January 15, 2008

Who Ate The Homework?

The Treasury Department Reports to Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties

On November 28, 2007, as mandated by the American Jobs Creation Act of 2004, the Treasury Department submitted to Congress a report (hereafter, the "Report") on earnings stripping, transfer pricing and U.S. income tax treaties, emphasizing intangible property in the case of transfer pricing.[1] While the 2004 Act added Code provisions intended to deter the "inversion" or expatriation of U.S. corporations, it did not change the earnings stripping, transfer pricing or tax treaty abuse rules that are arguably relevant to the "dynamics" of inversion transactions. The Treasury was instead directed to issue reports on the effectiveness of each of the rules. These were due in 2005. A study of the effect of the Act's inversion provisions was also mandated for 2005, but the Report says that more time is needed to assess their impact and also that the study should wait on the issuance of further regulations under Section 7784.[2]

In summary, the Report concludes that (i) while there is no "conclusive evidence" of earnings stripping – defined generally as the payment of "excessive deductible interest" to foreign-related parties – by foreign-controlled domestic corporations, other than by so-called "inverted" corporations (*i.e.*, U.S. corporations that inverted into, and became, foreign corporations prior to the effective date of the 2004 Act), there is "strong evidence" of earnings stripping by inverted corporations; (ii) the way forward on transfer pricing is for the Treasury to finalize regulations relating to cost sharing, related-party services

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[1] Department of Treasury, "*Report to Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties*," November 28, 2007, http://www.treas.gov/offices/tax-policy/library/ajca2007.pdf.

[2] Two sets of regulations have been issued and additional regulations are expected.

and global securities dealing; and (iii) the limitation on benefits articles in U.S. tax treaties are central to preventing the abuse of those treaties. In the absence of sufficient information about earnings stripping, a new tax form intended to collect information on potential earnings stripping was released for comment at the same time the Report was issued.[3] While deferring a report on the inversion provisions of the 2004 Act, the Report does conclude that the enactment of those provisions of the 2004 Act "appears to have been successful in curtailing inversion transactions by large, publicly traded corporations."[4]

Earnings stripping

As most readers of this article know, the earnings stripping rules in Section 163(j) suspend a current deduction for interest expense of a U.S. corporation on debt to, or guaranteed by, a related party to the extent that the net interest expense of the U.S. corporation would otherwise reduce taxable income before interest, depreciation or amortization, by more than 50% and the interest is not subject to the full 30% U.S. withholding tax. Disallowed interest may be carried forward indefinitely, subject to the limitation; and unused capacity, *i.e.*, any excess of what could have been deducted over what is deducted, may be carried forward for 3 years. A safe-harbor excludes corporations with a 1.5-to-1 or lower debt-to-equity ratio, calculated on a tax basis; and there is a proportionate reduction in the interest that will be disallowed if it is subject to a withholding tax of less than 30%.

In concept (and leaving aside some of the specific features), the rules seem to me to be very smart – the premise is that traditional thin capitalization cases don't work to stop extreme leverage; but, unlike the fixed debt-to-equity rules that some other countries use to deal with this, the earnings stripping rules relate the disallowance of interest expense to the specific issue that makes leverage a tax problem, *i.e.*, the reduction in taxable income.

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[3] Form 8926 (Disqualified Corporate Interest Expense Disallowed Under Section 163(j) and Related Information), which ask for information on debt-to-equity ratios, net interest expense, adjusted taxable income, excess interest expense, disqualified interest and the amount of the disallowance under Section 163(j). *See also* I.R.S. Announcement 2007-14.

[4] Stating further that "There do not appear to have been any high-profile inversions as defined by Seida and Wempe [the private sector study that the Report relies on] since 2002, which may be due to the enactment of section 7874".

Un-inverted corporations What are we to make of the Report's general conclusion with respect to earnings stripping? The earnings stripping rules were enacted in 1989 and expanded in 1993 to cover interest on guaranteed debt; and there have since then been a number of separate proposals for change, including proposals by the Treasury, to change Section 163(j). These include proposals to eliminate the 1.5-to-1 debt-to-equity safe harbor, drop the 50% of taxable income threshold to 35% or to 25%, limit the carryforward of suspended deductions to five or to three years, and to exclude interest on debt guaranteed by a related person (as opposed to interest on debt to a related person) if it is established that substantially the same amount could have been borrowed without the guarantee. Another proposal (possibly the most frightening of all) would suspend the deduction for interest on excess U.S. leverage, *i.e.*, leverage in excess of the worldwide leverage of the group. While some of these proposals would apply only where the foreign parent was an inverted U.S. corporation, others would apply without that restriction. The Report describes but does not evaluate the proposals.

