MOVING DEDUCTIONS INTO THE U.S. AS A TAX PLANNING STRATEGY

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The J.C.T. Report recognizes that, for multinational taxpayers engaged in cross-border transactions, the ability to claim deductions when determining Federal income tax liability is a fundamental component of international tax planning strategy.[1]

The U.S. has the highest combined Federal, state, and local corporate tax rate – a fact that incenti*vize*s multinational corporations to generate higher U.S. tax deductions in order to minimize the taxable base. The maximum U.S. Federal corporate tax rate is 35%, and the addition of state and local taxes can push the effective tax rate even higher. In New York City, for example, the combined effective tax rate can climb to approximately 45%. In contrast, the U.K. corporate tax rate is scheduled to be 20% in 2015. Consequently, a tax deduction in the U.S. is often more valuable than one in a foreign jurisdiction, and planning strategies may be designed to move or "shift" deductions into the U.S.

In light of this situation, the J.C.T. Report focuses on several areas where it may be worth considering legislative action in order to limit the shifting of deductions into the U.S.

MULTINATIONAL ARBITRAGE

Arbitrage between the creation of deductions in the U.S. and the shifting of income to a lower tax jurisdiction outside the U.S. is an erosion of the U.S. tax base. Effectively, this results in the U.S. subsidizing overseas growth and incenti*vizi*ng U.S. investment abroad.

Detailed regulations under Code §861 address allocation and apportionment of deductions and interest. These regulations impact non-U.S. persons in the determination of U.S.-source taxable income. In contrast, U.S. corporations that are taxable on worldwide income are not usually affected by these rules, in the sense that no matter how interest is apportioned or allocated to income baskets, the interest remains deductible to the extent provided by law. The apportionment rules have the greatest effect when determining foreign tax credit ("F.T.C.") limitations. As a result, opportunity remains for U.S. corporations with foreign affiliates to utilize tax planning maneuvers in order to lower their U.S. tax liability, and the J.C.T. Report expresses concern about this.

A U.S. corporation may deduct interest expense incurred in connection with a borrowing to fund operations, but because the money is fungible, it is difficult to

[1] As a general rule, taxpayers may deduct ordinary and necessary expenses paid or incurred during a taxable year in which they are engaged in carrying on a trade or business in the U.S. Exceptions apply to certain disallowances indicated in the Code.

determine whether the loan is actually used to fund a company's operations or if that money is used for another purpose. A company that borrows for an investment frees up other cash to be used for other purposes. A U.S. multinational corporation may choose to locate its borrowing in the country where the interest expense deduction will produce the highest tax benefit (*i.e.*, the country with the highest tax rate and the fewest restrictions on deductibility), while utilizing those funds in another jurisdiction. The J.C.T. Report notes that:

> The fact that a U.S.-based multinational can claim a current U.S. tax deduction for borrowing to invest in low-taxed countries increases the after-tax return of those investments and may encourage some investments that would not otherwise be made. In this respect, the current U.S. tax system can be viewed as subsidizing overseas growth and investment by U.S.-parented groups.

A U.S. corporation can claim a deduction under Code §174 for expenditures in relation to research and development ("R&D") activities. Where that R&D results in innovative techniques, processes, or formulas, U.S. corporations will sometimes transfer valuable intellectual property ("I.P."), or rights to use the I.P., to foreign affiliates, thereby allowing some or all of the profit from the I.P. to accumulate in low-tax environments offshore. The combination of a high U.S. tax rate that encourages placement of deductions in a U.S. entity and the deferral of earnings offshore promotes a scenario in which taxpayers are incenti*vize*d to distort the location of income and expenses. The distortion is magnified if inadequate compensation is received by the U.S. member of an M.N.G. in the form of royalties and other payments.

EARNINGS STRIPPING

A foreign parent with a U.S. corporation may reduce its U.S. taxable income by making deductible payments to the foreign parent or affiliates; these include interest, royalties, management or service fees, rents, and reinsurance premiums. Taking tax deductions in the U.S. in connection with borrowings from foreign affiliates so that U.S. tax is reduced for the payor without tax being imposed on the recipient is known as "earnings stripping." The result arises because income tax treaties usually reduce or eliminate the statutory 30% withholding tax on payments of fixed and determinable, annual and periodic income to foreign entities.

