, a U.S. corporation might incur a substantial net operating loss in year 1 which result to a large extent from interest paid to related foreign parties. Under the carry forward rules, the loss will be fully available against taxable income in year 2 to the same extent as if the loss had resulted from other deductions. We believe that the generally applicable limitations on a corporation's ability to accrue interest deductions on a noneconomic basis are sufficiently restrictive that such a situation is not likely to occur except on an infrequent basis. Therefore, we

believe that curbing this potential abuse would not justify the complex drafting and resulting interpretive problems that probably would be involved in doing so.