Given these proposals and the time that has elapsed since Section 163(j) was enacted, it is surprising for the Report to conclude that more information is needed to determine whether there is earnings stripping and how foreign-controlled domestic corporations would be affected by the proposals for change – also, that the "overall effect of income stripping on U.S. employment is unclear" and that "existing studies do not address the question of how income shifting affects cross-border investment."

And what about the Section 163(j) regulations, proposed in 1991 but never adopted? These address a number of quite fundamental issues, such as whether the disallowance is computed on a consolidated basis in the case of U.S. corporations that are commonly owned but not members of the same affiliated group and how Section 163(j) applies to a foreign bank that has a U.S. branch (as well as U.S. subsidiaries). Adoption or non-adoption of the regulations is not considered by the Report, and there is no discussion of the possibility of guidance with respect to the existing earnings stripping rules.

The Treasury Department's December 2007 study, "Approaches to Improve the Competitiveness of the U.S. Business Tax System for the 21st Century," does not deal with investment into the United States, but in its discussion of foreign investment by U.S. corporations stresses the declining share of the United States in worldwide output and as the home for the largest corporations in the world, concluding

that by any measure, the United States today is less economically dominant that it was 45 years ago." This leads the study to consider possible relaxations in the subpart F rules. Does this same concern about the economic position of the U.S. underlie the Report's views on tightening the earnings stripping rules?

Inverted corporations In the case of inverted corporations, the Report says the data "strongly suggest that these corporations are shifting substantially all of their income out of the United States, primarily through interest payments." But the source for this seems to be limited to one private-sector study, [5] and as noted above the Treasury at this time is not ready to report comprehensively on the expatriation rules of the 2004 Act, notwithstanding the Congressional direction to do so by the end of 2005.

What should we make of the Report's conclusion with respect to inverted corporations? Should the Report be interpreted as saying that U.S. subsidiaries of inverted corporations are, as a factual matter, more highly-leveraged than U.S. subsidiaries of other foreign corporations? That seems unlikely. Or is the Report's conclusion just that – which seems to me to be right – that the *increase* in leverage is visible?

Should inverted corporations be nervous? The Report says that "data indicate[s] at the very least modifications to section 163(j) are needed to address the problems of earnings stripping by *existing*" inverted corporations.[6] Once a U.S. corporation has inverted and restructured, however, there is no tax policy (other than revenge) that would justify viewing the inverted corporation any differently than any foreign corporation, and the Report's concern about foreign corporations is the possibility that changes in the earning-stripping rules could affect cross-border investment and the U.S. economy. So I do not think

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[5] Jim A. Seida & William F. Wempe, *Effective Tax Rate Changes and Earnings Stripping Following Corporate Inversion*, NATIONAL TAX JOURNAL 57(4) (December): 805-28 (calculating that the revenue cost for 2002 and 2003 from earnings stripping by the inverted corporations included in the study was more than $700 million). The Report also notes that "In the SEC filings seeking shareholder approval of these transactions, significant reductions in the U.S. corporate taxes are listed as a key reason that the former U.S. parent corporations undertook these transactions."

[6] Emphasis added.

that the Report provides a sensible rationale for changing the rules that apply to corporations that have already inverted, and I would be surprised if Congress took a different tack. The Treasury, in its 2002 study of inversions, pointed out that the "techniques" used by inverted corporations "are available to any foreign-controlled corporate group" and thus "inversion transactions simply exposed areas of weakness in the Code and U.S. income tax treaties."

Income tax treaties

Turning to income tax treaties, the Report focuses on treaty-based "abuses" of the U.S. withholding tax rules, particularly in the case of interest and dividends, and also on the U.S. policy with respect to the elimination by treaty of the excise tax on premiums paid to foreign insurance companies to insure or reinsure U.S. risks.