Use of Debt Rather Than Equity

There are tax advantages to financing a business through a combination of debt and equity. Debt financing allows a business to raise funds at a lower cost, which therefore allows for a lower cost on the return to debt investors.

A U.S. corporation can claim an interest deduction, but it cannot claim a deduction for dividends paid to its shareholders. The debt principal may be repaid on a tax-fee basis. In contrast, distributions to shareholders that are treated as dividend distributions are subject to a 30% withholding tax and earnings must be distributed before capital is repaid. Tax treaties historically provide better treatment for payments of interest rather than payments of dividends. Most entirely eliminate withholding tax on interest. In comparison, with several recent exceptions, the withholding tax on dividends is lowered to 5% or 15%.

In general, earnings stripping provides a net tax benefit only to the extent that the foreign recipient of the income is subject to a lower amount of foreign tax on such income than the net value of the U.S. tax deduction applicable to the payment, *i.e.*, the amount of the U.S. deduction times the applicable U.S. tax rate, less the U.S. withholding tax levied at a percentage provided under the relevant income tax treaty. Such may be the case if the country of the income recipient provides a low general corporate tax rate. The U.K.-U.S. Income Tax Treaty is one example, in light of its general corporate tax rate of 20%. Alternatively, the recipient may benefit from certain tax characteristics, such as a net operating loss, excess credits, or an anti-abuse rule that treats the interest payment as a tax-free dividend.

Code §163(j) was enacted to restrict this type of conduct. A cap is placed on deductions claimed for related-party interest if (i) a U.S. debtor corporation pays interest expenses to a related foreign person that is not subject to a 30% withholding tax, (ii) the debt to equity ratio of the U.S. debtor corporation exceeds 1.5 to 1, and (iii) the corporation has excess interest expense, which broadly means that e interest expense exceeds 50% of the corporation's E.B.I.T.D.A., adjusted for certain items that are tax related. If these conditions apply, then the interest expense deduction on payments to related lenders will be deferred so that the cap of 50% of adjusted E.B.I.T.D.A. is not breached. Any disallowed amount will be deferred until the succeeding year, when it is again subject to these limitations.

The prevalence of earnings stripping is not entirely clear. One Treasury Report concluded that strong evidence indicated that inverted corporations were stripping earnings out of U.S. operations and, consequently, that Code §163(j) was ineffective. The results for other foreign-controlled domestic corporations were not conclusive.

Royalties and Other Deductible Payments

Apart from the use of debt, the potential for earnings stripping also exists for transactions involving the payment of other deductible amounts, such as royalties, management or service fees, rents, reinsurance premiums, and similar types of payments to related foreign entities. Code §482 requires that the fees being charged reflect an arm's length price. However, special earnings stripping rules do not currently exist for these transactions.

As a result, a U.S. corporation may enter into a licensing or distribution agreement with a foreign related party in exchange for royalty payments. The royalty payments have the effect of eroding the U.S. tax base. Alternatively, the U.S. corporation may transfer performance or other risks to a foreign related party in exchange for service or similar fees, leaving a small profit margin in the U.S. that reflects the local market distribution activities. The J.C.T. Report observes that:

> As opportunities for stripping earnings based on interest payments are exhausted, taxpayers may increasingly find it attractive to strip earnings through other means. Although the generation of earnings stripping payments other than interest, such as royalties, may require a real movement of tangible or intangible assets or a change in business operations of the corporation, firms may engage in this tax planning to improve the after-tax return on investment.

Thus, the J.C.T. suggests possible legislative action, such as the addition of earnings stripping rules dealing with non-interest payments.

CONCLUSION

"The J.C.T. Report considers a several legislative solutions that may be used to curtail excessive tax deductions taken by multinational businesses."

The J.C.T. Report considers a several legislative solutions that may be used to curtail excessive tax deductions taken by multinational businesses. However, the possible expansion of earnings stripping rules, and other suggested techniques, may serve only to increase the complexity of taxpayer planning and to create an added burden for the I.R.S. at the time it examines the tax return of a U.S. member of the M.N.G. While such changes may produce higher effective tax rates for multinational corporations, any Congressional action should be approached with care, due to concerns that aggressive action may inhibit U.S. competitiveness in the global economy and ultimately prove to be detrimental to the preservation of a solid U.S. tax base.