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Unsatisfactory Response to the International Problem of Thin Capitalization: Can Regulations Save the Earnings Stripping Provision, An

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An Unsatisfactory Response to the
International Problem of Thin
Capitalization: Can Regulations
Save the Earnings Stripping
Provision?

by
Robert J. Misey Jr.*

I. INTRODUCTION

The Internal Revenue Code (the “Code”) contains a bias toward financing a corporation with debt instead of equity. The Code subjects corporate distributions on equity to double taxation. The Code first taxes the corporation for the net income it earns. It then taxes the equity-holder for receipt of a dividend from the corporation. On the other hand, the Code imposes a tax on corporate distributions to debtholders only once. The debtholder pays tax on the interest income he receives, but the corporation may deduct the payment as an interest expense.

For this reason, an equityholder has the incentive to characterize additional contributions to a corporation as debt in order to minimize its tax burden. This tax incentive creates a problem as corporations are encouraged to finance their capital structure with excessive debt. Corporations with a

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2. Id. § 1; I.R.C. § 61(a)(7) (West Supp. 1990).
4. On the other hand, one could argue that high bracket taxpayers prefer holding equity while low bracket taxpayers prefer holding debt. High bracket taxpayers prefer equity because, assuming there are no cash distributions, the gain is taxed against basis on the sale of stock. The converse is that low bracket taxpayers will prefer debt because they will pay little tax on the periodic payments they receive and are less likely to be able to wait until they sell their underlying investment for cash.
high proportion of debt to equity financing are referred to as "thinly capitalized."

When the Code’s favoritism of debt over equity combines with the dynamics of international taxation, the problem of international thin capitalization results. The major result of international thin capitalization is the loss of U.S. tax revenue due to interest payments that the U.S. corporation deducts, while the foreign recipient avoids U.S. tax due to a treaty or an exemption in the Code. When a foreign investor finances the debt of an American corporation, even a single tax may be avoided. Characterizing the capital contribution as a loan, the U.S. corporation deducts the interest payments, thereby decreasing its taxable income. The foreign investor is then exempted from paying tax by either the Code or a treaty.

After failing to formulate legislation dealing with leveraged buyouts (LBOs) in the 1989 Omnibus Budget Reconciliation Act (OBRA), Congress adopted the earnings stripping provision, ostensibly attempting to solve the problem of foreign investors thinly capitalizing U.S. corporations. Prior to the enactment of the earnings stripping provision, the Code did not limit the amount of interest that the U.S. corporation could deduct in the year of payment to its foreign investors. The earnings stripping provision disallows deductions by a U.S. corporation if the corporation qualifies under the provision’s five-point test.

This article will focus on the earnings stripping provision and possible regulatory proposals to make the provision more effective. Section II reviews problems with the Code and the increasing trend toward thin capitalization which prompted Congressional action. Section III examines the legislative history of the earnings stripping provision, showing how the provision sprouted from an attempt to limit LBOs. Section IV explains the mechanics of the provision. Section V demonstrates how the earnings stripping provision overrides most U.S. tax treaties and fails to follow the economics of corporate finance. Section VI explains the reasons that Congress should repeal the provision. Additionally, the section advances regulatory proposals that eliminate the provision’s economic problems in the event the section is not repealed.

5. The portfolio interest exception exempts interest received by foreign taxpayers who own less than 10% of the paying U.S. corporation. I.R.C. §§ 871(h), 881(c) (1988). The bank deposits exception exempts foreign investors from taxation of interest income on their deposits. Id. §§ 871(i)(2)(A), 881(c).


8. Id. § 163(a); I.R.C. § 461(a) (1988).
II. BACKGROUND AND OVERVIEW

A. Prior Law

Prior to 1989, the Code did not deal with either the domestic or international problem of thin capitalization. Although Congress enacted many provisions that directly and indirectly tried to limit interest deductions, most of them failed because of their technical definitions. The definitions did not adequately account for varying circumstances.

Courts had long been baffled by the many standards used to distinguish debt from equity. In 1969, Congress legislated section 385, which authorizes the Secretary of the Treasury to write regulations that distinguish debt from equity.\(^9\) In 1980, eleven years after section 385's enactment, the Internal Revenue Service (the "Service") finally issued regulations.\(^10\) These regulations were greatly criticized as being too anti-business.\(^11\) The Service, therefore, twice extended the effective date before finally being forced to withdraw the regulations.\(^12\)

In 1969, Congress also enacted several other provisions to eliminate excessive interest deductions. Section 279 limits deductions for interest on large corporate acquisitions financed by debt having equity characteristics.\(^13\) While the section has succeeded in form, it has failed in substance. Its many technical definitions permit innovative financiers to avoid its application.\(^14\)

There are similar problems with the other sections adopted. For example, section 482 authorizes the Service to allocate deductions between two

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9. I.R.C. § 385 (1988). The regulations could take the following five factors into account:
   (1) whether there is a written unconditional promise to pay on demand or on a specified date a sum certain in money in return for an adequate consideration in money or money's worth, and to pay a fixed rate of interest,
   (2) whether there is subordination to or preference over any indebtedness of the corporation,
   (3) the ratio of debt to equity of the corporation,
   (4) whether there is convertibility into the stock of the corporation, and
   (5) the relationship between holdings of stock in the corporation and holdings of the interest in question.


entities owned or controlled directly or indirectly by the same interests.\footnote{I.R.C. \S 482 (1988). Section 482 provides that: 
\begin{quote} 
in any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses. \end{quote} \textit{Id.}} Among other things, section 482 gives the Secretary authority to allocate deductions "if he determines that such distribution . . . is necessary in order to prevent evasion of taxes."\footnote{Id.} On its face, this language addresses the problem of excessive interest deductions. However, the Service has not applied it in that manner and has not provided specific regulatory guidance.\footnote{The regulations merely provide for determining the arms length rate of interest, not the arms length amount of debt. \textit{See} Treas. Reg. \S 1.482-2(a) (1988).} Instead, the Service has focused on section 482's role in the pricing of intangibles licensed in foreign countries.\footnote{\textit{See infra} note 176 and accompanying text.}

Sections 453(e) and 1239 deal with the shifting of income between related parties.\footnote{I.R.C. \S\S 453(e), 1239 (1988).} However, the sections' application to income shifting does not relate directly to the problem of thin capitalization and cannot be applied as such. Instead, the sections deal with the exchange of property.\footnote{Section 453(e) specifically refers to situations in which "[a]ny person disposes of property to a related person." \textit{Id.} \S 453(e) Section 1239 applies only to the gain from the sale of depreciable property between certain related taxpayers. \textit{Id.} \S 1239.} Section 163(e)(3) prohibits deductions on original issue discount obligations until an issuer actually makes payment to a foreign investor.\footnote{Id. \S 163(e)(3).} Once again, this section does not adequately deal with international thin capitalization. A U.S. corporation wanting to increase the amount of the current interest payment would not have any reason to issue notes containing original issue discount.

Section 512(b)(13) involves a limited segment of thin capitalization interest payments to tax exempt organizations.\footnote{Id. \S 512(b)(13).} This section provides that a parent corporation which is a U.S. tax exempt organization\footnote{See \textit{id.} \S 501(c)(3) (defining tax exempt organizations).} must pay tax on any unrelated business income, including interest income. Thus, a charity loaning money to its subsidiary engaged in a business unrelated to the charity may not use its exempt status to avoid paying tax on the interest. Under section 512(b)(13), the charity is still subject to tax on the interest income that the corporation deducts.
By 1989, Congress had not yet enacted a provision to adequately deal with thin capitalization. Congress eventually addressed the problems of thin capitalization indirectly, as other concerns prompted Congress' movement towards the earnings stripping provision.

B. The History Leading to Congressional Action

The earnings stripping provision emerged in response to two other problems: (a) the corporate deduction of interest on debt incurred to finance acquisitions and (b) the taxation of foreign investment in the United States.

Late in 1988, the press began widely publicizing the abuse of the corporate deduction for interest paid as large corporate mergers dominated the financial news. The acquirors typically financed these mergers through LBOs.

LBOs finance acquisitions through debt. The acquiring corporation typically uses the target corporation's assets as collateral to borrow money to buy the stock of the target. Eventually, only a few individuals will own stock in the target. The resulting interest deductions theoretically erode the borrowing corporation's taxable income. As the volume of merger activity and the use of the LBO to finance those mergers increased, LBOs had the effect of decreasing taxable income. From 1981 to 1987, LBOs, as a percentage of all merger activity, rose from four percent to twenty percent. Because of the increase in merger activity, Congress was particularly concerned that the debt held by foreign investors was often exempt from tax through either the Code or a tax treaty.