Limitation on benefit articles After reviewing the history and evolution of "limitation on benefits" articles in U.S. tax treaties through the "model" income tax convention released by the Treasury Department at the end of 2006, the Report says that these articles are "critical" and that they provide "significant deterrence against" treaty "abuse." It goes on to say that there is empirical evidence that, in the absence of a "limitation on benefits" article, withholding tax reductions or eliminations in older treaties, such as those with Iceland, Hungary[7] and Poland (and Barbados prior to the 2004 protocol), have been abused, and that limitation on benefits articles in treaties appear to provide a "significant deterrence" against abuse. It cites the signing of a new treaty with Iceland in October 2007 as the "most noteworthy development to date" in this area.

This is interesting, but is it news? The use of Hungarian and Icelandic companies to avoid U.S. withholding taxes on interest has been around for some time, and is essentially part of the 1995 decision

[7] According to the Report, interest paid to related Icelandic corporations grew from $.3 million in 1998 to $912.7 million in 2004 and interest paid to related Hungarian corporations grew from $50 million in 1998 to $1,238.1 million in 2004, making those countries the 8th and 9th largest recipients of related party U.S. source interest.

that the anti-conduit regulations[8] would not deal with foreign conduits financed by non-redeemable non-putable stock but rather would wait on the extension to all treaty partners of limitation on benefit articles.

Representative Rangel's "mother" of all tax bills,[9] introduced in October, would provide that interest, royalties and other deductible payments made by a foreign-controlled U.S. corporation are to be treated as paid directly to the ultimate foreign parent for withholding tax purposes. This would close down the use of Hungary and whatever else remains of the use of treaties to reduce withholding taxes on interest and royalties.

Other treaty rules What about other treaty rules? In 2000, concerned about the use of fiscally transparent entities to finance U.S. operations, the Treasury issued regulations, subsequently blessed by Congress, that interpret all U.S. tax treaties to deny treaty benefits to interest and other investment (or fixed and determinable annual or periodical) income of a foreign "regular" hybrid unless the income is taxed to the entity or its owners as the income of a resident of the treaty partner.[10] Regulations issued in 2002 went on to provide that interest paid to a related person by a domestic reverse hybrid would be treated as a dividend (and thus as non-deductible and subject to withholding) to the extent funded by U.S. source dividends received by the hybrid.[11]

As a matter of course, U.S. treaties now confirm what is provided by the Section 894 regulations and extend the rules to income of a fiscally transparent entity that is not fixed or determinable annual or periodical (*i.e.*, business profits that would be taxable if there was a permanent establishment). The pending protocol to the U.S.-Canada treaty would go further than the Section 894 regulations (and the

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8 Set out in Regs. §1.881-3. Stock will be a "financing transaction" only under the circumstances set out in Regs. §1.881-3(a)(2)(ii)(B).

9 The Tax Reduction and Reform Act of 2007.

10 Regs. §1.894-1(d)(1).

11 Regs. §1.894-1(d)(2).

U.S. model tax treaty) and deny treaty benefits to payments made by a domestic reverse hybrid that are re-characterized as dividends. [12]

There is no real difference between the purpose of limitation on benefits articles and the purpose of the regulations under Section 894 – both are intended to deny treaty benefits to income that is not substantively taxed as the income of a resident of the other country. While the main focus of the Section 894 regulations is on hybrid entities, the rules with respect to payments made by a domestic reverse hybrid are equally about hybrid transactions. But the Section 894 regulations and the related treaty rules for fiscally transparent entities go without mention in the part of the Report dealing with U.S. tax treaties. As a consequence, there is no discussion in the Report of the broader question of whether it is enough to deal with hybrid entities or whether treaties might not also be a way of dealing with hybrid instruments or different concepts of ownership.[13]

Insurance and reinsurance Some U.S. treaties eliminate the excise tax imposed on premiums paid to foreign insurers but others do not,[14] and the Report says that, when asked to do so in treaty negotiations, the Treasury conducts a "thorough review" of the taxation of the other country's insurance industry and accedes to the request only if satisfied that an insurance company resident in the other state will "face a level of taxation that is substantial relative to the level of" tax faced by U.S. insurers. This is more informative than the technical explanation of the 2006 model treaty, which was silent on the U.S. treaty policy with respect to the excise tax.

Should more be said about insurance? The Report makes no mention of the other current issues involved in offshore insurance and whether there is a transfer pricing problem that needs to be addressed.[15] The private sector study that provides the basis for the Report's conclusion that inverted

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[12] *See* Article IV(7)(b) as it would be changed by the protocol.