Many statistics indicating that investors financed corporations with debt instead of equity further worried Congress about the risks of excessive corporate debt in the marketplace. Since 1983, non-financial, or manufacturing,
corporations retired $313 billion of equities while increasing their debt by $613 billion.\textsuperscript{33} The percentage of cash flow that non-financial corporations devoted to net interest payments increased six percentage points during the period from 1971 through 1985.\textsuperscript{34} Corporate debt as a percentage of gross national product rose from 30.5 percent in 1982 to 36.8 percent in 1987.\textsuperscript{35} The debt to equity ratio, measured at book value, increased over ten percentage points from 1976 through 1988.\textsuperscript{36}

Conversely, proponents of LBOs argued that LBOs forced corporate managers to operate more efficiently to avoid losing their jobs.\textsuperscript{37} Proponents favored LBOs because they provided incentive to engage in riskier investments that could be more productive in the long run.\textsuperscript{38} Furthermore, supporters of LBOs relied on statistical evidence to prove that LBOs did not result in excessive debt. They noted that the debt to equity ratio, measured at fair market value, actually decreased from 1976 to 1988.\textsuperscript{39} Supporters also

\begin{tabular}{|c|c|}
\hline
Period & Interest Payment as Percentage of Cash Flows \\
\hline
1971 to 1975 & 13\% \\
1976 to 1980 & 15\% \\
1981 to 1985 & 19\% \\
\hline
\end{tabular}

TAX ASPECTS, supra note 27, at 12.

\begin{tabular}{|c|c|c|}
\hline
Period & Debt to Equity Ratio (Book Value) & Debt to Equity Ratio (Fair Market Value) \\
\hline
1976 to 1980 & 33.8\% & 72.5\% \\
1981 to 1985 & 33.1\% & 62.5\% \\
1986 to 1988 & 44.4\% & 65.5\% \\
\hline
\end{tabular}

Id. at 64-66.

\textsuperscript{33} Hearing, supra note 32, at 6 (testimony of Rep. Rostenkowski, Chairman, House Committee on Ways and Means).

\textsuperscript{34} Id.

\textsuperscript{35} Id.

\textsuperscript{36} Id.

\textsuperscript{37} Id. at 10-14.

\textsuperscript{38} Id. at 60-61.

\textsuperscript{39} Id.

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pointed to the $94 billion in tax revenue raised by the corporate income tax in 1988.\textsuperscript{40}

While debate over the advantages of LBOs continued, the Service encountered problems when applying the internal revenue laws to foreign investment in the United States.\textsuperscript{41} Congress worried that foreign investors were abusively characterizing their investments as debt. In 1987, foreign investors held only 6.1 percent of all corporate equities, but 13.3 percent of total corporate debt.\textsuperscript{42} That same year, an Internal Revenue Service study indicated that foreign-owned U.S. corporations paid from sixteen to nineteen percent less tax than the U.S. firms with which they competed.\textsuperscript{43} One possible reason for the disparity in tax paid was the disparity in the disclosure of information.

The Securities and Exchange Commission (SEC) requires U.S. corporations to file records that follow Generally Accepted Accounting Principles (GAAP).\textsuperscript{44} The principles call for segmental disclosure by product line and geographic area.\textsuperscript{45} In addition, U.S. corporations must disclose the country of source for their income.\textsuperscript{46}

The SEC waives these disclosure requirements for foreign corporations. Consequently, the Service may not know the amount of debt or equity the foreign parent owns in a new U.S. subsidiary.\textsuperscript{47} The Service’s inability to use its summons power to obtain these documents from a foreign parent further compounds record-keeping problems and presumably enforcement problems.\textsuperscript{48}

\textsuperscript{40} Id. at 5.

\textsuperscript{41} Press Conference of Percy P. Woodard, Jr., IRS Assistant Commissioner (International), March 31, 1987, Washington, D.C., reported in Uhlfelder, IRS to Increase Audit Coverage of Foreign Corporations Operating in the U.S., 35 TAX NOTES 17 (1987) [hereinafter Press Conference].

\textsuperscript{42} The absolute numbers are $173.4 billion of corporate equities and $157.6 billion of corporate debt. TAX ASPECTS, supra note 27.

\textsuperscript{43} Press Conference, supra note 41.


\textsuperscript{45} Id.

\textsuperscript{46} Form 10-K is used for compiling annual reports pursuant to section 13 of the Securities and Exchange Act. Fed. Sec. L. Rep. (CCH) ¶ 31,102 (Mar. 31, 1989). Item 8 of Form 10-K refers the corporation to Regulation S-K, which states that the financial disclosure of initial public offerings for domestic issuers must be in accordance with Generally Accepted Accounting Principles. Id.

\textsuperscript{47} On the other hand, item 18 of Form 20-K states that the financial disclosure of initial public offerings for foreign issuers must be in accordance with either GAAPs or “a comprehensive body of accounting principles other than those generally accepted in the United States.” Rules, Registration and Annual Report Form for Private Foreign Issuers, Exchange Act Release No. 34-16731 [1979-1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,363 (Nov. 29, 1979).

The OBRA amendment to section 6038A should help solve the auditing problem.\textsuperscript{49} Section 6038A empowers the Service with special authority in two respects. First, the Service could require a foreign parent to deem its U.S. subsidiary the agent for service of process.\textsuperscript{50} Secondly, the section enables the Service to write regulations forcing a foreign parent to keep its records in the United States.\textsuperscript{51} Finally, the section now imposes substantial penalties for a domestic subsidiary's failure to follow section 6038A.\textsuperscript{52}

Having only been in effect since 1989,\textsuperscript{53} it is too early to determine the effect of the OBRA legislation. It will be a few years before we can determine whether the joint effect of sections 163(j)\textsuperscript{54} and 6038A\textsuperscript{55} solve the problems of LBOs and the taxation of foreign investment in the United States.

\section*{III. THE LEGISLATIVE SOLUTION}

Although the problem of international thin capitalization existed, Congress did not enter the 1989 lawmakering session with it in mind. The 1989 Congressional action that led to enactment of the earnings stripping provision did not address the problem of international thin capitalization, but instead began as an attempt to limit LBOs. Alarmed by all of the attention being given to high profile LBOs, Congress' Joint Committee on Taxation ("Joint Committee") studied the problem of the corporate deduction of interest. The Joint Committee published a discussion draft which outlined the problems of corporate financial structures and possible legislative solutions.\textsuperscript{56} The Ways and Means Committee then held hearings from January 31, 1989 through February 2, 1989.\textsuperscript{57}

The highlight of the Ways and Means Committee hearings was the controversial testimony of the Secretary of the Treasury, Nicholas F. Brady.\textsuperscript{58} The sharp exchanges between the committee members and Secretary Brady displayed their philosophical differences toward LBOs.\textsuperscript{59} The committee members appeared to assume that LBOs were disrupting financial markets,

\begin{itemize}
  \item \textsuperscript{49} Budget Reconciliation Act § 7403, I.R.C. § 6038A (West Supp. 1990).
  \item \textsuperscript{50} \textit{Id.} § 6038A(c)(1).
  \item \textsuperscript{51} \textit{Id.} § 6038A(a)-(b). Although the Service has not yet promulgated these regulations, they will probably require the foreign parent to maintain the records in the United States where a summons, if necessary, can reach them.
  \item \textsuperscript{52} \textit{Id.} § 6038A(d) (penalizing the domestic subsidiary $10,000 for each taxable year plus $10,000 for each 30-day period during which noncompliance continues after the expiration of a 90-day period starting on the date the corporation is notified of the original $10,000 penalty).
  \item \textsuperscript{53} \textit{Id.} § 163(j)(3)(B)(i).
  \item \textsuperscript{54} \textit{See supra} text accompanying notes 7 - 8.
  \item \textsuperscript{55} \textit{See supra} text accompanying notes 49-52.
  \item \textsuperscript{56} \textit{See TAX ASPECTS, supra} note 27.
  \item \textsuperscript{57} \textit{See Hearing, supra} note 32.
  \item \textsuperscript{58} \textit{Id.} at 20 (testimony of Nicholas F. Brady, Secretary of the Treasury).
  \item \textsuperscript{59} \textit{Id.}
\end{itemize}
while the Secretary thought that they had not become a problem, and that Congress should take a "wait and see" attitude before acting.  

Following the January-February hearings, the Ways and Means Committee announced further hearings for May on this issue and concurrently offered alternative proposals designed to deal with corporations issuing excessive debt. These solutions fell into three major categories: (a) an integrated corporate and shareholder tax system, (b) a limit on interest deductions, and (c) proposals designed to deal with foreign investors.

Throughout the legislative discussion of the earnings stripping provision, controversy existed regarding whether the proposals were proper for Ways and Means consideration because they did not appear to raise revenue. In his April 12, 1989 announcement of the proposals and the May hearings, Chairman Rostenkowski stated that "the revenue impact, if any, of the options being considered . . . is unknown." He noted that if the purpose of legislation were to eliminate hostile acquisitions, including LBOs, it should do so directly, rather than indirectly, by changing the tax laws.

Despite this bureaucratic distraction, Chairman Rostenkowski announced three proposals to integrate corporate and shareholder taxes. The integration proposals would eliminate the double taxation at either the corporate or the shareholder level. In turn, elimination of double taxation

60. Id. at 54.
61. Because the Ways and Means Committee could not conclude their discussions in two days, the first round of hearings actually concluded in mid-March.
63. Id. at 3.
64. Id.
65. Id. at 12. The revenue estimate determined by the Joint Committee states that the provision raises little revenue — $206 million dollars from 1990 through 1994. It ranges from a low of $28 million in 1990 to a high of $49 million in 1994. However, considering that OBRA's five year estimated revenue effect of $6.71 billion dwarfs the revenue that the earnings stripping provision raises, it appears that Chairman Rostenkowski correctly asserted that Congress should directly regulate LBOs rather than indirectly discourage them through tax law changes.
66. Id. at 4. These three proposals are:
1. A shareholder level credit for a percentage of corporate taxes paid;
2. A shareholder exclusion of income for a percentage of dividend income; and
3. A corporate deduction for a percentage of dividends paid to shareholders.
67. TAX ASPECTS, supra note 27, at 84-85. Proponents of an integrated system have many criticisms of the current two tier tax system. They claim it promotes non-corporate over corporate forms of investment even though non-tax considerations would favor operation as a corporation. They further argue that the two tax tiers promote retention versus distribution of corporate earnings; and while retained earnings can increase share value, which will result in capital gains, until then, the shareholder will lack the cash necessary to invest more efficiently.
68. Integration can reduce tax at the corporate level by allowing a corporate deduction for dividends paid.
69. Integration can reduce tax at the shareholder level through dividend relief by either excluding dividends from the shareholder's gross income or allowing the shareholder a credit for corporate taxes paid.
would reduce the incentive to capitalize an acquisition with debt instead of equity. 70

Although legislative history suggests that eliminating double taxation might discourage LBOs, 71 this approach did not ensure a viable solution to the problem of LBOs resulting in excessive business deductions. A loss in large amounts of revenue would necessarily result, making integration unrealistic. 72

While integration did not provide a workable solution, its analysis forced Congress to consider the extent to which the Code should grant relief to shares in U.S. corporations owned by foreign persons. 73

Opinion was staunchly divided on this issue. One camp believed that denying relief to foreign investors was inconsistent with eliminating two tiers of tax. Others argued that Congress never intended integration as a means for relieving the taxation of foreign investors, many of whom pay few taxes because of treaty reductions. 74 Denying relief to shares held by foreign investors would hinder the well-established treaty policy that only one country could tax income. 75

Furthermore, foreign tax relief reinforced the policy of allowing U.S. borrowers easier access to foreign capital markets. 76 However, Congress never formed any conclusions as to foreign investors because it never pursued integration further than the preliminary stage.

70. TAX ASPECTS, supra note 27, at 85-86.
71. CONFERENCE REPORT, supra note 62, at 43.
72. Id. at 691.
73. TAX ASPECTS, supra note 27, at 98.
74. Other countries that have integrated systems have denied the relief to foreign persons. In the United States, such a move would decrease the value of a U.S. shareholder's shares, which the ownership of other shares should not affect. TAX ASPECTS, supra note 27.
75. The preamble of every tax treaty that the United States has entered says that the purpose is to avoid double taxation. See, e.g., Convention Between the United States of America and the French Republic with Respect to Taxes on Income and Property, Tax Treaties (CCH) ¶ 3003.05.
76. STAFF OF SENATE COMM. ON FINANCE, 98TH CONG., 2D SESS., DEFICIT REDUCTION ACT OF 1984, 416 (Comm. Print 1984).
Chairman Rostenkowski announced nine proposals to limit corporate interest deductions.\textsuperscript{77} In general, the policy behind these proposals was to reduce the effectiveness of LBOs by limiting interest deductions, which simultaneously would prevent erosion of the corporate tax base.\textsuperscript{78} Although limiting interest deductions received the most criticism of all the proposals, the critics were typically interested parties in the private sector whose arguments avoided the LBO issue. Those opposed to limiting interest deductions claimed that limitations would undermine our system of taxing only net income.\textsuperscript{79} They further argued that if Congress began limiting interest deductions, it could arbitrarily and artificially limit other deductions.\textsuperscript{80} Moreover, a tax on gross income, which might result, would cause distortions as companies with equal gross income would pay different taxes.\textsuperscript{81}

Opponents of limiting the deductions pointed out that most of the U.S.' trade competitors allow interest deductions.\textsuperscript{82} Denying them here would put U.S. corporations at a competitive disadvantage.\textsuperscript{83} The proposal would also make target-type companies more attractive to acquisition-minded foreign corporations. Foreign corporations, which could deduct interest, would then have a competitive edge in acquiring companies over competing American bidders who would be unable to deduct the interest. Consequently, a foreign corporation would have greater after-tax income than a U.S. corporation that has an identical capital structure.

Chairman Rostenkowski also announced five proposals that specifically dealt with foreign investors. One of these was an earnings stripping proposal,

\begin{itemize}
\item 77. \textit{Conference Report}, \textit{supra} note 62, at 2. These nine proposals are summarized as follows:
\item 1. deny interest deductions on debt used in either a hostile takeover or to purchase 20 percent of another company;
\item 2. deny the deduction on interest for debt incurred in mergers determined not to be in the public interest;
\item 3. deny the deduction for interest on junk bonds where the rate of the junk bonds is above a specified threshold amount;
\item 4. reduce the corporate interest deduction by a specified percentage;
\item 5. completely repeal the deduction for corporate interest expense and replace it with a credit to shareholders;
\item 6. disallow in whole or in part a corporate deduction for interest in excess of a specified rate;
\item 7. establish a normative level of debt to equity, such as 80 percent;
\item 8. replace the corporate interest deduction with an annual percentage deduction based on the overall capitalization of the company; and
\item 9. defer interest expense that is not actually paid.
\item 78. \textit{Tax Aspects}, \textit{supra} note 27, at 103.
\item 79. \textit{Conference Report}, \textit{supra} note 62, at 168.
\item 80. \textit{Id.} at 230.
\item 81. \textit{Hearing}, \textit{supra} note 32, at 383.
\item 82. \textit{Tax Aspects}, \textit{supra} note 27, at 103.
\item 83. \textit{See supra} notes 79 - 81 and accompanying text.
\end{itemize}
which would apply when a corporation's net interest expense exceeded a percentage of the corporation's taxable income. The proposal targeted only those instances where the recipient of the interest would not pay U.S. income tax on the payments. Although the Ways and Means Committee did not espouse any policy behind the foreign investors' proposals, they apparently were intended to limit LBOs by preventing deductions for interest payments to foreign investors.

James Carter, a representative of the Organization for Fair Treatment of International Investment, testified that the foreign proposals were unnecessary because evidence did not demonstrate abuse by foreign taxpayers. The prior hearings and the Joint Committee's discussion draft supported Carter's conclusion that foreign investors' behavior was not a catalyst behind the LBO trend. Carter further thought that the foreign proposals would wreak havoc in U.S. financial markets. He rationalized that any restrictions on foreign investment in the United States would decrease investment opportunities for foreign-held dollars and simultaneously raise U.S. interest rates as the number of lenders declined.