[13] As, *e.g.*, in Article 24(4)(c) of the U.S.-U.K. income tax treaty.

[14] The excise tax is imposed on premiums for the insurance or reinsurance of U.S. risks that are paid to foreign insurance companies that do not carry on business in the U.S.

[15] The Report does not address offshore reinsurance, which has recently been the subject of hearings before the Senate Finance Committee. *See* Joint Committee on Taxation, "*Present Law and Analysis Relating to Select International Tax Issues*" (JCX 85-07), September 24, 2007.

corporations "are shifting substantially all of their income out of the United States, primarily through interest payments" does not include insurance companies in the corporations that were tested. This is sensible if the study is limited to earnings stripping through interest payments as opposed to reinsurance, but begs the question of whether related-party reinsurance may be a form of stripping. (The United Parcel Service case, listed under the strategic litigation component of the IRS' Section 482 strategy, is on one level an insurance/reinsurance case.[16])

Transfer pricing

The part of the Report dealing with transfer pricing is most satisfying (and the longest of the three chapters), although it includes no real surprises. The Report says that the fundamental components of the IRS' five-part strategy to improve the administration of Section 482 that were described in the report issued in 1999[17] remain unchanged. In addition, the Treasury needs to finalize and modernize transfer pricing guidance on (1) cost sharing rules with respect to the type and valuation of external contributions (*i.e.*, buy-in payments);[18] (2) related party (or "controlled") services transactions, including coordination with the rules that apply to transfers of intangible property generally;[19] and (3) the determination of income from global securities dealing (*i.e.*, the income of a dealer in securities that operates in more than one country).[20] The cost sharing rules were proposed in 2005, and the Report states that the Treasury Department is working to finalize these. Temporary and proposed regulations have been issued with

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16 United Parcel Service of America, Inc. v. Comm'r, 254 F.3rd 1014 (11th Cir. 2001), rev'g 78 T.C.M. (CCH) 262 (1999) on the question of whether the restructuring of the taxpayer's excess value charge activities into a Bermuda corporation had substance and should be respected, but sending the case back to the Tax Court to address the Section 482 and Section 845(a) issues involved in the transactions between that corporation and the taxpayer.

17 *Report on the Application and Administration of Section 482* (April 21, 1999), which was followed two years later by a report on *Fiscal Years 2000-2001 IRS Study: Effectiveness of Internal Revenue Code Section 6662(e)* (December 28, 2001).

18 *See* Prop. Treas. Reg. § 1.482-7 (setting forth methods to determine taxable income in connection with a cost sharing arrangement).

19 *See* Temp. Treas. Reg. § 1.482-9T (setting forth methods to determine taxable income in connection with a controlled services transaction).

20 *See* Prop. Treas. Reg. § 1.482-8 (setting forth methods to determine taxable income in connection with global dealing operations).

respect to related party services and new proposed regulations with respect to global dealing operations are "to be issued shortly."

The "fundamental components" of the IRS' five-part strategy described in the 1999 report (itself mandated by the 1999 Omnibus Consolidated and Emergency Supplemental Appropriations Act) are (1) the issuance of additional guidance under Section 482, (2) encouraging upfront compliance on the part of taxpayers, (3) building international consensus concerning transfer pricing issues, (4) resolving contentious transfer pricing cases by means of advance pricing agreements and (5) "where appropriate," pursuing strategic Section 482 litigation. The Report includes a useful summary of IRS audit programs, such as the Compliance Assurance Process (which allows the IRS to determine tax return accuracy before the return is filed), the Limited Issue Focused Examination program and the Prefiling Agreement program, as well as of the initiatives of the cross-functional Issue Management Teams established by the IRS.

Strategic litigation listed in the Report includes old favorites, such as Glaxo SmithKline Holdings, United Parcel Service,[21] Xilinx[22] and the Section 482 issues involved in Compaq Computer Corp.[23], and other cases, largely dealing with intangibles.[24] The taxpayers in most of the cases (Glaxo SmithKline Holdings and Schneider Electric Holdings and BIB (USA), Inc. being the exceptions) are U.S.-, not foreign-, controlled, which is curious in light of the Congressional focus (*see* below) on transfer pricing by foreign-controlled U.S. corporations.

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[21] United Parcel Service of America, Inc. v. Comm'r, 254 F.3d 1014 (11th Cir. 2001).