In early October 1989, the House of Representatives passed the earnings stripping provision, as recommended by the Ways and Means Committee. There is no legislative history indicating why Ways and Means chose the earnings stripping provision instead of the other proposals. The House bill was virtually identical to an earlier Senate version. This time, however, the Senate Finance Committee rejected it. In the Conference Committee, the Senate conferees only accepted the provision after the House conferees agreed to accept several changes, including a requirement of a debt to equity ratio of

84. **CONFERENCE REPORT, supra** note 62, at 6. The four other proposals are summarized as follows:

1. add gross income to a corporation that is controlled by foreign persons to account for interest deductions that other options would disallow;
2. reimpose a 30% withholding tax on interest earned by foreign persons on portfolio debt in the United States;
3. allow an amortization deduction of goodwill for U.S. corporations; and
4. tax gain realized by foreign persons on the liquidation of a U.S. corporation as a dividend to the extent of earnings and profits.

Id.

85. **Id.**
86. **Id.** at 257.
87. **Id.**
88. **Id.**
89. **Id.**
90. The current earnings stripping provision has its roots in the Tax Reform Act of 1986. The Senate Finance Committee proposed to deal with international thin capitalization by denying the deduction for interest paid or accrued to related, tax exempt parties to the extent that interest exceeded 50% of taxable income. S. REP. NO. 313, 99th Cong., 2nd Sess. 423 (1986).
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1.5 to 1 to trigger the provision.\textsuperscript{92} On November 22, 1989, the earnings stripping provision was finally adopted in its current form.\textsuperscript{93}

IV. STATUTORY ANALYSIS

Generally foreign debtholders are subject to a thirty percent tax on their U.S. source interest income,\textsuperscript{94} which their U.S. obligers must withhold and pay to the Service.\textsuperscript{95} However, the Code and most tax treaties provide exceptions. The basic premise of the earnings stripping provision is to limit deductions of U.S. corporations for interest payments to related foreign investors, who are exempt from having tax withheld on their interest income. The corporation must, however, pass several tests before the provision disallows interest deductions. The earnings stripping provision prescribes a five-point test before disallowing interest deductions:

1. the debt-to-equity ratio must exceed 1.5 to 1;
2. interest expense must exceed interest income for a net interest expense;
3. the net interest expense must exceed fifty percent of the adjusted taxable income for an excess interest expense;
4. related parties who will not pay U.S. tax on the interest income must receive some of the corporation's interest payment, which is called disqualified interest; and
5. the corporation must have both excess interest expense and disqualified interest.\textsuperscript{96}

This article will next examine each of these requirements.

A. Debt-to-Equity Ratio Requirement

A corporation passes the first test when it has a debt-to-equity ratio in excess of 1.5 to 1.\textsuperscript{97} The corporation computes the ratio by comparing the total liabilities to the total assets, less liabilities.\textsuperscript{98} This definition of equity avoids looking at the stockholders' equity section of the corporation's balance sheet and assumes that the mix of capital stock and retained earnings is irrelevant. Furthermore, the formula measures asset and debt amounts at their adjusted cost basis,\textsuperscript{99} not their fair market value. This approach eliminates valuation problems. If fair market value were used as a measure, the overall debt to equity ratio would decrease. Application of cost as a measure causes

\textsuperscript{92} Id. at 564.
\textsuperscript{93} I.R.C. § 163(j) (West Supp. 1990).
\textsuperscript{95} Id. §§ 1441(a), 1442(a).
\textsuperscript{96} I.R.C. § 163(j) (West Supp. 1990).
\textsuperscript{97} Id. § 163(j)(2)(A)(ii).
\textsuperscript{98} Id. § 163(j)(2)(C). This is the same test advanced by Treas. Reg. § 1.279-5(f)(1) (1973).
the ratio to be higher. Because many assets, such as real estate and securities, have increased in value over the years, it is probable that the ratio, if based on fair market value, would never trigger the earnings stripping provision.

The application of the provision's first requirement is best seen by illustration. Assume a corporation has the following balance sheet:

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$100</td>
</tr>
<tr>
<td>Real Estate</td>
<td>500</td>
</tr>
<tr>
<td>Securities</td>
<td>200</td>
</tr>
</tbody>
</table>

$800

The corporation would pass the first test. The debt — $500 in bonds — exceeds total equity of $300 by a ratio of 1.67 to 1, which exceeds 1.5 to 1.

If a corporation issues a bond with an original issue discount, the amount of debt equals the issue price plus any portion of the original issue discount that has accrued. For example, if a corporation issues ten-year bonds with a stated value of $500, but an issue price of $400 on December 31 of year one, that corporation would count $400 as debt. If, however, an extra $10 worth of debt accrues in the second year, the debt amount is $410.

While the specification of a 1.5 to 1 debt-to-equity ratio is a seemingly simple formulation, it has one serious flaw. The statute fails to define debt, leading to potentially drastic consequences. Suppose, for example, a corporation has the following balance sheet:

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$100</td>
</tr>
<tr>
<td>Real Estate</td>
<td>600</td>
</tr>
<tr>
<td>Securities</td>
<td>300 $1000</td>
</tr>
</tbody>
</table>

$1000

Now the subsidiary would not pass the first test. The debt — $500 in bonds — equals total equity of $500 for a ratio of only 1 to 1, which is below the 1.5 to 1 threshold.

100. See supra notes 36 & 39 and accompanying text.
101. Assets of $800 less liabilities of $500 equals $300.
102. On the other hand, if Congress chose to measure the debt-to-equity ratio at the fair market value, the same corporation would have the following balance sheet:

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$100</td>
</tr>
<tr>
<td>Real Estate</td>
<td>600</td>
</tr>
<tr>
<td>Securities</td>
<td>500</td>
</tr>
</tbody>
</table>

$1000

Now the subsidiary would not pass the first test. The debt — $500 in bonds — equals total equity of $500 for a ratio of only 1 to 1, which is below the 1.5 to 1 threshold.

104. The original issue discount provisions require borrowers and lenders to amortize any original issue discount over the term of a loan. I.R.C. § 1274 (West Supp. 1990).
Now the corporation will have difficulty determining if the debt-to-equity ratio has triggered the provision. If short term debt, such as accounts payable, constitutes debt, then the debt-to-equity ratio of $500\textsuperscript{106} to $300\textsuperscript{107} equals a ratio of 1.67 to 1. This passes the first test. On the other hand, if short term debt, such as accounts payable, does not constitute debt, then the provision does not apply because the debt-to-equity ratio of $400\textsuperscript{108} to $400\textsuperscript{109} is only a one to one ratio.\textsuperscript{110}

B. Existence of Net Interest Expense

The second test is the existence of net interest expense. The provision defines net interest expense as the amount of interest expense less the amount of interest income.\textsuperscript{111} If the interest income that a corporation earns equals or exceeds its expense, the test is not met. Although there is little legislative history behind the net interest expense test, it is ostensibly pro-taxpayer, allowing a corporation to deduct as much interest as it pays provided it has earned enough interest income to offset the expense.

C. Excess Interest Requirement

The third test is the excess interest expense requirement. The excess interest expense is the corporation's net interest expense less fifty percent of the adjusted taxable income of the corporation.\textsuperscript{112} The provision refers to fifty percent of the adjusted taxable income\textsuperscript{113} as the limitation.\textsuperscript{114}

Assume, for example, that a corporation earns adjusted taxable income of $1,000 and additional interest income of $100. If the corporation incurs an interest expense of $700, it has a net interest expense of $600.\textsuperscript{115} Its excess

\begin{tabular}{|c|c|c|c|}
\hline
\textbf{Assets} & \textbf{Liabilities} \\
\hline
Cash & $100 & Accounts Payable & $100 \\
Real Estate & 500 & Bonds & 400 \\
Securities & 200 & Stockholders' equity & 300 \\
\hline
$800 & $800 \\
\hline
\end{tabular}

\textsuperscript{106} Accounts payable of $100 plus $400 of bonds equals $500.

\textsuperscript{107} Assets of $800 less $500 of liabilities equals $300.

\textsuperscript{108} The $400 in bonds is the only liability.

\textsuperscript{109} The $800 of assets less $400 of liabilities — the bonds — equals $400.

\textsuperscript{110} See Section VI of this article which discusses possible regulatory solutions to this definition of debt.


\textsuperscript{112} Id. § 163(j)(2)(B).

\textsuperscript{113} The corporation computes the adjusted taxable income without deducting net interest expense. Id. § 163(j)(6)(A)(i)(I).

\textsuperscript{114} Id. § 163(j)(2)(B)(iii).

\textsuperscript{115} Interest expense of $700 less $100 of interest income equals $600 of net interest expense.
Interest expense is $100 because $600 exceeds $500 by $100; $500 is fifty percent of the adjusted taxable income of $1,000.

On the other hand, assume the corporation earns the same adjusted taxable income of $1,000 and interest income of $100. If the corporation incurs an interest expense of $550, it has no excess interest expense because the corporation has a net interest expense of $450,116 which is less than fifty percent of the adjusted taxable income of $1,000.117 A corporation computes the adjusted taxable income without deducting net operating losses,118 depreciation, depletion, or amortization.119

A more complex example would involve a corporation with the following profit and loss statement:

<table>
<thead>
<tr>
<th>Revenues</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales revenue</td>
<td>$1000</td>
</tr>
<tr>
<td>Interest income</td>
<td>100</td>
</tr>
<tr>
<td></td>
<td>1100</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Expenses</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Depreciation</td>
<td>(100)</td>
</tr>
<tr>
<td>Amortization</td>
<td>(100)</td>
</tr>
<tr>
<td>Depletion</td>
<td>(100)</td>
</tr>
<tr>
<td>Interest expense</td>
<td>(700)</td>
</tr>
<tr>
<td>NOL carryforward from prior year</td>
<td>(50)</td>
</tr>
<tr>
<td>Net Income</td>
<td>$50</td>
</tr>
</tbody>
</table>

Although net income is $50, the adjusted taxable income is $1,000, because the corporation computes adjusted taxable income without the deductions for net interest,120 net operating losses,121 depreciation, depletion, or amortization.122 The only remaining item on the profit and loss statement — the sales revenue of $1,000 is the adjusted taxable income. Because the corporation incurs a net interest expense of $600,123 which exceeds half the adjusted taxable income of $1,000 by $100,124 the excess interest expense equals $100.

116. Interest expense of $550 less $100 of interest income equals $450 of net interest expense.
117. 50% of $1000 is $500.
120. Id. § 163(j)(6)(A)(i)(I).
121. Id. § 163(j)(6)(A)(i)(II).
122. Id. § 163(j)(6)(A)(i)(III).
123. Interest expense of $700 less $100 interest income equals $600 net interest expense.
124. Half the adjusted taxable income of $1,000 is $500.
D. Payment to Related Persons

The fourth requirement is that the corporation must pay or accrue interest to a related person who does not pay U.S. tax on the interest income.125 This related person will always be a foreign investor because all U.S. individuals are subject to tax on their interest income.126 The provision refers to the interest paid to such an exempted party as disqualified interest.127 If all the recipients of a U.S. corporation's interest payments are either unrelated to the U.S. corporation or pay U.S. tax on their interest income, then the provision will not apply.

Difficulty comes in defining who qualifies as a related person. The provision refers to sections 267(b)128 and 707(b)(1)129 for the definition of a related person.130 Section 267(b) defines a myriad of possible party relationships.131 The two most relevant relationships are a corporation to an individual and a corporation to a partnership.

According to section 267(b), a corporation is related to an individual if the individual simply owns fifty percent of the corporation.132 More complex

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129. Id. § 707(b)(1).
131. The relationships described in section 267(b) are:
   (1) Members of a family, as defined in subsection (c)(4);
   (2) An individual and a corporation more than 50% in value of the outstanding stock of which is owned, directly or indirectly, by or for such individual;
   (3) Two corporations which are members of the same controlled group (as defined in subsection (f));
   (4) A grantor and a fiduciary of any trust;
   (5) A fiduciary of a trust and a fiduciary of another trust, if the same person is a grantor of both trusts;
   (6) A fiduciary of a trust and a beneficiary of such trust;
   (7) A fiduciary of a trust and a beneficiary of another trust, if the same person is a grantor of both trusts;
   (8) A fiduciary of a trust and a corporation more than 50 percent in value of the outstanding stock of which is owned, directly or indirectly, by or for the trust or by or for a person who is a grantor of the trust;
   (9) A person and an organization to which section 501 (relating to certain educational and charitable organizations which are exempt from tax) applies and which is controlled directly or indirectly by such person or (if such person is an individual) by members of the family of such individual;
   (10) A corporation and a partnership if the same persons own-
      (A) more than 50% in value of the outstanding stock of the corporation, and
      (B) more than 50% of the capital interest, or the profits interest, in the partnership;
   (11) An S corporation and another S corporation if the same persons own more than 50% in value of the outstanding stock of each corporation; or
   (12) An S corporation and a C corporation, if the same persons own more than 50% in value of the outstanding stock of each corporation.
132. Id. § 267(b)(2).
rules relate a corporation to a partnership; the same persons must own more than fifty percent of the stock in a corporation and more than fifty percent of a partnership.\textsuperscript{133}

However, interest payments to a related partnership will not be disqualified interest if the aggregate of the ownership percentages exempt from U.S. tax is less than ten percent.\textsuperscript{134} For example, suppose a foreign investor (F) forms a partnership with two U.S. persons (US1 and US2) who apportion the partnership as follows:

<table>
<thead>
<tr>
<th></th>
<th>F</th>
<th>US1</th>
<th>US2</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>8%</td>
<td>46%</td>
<td>46%</td>
</tr>
</tbody>
</table>

The partnership then purchases over fifty percent of the stock in a U.S. corporation, making the partnership and the U.S. corporation related parties.\textsuperscript{135} The interest the corporation pays to the partnership is related party interest. The interest owed by the corporation is not disqualified regardless of whether F is exempt from U.S. taxation because F owns less than ten percent of the partnership.

A treaty may also reduce the amount of tax that F might have to pay. Suppose that F has increased his share of the partnership to the following:

<table>
<thead>
<tr>
<th></th>
<th>F</th>
<th>US1</th>
<th>US2</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>16%</td>
<td>38%</td>
<td>46%</td>
</tr>
</tbody>
</table>

Assume further that the country of F's residence has a treaty with the United States that reduces taxation in half — from thirty percent to fifteen percent. After applying the treaty, the provision treats half of F's sixteen percent share of the partnership's interest income — eight percent — as tax exempt while treating the other eight percent as subject to tax. Since less than ten percent of the partnership receives interest income tax-free, none of the interest that the corporation pays to the partnership is disqualified interest.

Now suppose that the treaty between the United States and F's country still reduces taxation by half, and F's share in the partnership increases to the following:

<table>
<thead>
<tr>
<th></th>
<th>F</th>
<th>US1</th>
<th>US2</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>22%</td>
<td>35%</td>
<td>43%</td>
</tr>
</tbody>
</table>

Half of F's share in the partnership is now eleven percent. This exceeds the ten percent threshold. Consequently, the corporation treats the interest it

\textsuperscript{133} The Code defines ownership of the partnership as constituting a share of either the capital interest or the profits interest. Id. §§ 267(b)(10), 707(b)(1).


pays to the partnership as disqualified interest. The Conference Report, however, fails to specify whether it treats the interest paid to all partners or only the portion paid to tax exempt partners as disqualified interest.\textsuperscript{136} Because of the "pass-through nature" of partnerships, the provision should treat only the portion of interest paid to tax exempt partners as disqualified interest.

Once related parties have been identified, the question remains as to who will not pay tax on the interest income received. The provision will most often apply to the payment of interest\textsuperscript{137} that is exempt from the thirty percent withholding.\textsuperscript{138} Usually, a treaty provides for such exemption. The provision says that when a treaty reduces the thirty percent withholding, it treats as nontaxable interest\textsuperscript{139} the percentage of reduction in withholding times the amount of interest paid.

For example, assume that a Canadian resident receives $600 of interest income from a U.S. corporation in which he also owns a majority of the stock.\textsuperscript{140} Because a treaty between the United States and Canada limits the tax on interest to fifteen percent,\textsuperscript{141} half of the interest income is exempt. The corporation, therefore, treats $300 of the interest paid as disqualified interest.

Not only may a treaty apply, but the Code contains two exceptions to the thirty percent withholding of tax on interest paid to foreign investors. The bank deposits exception exempts from U.S. taxation interest a bank pays to foreign depositors if the interest is not effectively connected with the conduct of a business in the United States.\textsuperscript{142} Suppose, for example, that a foreign person owns over fifty percent of a U.S. bank in which she also accrues interest income on his deposits. Section 871(i)(2)(A) exempts the interest income from U.S. tax. Assuming the foreign investor is a related party,\textsuperscript{143} all of the interest paid to her is disqualified interest.