[22] Xilinx, Inc. v. Comm'r, 125 T.C. 37 (2005), on appeal to the 9th Circuit.

[23] Compaq Computer Corp. v. Comm'r, T.C. Memo. 1999-220 (1999),

[24] These include cases involving cost-sharing arrangements (Veritas Software Corporation, Adaptec, Inc., and BMC Software) and/or whether payments for intangibles were at arm's length (BMC Software; Adaptec, Inc.; H Group Holdings, Inc.; and Schneider Electirc Holdings). May Kay Holding Corporation involves the deductibility by a U.S. parent of payments made to foreign subsidiaries to ensure a profit margin from the development of new markets for its products. Schneider Electiric Holdings also involves the deductibility of payments by a U.S. subsidiary to its French parent of payments for services provided by the parent. The transfer pricing issue in BIB (USA), Inc. is the methodology to be used to price services rendered by a U.S. subsidiary to its foreign parent.

The 1999 report, which in turn followed a 1992 report,[25] was generated by a Congressional concern about lost tax revenues from transfer pricing by foreign corporations with U.S. subsidiaries. The 1999 report, among other things, concluded that there was a Section 482 tax gap of about $2.8 billion of gross income a year during the period 1996-8, of which about $2 billion of gross income was attributable to foreign controlled corporations. The conclusion was heavily qualified, largely because the data was derived principally from IRS examinations. The 2001 report, in response to a Senate Appropriations Committee request, dealt with the effectiveness of Section 6662(e), which imposes the contemporaneous transfer pricing documentation requirement. The Senate request was based on the view that it was critical for the IRS to improve the enforcement of Section 482. While stating that what taxpayers provide as contemporaneous documentation "could be improved", the 2001 report also says that documentation is prepared "in most cases," that it "often covers a significant percentage" of the controlled transactions and that it "has proven useful" to the IRS, and that improvements are expected as taxpayers and the IRS "gain additional experience" with the requirement.

The Report and its predecessors covered different, albeit related areas; but it is the case that both the 1999 and 2001 reports are significantly more methodical in their approach, and more informative in their conclusions, than the Report. An illustration – the Report simply lists tax litigation under Section 482 in a way that makes it difficult (without a journey to the Tax Court, which is the only way that I was able to locate some of the cases) to determine what is involved; the 1999 report described the issues involved in the cases that it listed.

In between the Report and its predecessors, there were other IRS and Treasury Department comments on transfer pricing issues, including (importantly) Commissioner Everson's June 2006 testimony before the Senate Committee that taxpayers – presumably, U.S. corporations – "are continuing to shift significant profits offshore." Everson went on to say that "[t]axpayers often manipulate the price of related transactions so that the income of an economic group is ostensibly earned in low tax jurisdictions, or in no jurisdiction, rather than in the U.S., thus lowering the enterprise's worldwide tax burden. We

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[25] Report on the Application and Administration of Section 482 (April 1992).

apply the arm's length principle to determine the appropriate allocation of income between related parties based upon the application of acceptable transfer pricing methodologies."

Turning to proposed regulations, the Report refers to the cost sharing regulations that were proposed in August 2005. These govern agreements between related parties to share the costs and risk of the development of intangible property in proportion to reasonable expectations of anticipated benefits from the separate exploitation of the developed property. Temporary regulations relating to controlled services transactions were issued in August 2006, in particular, with respect to contributions to the value of an intangible owned by another controlled party. They also allow routine back-office services to be charged at cost with no markup. The global dealing regulations, to be issued shortly, are of more narrow interest, since they deal only with securities dealers; and they also differ in that, to a large degree, they are intended to resolve uncertainties, not to prevent transfer pricing abuses. Other projects, not dealt with in the Report, are the promised final regulations on foreign tax credits that were issued in proposed form in August 2006, and the planned issuance of guidance to address the use of contract manufacturing to produce property sold by controlled foreign corporations (including the manufacturing exception to the foreign base company sales rules under Section 954(d)(1) and the branch rule in –(d)(2)). Regulations to implement the notice (Notice 2007-13) that limited the definition of substantial assistance will also be issued.

The Report also says that the Treasury "does not recommend additional disclosure requirements at this time", given "the generally high audit rates of affected taxpayers" and the "enhanced ability" of the IRS to exchange information with other tax jurisdictions".