The portfolio interest exception relieves foreigners who own less than ten percent of a U.S. corporation from U.S. taxation of interest received from the U.S. corporation.\textsuperscript{144} By definition, a corporation can never have disqualified interest due to the portfolio interest exception. A related shareholder must own more than fifty percent of a corporation to be a related shareholder. If he

\textsuperscript{136} House Conference Report, supra note 91.
\textsuperscript{138} Id. §§ 871(a), 881(a)(1), 1441 (providing for 30% withholding on payments of fixed and determinable, annual, or periodic income to foreigners).
\textsuperscript{140} The Canadian investor would be a related party. I.R.C. § 267(b)(2) (1988).
\textsuperscript{141} Income Tax Treaty, Sept. 26, 1980, United States-Canada, art. XI, Tax Treaties (CCH) ¶ 1903.23.
\textsuperscript{142} I.R.C. §§ 871(i)(2)(A), 881(d) (1988).
\textsuperscript{143} Id. § 267(b)(2).
\textsuperscript{144} Id. §§ 871(h), 881(c).
owns ten percent or more, he does not qualify for the portfolio interest exception and must pay tax on his portfolio interest income. Because the foreigner will pay tax on this interest income, the provision will not apply to this interest income.

E. Need for Excess Interest Expense and Disqualified Interest

The fifth and final test disallows an interest deduction to the extent that a corporation has disqualified interest paid or accrued during the taxable year not exceeding the excess interest expense. This test is the simplest to apply. If a corporation has excess interest of $100, but disqualified interest of only $50, the amount of the disallowed deduction is only $50. If, however, the corporation has excess interest expense of $50, but disqualified interest of $100, the disallowed amount is also $50. The disallowed deduction is the lower of the two amounts.

Congress recognized that in the normal course of business operations, interest expense would vary once incentives to thin capitalization were removed. To deal with these variations, Congress created carryforwards of the excess limitations and the disallowed deductions.

The excess limitation carryforward provides that to the extent that fifty percent of the corporation's adjusted taxable income ("the limit") exceeds its net interest expense, the corporation can carry forward this amount for up to three taxable years. The corporation may also add the carryforward to adjusted taxable income when computing excess interest expense.

For example, assume that a corporation has adjusted taxable income of $1,000 and a net interest expense of $400. Half of the adjusted taxable income of $1,000 is $500, which exceeds the net interest expense of $400 by $100. The $100 is the excess limitation that the taxpayer can carry forward. Suppose further that in the following year the corporation has adjusted taxable income of $1,000 and a net interest expense of $600. The net interest expense of $600 exceeds $500, for an excess interest expense of $100. However, the corporation adds the $100 carryforward to the adjusted taxable income to eliminate the excess interest expense.

145. Id. § 871(b)(3).
149. Id. § 163(j)(2)(B).
150. Id. § 163(j)(2)(B)(ii).
151. Half of the adjusted taxable income of $1,000 is $500.
152. Although the language of section 163(j)(2)(B)(ii) does not say whether the corporation adds the excess limitation carryforward to adjusted taxable income or half the adjusted taxable income, the examples in the Committee Reports clearly indicate that the corporation should add the carryforward to half the adjusted taxable income. I.R.C. § 163(j)(2)(B)(ii) (West Supp. 1990).
The corporation may also carry forward the disallowed interest deduction to a following year.\textsuperscript{153} Assume that in the first year the corporation has a disallowed interest deduction of $50. Further assume that in the second year, the corporation has a net interest expense of $400 and an adjusted taxable income of $1,000, half of which is $500. Because half the adjusted taxable income exceeds the net interest expense by $100, the corporation may deduct the entire interest expense, plus the $50 carryforward of disallowed interest deduction from year one. In this scenario, the excess limitation carryforward to year three equals $50.\textsuperscript{154} The provision does not provide for carrybacks of either the excess limitation or the disallowed interest deduction.

Undoubtedly, the provision was open to many interpretive problems. For this reason, Congress gave the Service broad regulatory authority.\textsuperscript{155} The provision authorizes the Service to write regulations for adjustments to the debt-to-equity ratio,\textsuperscript{156} for adjustments to adjusted taxable income,\textsuperscript{157} for adjustments to net interest expense,\textsuperscript{158} and as may be appropriate to carry out the purposes of the provision.\textsuperscript{159} This final entitlement includes preventing the avoidance of the provision,\textsuperscript{160} regulating members of an affiliated group,\textsuperscript{161} and coordinating the provision with the branch profits tax.\textsuperscript{162}

\section*{V. WEAKNESSES IN THE EARNINGS STRIPPING PROVISION}

Despite its attempts to eliminate the problem of international thin capitalization, the earnings stripping provision causes two major problems. First, it overrides the associated enterprises and nondiscrimination articles of most U.S. tax treaties. This could hurt the United States in international affairs. Secondly, its mechanics fail to follow the economics of corporate finance. This may lead to abuse of the provision.

\begin{flushleft}
153. In allowing the carryforward, Congress made a policy decision against recharacterizing the interest as a dividend.
154. One half of the adjusted taxable income or $500, less $400 net interest expense, less $50 denied interest deduction from year one equals $50 excess limitation carryforward to year three.
155. Congress delegates the authority to the Secretary of the Treasury, whose delegate is the Commissioner of the Internal Revenue Service. I.R.C. § 7701(a)(11)-(12) (1988); Treas. Reg. § 301.7701-9(b) (1967).
158. \textit{Id.} § 163(j)(6)(B).
159. \textit{Id.} § 163(j)(7).
162. \textit{Id.} § 163(j)(7)(C).
\end{flushleft}
The United States has income tax treaties with thirty-eight countries. The goal of these treaties is to impose only a single tax on income by preventing both double taxation and tax avoidance. Unlike many other countries in which treaties supersede the foreign country's domestic law, the Supremacy Clause of the U.S. Constitution regards treaties and federal legislation equally. Consequently, if a treaty conflicts with legislation, the later enacted law will prevail. The term "treaty override" describes legislation which conflicts with an earlier enacted treaty.

When determining if a statute overrides a treaty, the analyst should try to read the statute and treaty in harmony. The analyst should view a subsequent statute as conflicting only if the words clearly and distinctly conflict with the treaty. Although Supreme Court dictum has stated that Congress has not breached treaty obligations unless there is a clear expression of intent, the intent shown in the legislative history is irrelevant when a clear and distinct conflict exists between the language of the treaty and the statute.

The clear and distinct conflict between the earnings stripping provision and two treaty articles - the associated enterprises article and the nondiscrimination article - shows that the earnings stripping provision overrides treaties.

Almost all U.S. tax treaties include an associated enterprises article, which is usually numbered paragraph 1 of article 9. The two major model treaties - the U.S. model and the Organization for Economic Cooperation and Development model (the "OECD Model") - have identical associated
THIN CAPITALIZATION

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enterprises articles. The article allows the U.S. to allocate profits between two associated enterprises, as if their financial relations were those of independent enterprises. Treating associated enterprises as independent enterprises resembles the arm's-length standard used to allocate income pursuant to section 482.

The associated enterprises article applies to the problem of foreign thin capitalization. The allocation of profits covers dividends paid, interest paid, and the extraordinary interest paid, which is actually a disguised dividend. Because the model treaties do not define the financial relations of an enterprise, they logically refer to the debt and equity constituting the enterprise's capital structure. If the extraordinary interest is really a dividend, the policy of symmetry would characterize the underlying investment as equity, and not as debt.

The earnings stripping provision is a mechanical calculation while the associated enterprises article is based on an arm's length standard. Therefore, the earnings stripping provision and the article conflict. The Conference Report, however, argues that the provision does not override the associated enterprises article. The Conference Report claims that it adheres to the arm's-length standard by providing safe harbors that are averages of the typical capital structures of corporations, such as a debt-to-equity ratio of 1.5 to 1. However, the legislative history does not provide any support for these averages, which appear arbitrary.

Not only does the thin capitalization provision override the associated enterprises article, it also conflicts with and overrides several paragraphs of the nondiscrimination article. The nondiscrimination article prevents the United States from taxing a foreign taxpayer more than a U.S. taxpayer. The

174. Id. The article states that where:
   a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or
   b) the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State, and in either case conditions are made or imposed between the two 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.

Id. at 1833-34.

175. Id.


179. HOUSE CONFERENCE REPORT, supra note 91, at 569.

180. See infra notes 211-15 and accompanying text.
U.S. model treaty contains a nondiscrimination article with six paragraphs and the earnings stripping provision overrides three of these paragraphs: nondiscrimination of deductions,\(^{181}\) nondiscrimination of capital ownership,\(^{182}\) and nondiscrimination of domestically located branches of foreign corporations.\(^{183}\)

The paragraph preventing discrimination of interest deductions allows discrimination only if the discrimination satisfies the associated enterprises article.\(^{184}\) Because the earnings stripping provision conflicts with, and overrides, the associated enterprises article, a U.S. corporation should deduct interest it pays to foreign debtholders as it would deduct interest paid to U.S. debtholders. Disallowing deductions for interest paid to related foreign debtholders, the provision conflicts with the nondiscrimination of deductions paragraph.

The earnings stripping provision also conflicts with the capital ownership paragraph.\(^{185}\) This paragraph prevents the United States from taxing a U.S. corporation owned by foreign investors more burdensomely than it taxes a similarly situated U.S. corporation owned by U.S. shareholders. The paragraph, however, leaves two phrases undefined: "similar circumstances" and "more burdensome."

Congress and the Service have traditionally stretched their interpretations to exclude almost all situations from being "similar circumstances."\(^{186}\) When legislating this provision, Congress also rationalized that a corporation's classification as either foreign or locally-owned was sufficient to classify

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181. J.R. MacDonald, supra note 6, at 4315-17.
182. Id.
183. Id.
184. Paragraph 4 of article 24 of the U.S. Model states:

\[\text{except where the provisions of paragraph 1 of Article 9 [Related Persons],... apply, interest,.. paid by an enterprise of a Contracting state to a resident of the other Contracting State shall, for the purpose of determining the taxable profits of such enterprise, be deductible under the same conditions as if they had been paid to a resident of the first-mentioned State.}\]

For the OECD Model, see paragraph 5 of article 24. Id. at 4315.

185. Paragraph 5 of article 24 of the U.S. Model states:

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

Non-discrimination based on capital ownership is in paragraph 6 of the OECD Model. Id. at 4316.

186. For example, when dealing with differentiation between residents of different countries, the Service has taken the view that it can treat foreign taxpayers differently than U.S. residents because foreign residents do not pay a local tax on their worldwide income. Furthermore, in justifying section 367(e)(2)'s denial of nonrecognition treatment of a U.S. corporation to a foreign corporation, the Service stated that the circumstances were not similar to liquidating a U.S. corporation into a U.S. corporation because the liquidation will remove the assets from the U.S. taxing jurisdiction. I.R.C. § 367(e)(2) (West Supp. 1990); see also Rev. Rul. 87-66, 1987-2 C.B. 376.
it as "dissimilar." Congress argued that foreign owners are situated differently because they do not pay U.S. tax on interest income received. In making this argument, Congress basically claimed that it could discriminate against a foreign owner because the foreign owner had previously received relief. This argument fails to recognize that the taxability of interest income puts the recipients, and not the corporations, in different circumstances.

Congress next claimed that the provision provided different, but comparable, tax treatment that reflected the different circumstances between foreign and domestically-owned corporations. However, the comparable Code sections cited did not involve either thin capitalization or LBOs.

This approach is inappropriate because relative burdens should be based on similar circumstances. Contrary to Congress' belief, the circumstances are similar; hence, burdens can be compared. Assume, for example, that the only difference between two U.S. corporations is that one has foreign investors while the other has only American investors. If the corporation with foreign investors passes all the tests, the earnings stripping provision disallows a deduction. The disallowed deduction results in the foreign-owned corporation having higher taxable income, which causes a higher and more burdensome tax bill.

The provision also conflicts with the domestically located branch paragraph. This paragraph specifies that the United States cannot tax a branch of a foreign corporation more burdensomely than a U.S. establishment carrying on the same activities. The term, "same activities," refers to the same type of industry. The provision applies to any corporation, including a foreign corporation paying interest that is U.S. sourced. The discrimination involved is similar to discrimination based on capital ownership. The effects of this discrimination can best be seen using the following example with two

187. HOUSE CONFERENCE REPORT, supra note 91, at 568.
188. Id.
189. See supra notes 5-6 and accompanying text.
191. HOUSE CONFERENCE REPORT, supra note 91, at 568. See also I.R.C. §§ 267, 512(b)(13), 4975 (1988). Congress further stated that these sections addressed comparable treatment domestically, but failed to mention that none of these sections applied to taxpayers or excluded foreign persons.
193. Paragraph 3 of article 24 states that

[J.R. MACDONALD, supra note 6, at 4315.
196. See Treas. Reg. § 1.882-5 (1984). This regulation provides two methods for allocating the interest deduction of a foreign corporation to the United States. These methods are 1) the branch book/dollar pool method and 2) the separate currency pools method. Id. §§ 1.882-5(b)(3)(i)-(ii).]
corporations: a U.S. corporation that operates entirely in the United States and a foreign corporation with U.S. branch activities that are identical to those of the U.S. corporation. Both corporations have a portion of their debt held by shareholders. If the foreign corporation passes all the tests, the provision disallows the foreign corporation's deduction. As in our previous example involving corporations with debt held by foreigners, the disallowance will result in the foreign corporation paying more tax on its U.S. branch's activities because it will have higher taxable income.

Conflicting with these paragraphs, the earnings stripping provision, which was just enacted, overrides the nondiscrimination article pursuant to the later-in-time rule of the Supremacy Clause and section 7852(d).

While treaty overrides do not limit the effect of the legislation, they result in a loss of trust by treaty partners. This may have especially damaging effects when dealing with tax treaties. Tax treaties represent a careful balancing of interests. They confer benefits on both U.S. persons investing overseas and foreign persons investing in the United States. By overriding tax treaties, tax legislation tilts the balance of interests. The foreign country likely will try to rebalance, hindering the long term economic and political interests of the United States. A foreign country which retaliates by heavily taxing U.S. investment abroad, would hurt the United States, as American investment abroad traditionally exceeds foreign investment in the United States. Both Canada and the United Kingdom, countries in which legislation supersedes prior treaty obligations, could retaliate. Furthermore, France, whose treaties have priority over domestic legislation, has indicated that it will require including specific language in future treaties enabling it to withdraw from articles that the United States fails to honor.

B. The Earnings Stripping Provision Is Subject to Abuse Because It Fails to Follow the Economics of Corporate Finance

The earnings stripping provision's mechanical tests are subject to abuse because they disregard the economics of corporate finance. The economic

198. CONFERENCE REPORT, supra note 62, at 29.
199. Id.
200. STAFF OF JOINT COMMITTEE ON TAXATION, 101ST CONG., 2D SESS., BACKGROUND AND ISSUES RELATING TO THE TAXATION OF FOREIGN INVESTMENT IN THE UNITED STATES 2 (Joint Comm. Print 1990). However, this position has fluctuated in recent years. Id.
201. CAN. CONST. art IX, para. 129.
203. FRENCH CONST. tit. VI, art. 55.
204. The Digest (United States), Pending Legislation, TAX NOTES INT'L 555 (Nov. 1989) [hereinafter TAX NOTES INT'L].
substance of a transaction having priority over its form has a strong foundation in U.S. tax law. However, this provision is a written law containing numerous mechanical definitions which make it susceptible to attempts to comply in form, but not in substance. The provision's written form encourages international financiers to abuse interpretive loopholes that focus on the form of the transaction. Moreover, the mechanical measures used in the provision are not necessarily accurate indicators of the real financial risks and rewards implicit in a corporation's capital structure. Thus, since the measures do not separate cases of abusive thin capitalization from cases of economically-justified high leverage, the provision will not necessarily apply to some thinly capitalized corporations to which it should apply. Likewise, the provision will apply to some corporations that are not thinly capitalized. These difficulties are exhibited below.

The debt-to-equity ratio of 1.5 to 1 neglects the economics of corporate finance by begging the question of what is thin capitalization. If the Service could easily distinguish debt from equity in order to compute the ratio, it could just as easily disallow the interest payments of high ratio corporations that are disguised dividends. Instead, the provision merely repositions, as opposed to replacing, the issue of distinguishing debt from equity at a lower level of analysis. For example, instead of deciding whether an interest payment is deductible because of the debt-to-equity ratio, the provision merely repositions the debt-to-equity analysis as a gateway to the other four tests.

Previously, both Congress and the Treasury Department had failed to define debt and equity. The absence of Congressional guidelines demonstrates the benefits of flexible definitions over rigid ones.

Although the current case law regarding the definition of debt and equity is occasionally confusing, it is certainly flexible. The U.S. Supreme Court pronounced the need for flexibility in John Kelley Co. v. Commissioner, stating that "[t]here is no one characteristic . . . which can be said to be decisive in the determination of whether obligations are . . . debt." A

206. See supra notes 9-12 and accompanying text.
207. In re Lane, 742 F.2d 1311, 1314-15 (11th Cir. 1984).
209. John Kelley Co., 326 U.S. at 530. An analysis of all the factors used in distinguishing debt and equity is beyond the scope of this paper. For a thorough analysis of the factors, see Texas Farm Bureau v. United States, 725 F.2d 307 (5th Cir. 1984). The court listed the following factors:

(1) the names given to the certificates evidencing indebtedness;
(2) the presence or absence of a fixed maturity date;
(3) the source of payments;
(4) the right to enforce payment of principal and interest;
(5) participation in management flowing as a result;
(6) the status of contributions in relation to regular corporate creditors;
(7) the intent of the parties;
(8) "thin" or adequate capitalization;
(9) identity of interest between creditor and shareholder;
(10) source of interest payments;
broad rule is flexible because it can deal with variations. On the other hand, a precise rule is inflexible, as an innovative financier can find a way around it. The fixed debt-to-equity ratio is a precise rule that is subject to abuse by innovative financiers. A fixed ratio also suffers from the drawback that ratios vary by industry and by corporate life cycle. A fledgling industry, such as microchips, is likely to carry more debt than an established industry, such as lumber. The same analysis applies to the life cycle of a particular corporation. A new corporation will necessarily need more working capital and will have a higher ratio than an older corporation. Unfortunately, varying the ratios to solve this economic problem would add a new level of complexity.

Even if a rigid debt-to-equity ratio is acceptable, the 1.5 to 1 ratio chosen by the Conference Committee is too low. The standard gives no clear indication of thin capitalization. The average debt-to-equity ratio of the 500 largest U.S. industrial corporations during 1989 was 3.18 to 1. The section 385 regulations provided a safe harbor ratio if the ratio was less than or equal to 10 to 1;212 section 279 provides for a ratio of 2 to 1.213 Testimony before the Ways and Means considered debt as equity once the ratio exceeded 4 to 1.214 The Service had previously ruled that corporate obligations in the foreign area were debt if they did not exceed the ratio of 5 to 1.215

Passing the debt-to-equity ratio test might result from economic motivations instead of an abusive thin capitalization intent. The Joint Committee listed the following four economic reasons why a corporation might increase debt:

1. debt increases the value of the stock of the corporation;
2. debt increases earnings per share;
3. debt concentrates common shareholder holdings; and
4. the ability of the corporation to obtain loans from outside lending institutions;
5. the extent to which the advance was used to acquire capital assets; and
6. the failure of the debtor to repay on the due date or seek a postponement.

Id. at 311. The Service's factors are similar to those considered by the Fifth Circuit. They include:
1. the names given to the instruments;
2. a fixed maturity date with no provision for extension;
3. payment not dependent on earnings (to the extent LBO candidates may not have earnings stability, payment should not be found dependent on earnings);
4. the right to seek court enforcement in the event of default on payment of principal or interest;
5. thin or adequate capitalization;
6. the identity of interest between creditors and shareholders;
7. the ability to obtain loans from outside lending institutions; and
8. timely payment of all sums due by the borrower.
THIN CAPITALIZATION

(4) debt is a defensive maneuver against takeovers. The ratio might also be high due to decreases in equity, which do not increase the amount of interest payments that leave the United States.

Determining the measuring rod of taxable income may pose another economic problem for calculating excess interest expense. The Senate originally excluded the earnings stripping provision from its bill due to the use of adjusted taxable income. Adjusted taxable income fails to fairly represent a corporation's ability to carry its debt obligations due to the clutter of policy incentives and relief provisions bearing little relationship to the corporation's capacity to periodically pay interest.

At the Ways and Means hearings, both Secretary Brady and Alan Greenspan, the Chairman of the Federal Reserve Board, proposed different measures for determining a corporation's ability to service debt. While Secretary Brady said that the proper measure should be net interest expense to cash flow, Chairman Greenspan stated that gross interest payments to cash flow should be used.

Although neither measure could be used alongside the earnings stripping provision, both indicated that cash flow acts as a better measuring rod than taxable income. Congress could easily substitute fifty percent of cash flow for taxable income in the mechanics of the provision. However, Congress would still have to determine the proper measure of cash flow.

Congress vaguely indicated that adjusted taxable income would exclude capital gains. Excluding capital gains would further penalize a struggling corporation needing an influx of new capital. The corporation might elect to sell a capital asset to avoid issuing bonds to obtain needed cash. If the provision includes capital gains in adjusted taxable income, the corporation would not have to thin its capital structure by issuing more debt. However, including capital gains provides the foreign investor an opportunity to abusively liquidate corporate assets merely to increase the limitation.

The use of related parties, pursuant to section 267(b), also deviates from the economics of corporate finance. Section 267(b) deems a shareholder related to a corporation if he owns more than fifty percent of the outstanding stock. Congress chose section 267(b) over the more flexible section 482 "owned or controlled" standard.

217. TAX NOTES INT'L, supra note 204, at 473-74.
218. TAX ASPECTS, supra note 27, at 13.
219. Id. at 466.
220. The Conference Report states that the definition of adjusted taxable income should disregard the proceeds of certain capital asset dispositions. HOUSE CONFERENCE REPORT, supra note 91, at 566.
223. Id. § 482.
The owned or controlled standard is superior to the fifty percent ownership standard because it deals with a shareholder who owns a controlling, but not majority, interest. Suppose, for example, that individuals F, US1, and US2 own all the stock of a corporation in the following ratio:

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<th>F</th>
<th>US1</th>
<th>US2</th>
</tr>
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<tr>
<td></td>
<td>40%</td>
<td>35%</td>
<td>25%</td>
</tr>
</tbody>
</table>

F owns less than a majority interest, but he still has a great degree of influence over the corporation because he owns most of the shares. The Accounting Principles Board has issued an opinion stating that twenty percent ownership, which is significantly less than the fifty percent needed for majority control, is sufficient to create a presumption that the shareholder has the ability to exercise significant influence.225 Although the twenty-percent test also contains the inflexibility problem shared by the fifty-percent test, the opinion of the Accounting Principles Board shows the deficiency of the majority control test.226

The use of net interest expense227 causes similar problems because the provision once again fails to provide an adequate definition. Since the provision applies to interest that a corporation pays or accrues, it would seem to apply to interest that the corporation capitalizes but does not currently deduct. However, the House Report says that net interest expense should include interest expense only when deducted.228 This statement implies that the corporation should include the interest as net interest expense only when the corporation later deducts the capitalized interest.

Abuse through back-to-back loans occurs when a foreign investor lends money to an unrelated foreign intermediary who relends the money to a U.S. corporation. In the Committee Reports, Congress expressed its intention to authorize the Treasury Department to write regulations dealing with the problems of back-to-back loans through third parties and debt of a U.S. corporation that a foreign investor guarantees.229 Both of these problems deal with economic substance over form.230


226. The Ways and Means Committee anticipated that the Service will write regulations designed to prevent foreign investors from artificially manipulating their ownership structures to avoid the fifty-percent rule. However, it merely cited sources focusing on the majority control test. See Treas. Reg. § 1.957-1(b)(2) (as amended in 1988); Garlock, Inc. v. Commissioner, 489 F.2d 197 (2d Cir. 1973); Koehring Co. v. Commissioner, 583 F.2d 313 (7th Cir. 1978). It did not provide any authority for the Service to deal with legitimate ownership structures where a controlling interest was a minority interest. H.R. REP., supra note 147, at 1243.


228. H.R. REP., supra note 147, at 1244.

229. Id. at 1246; HOUSE CONFERENCE REPORT, supra note 91, at 567.

Assuming that the interest flowing from the United States to the foreign country is untaxed, the use of the intermediary allows the related parties to avoid having the interest deemed disqualified. This is possible even though the back-to-back loan arrangement has the economic substance of a loan from the foreign investor to the U.S. corporation. The Service should clarify the standard or standards it will use to collapse back-to-back loans into a single loan.

Congress gave little guidance for dealing with the substance over form problem of guarantees. The House Report mandates that the Service characterize the interest subsequently paid on guaranteed loans as disqualified interest. However, the Conference Report leads to this result only if a foreign investor uses the guarantee as a device to avoid the provision when the U.S. corporation is thinly capitalized, as in Plantation Patterns, Inc. v. Commissioner. In Plantation Patterns, the court ruled that a thinly capitalized corporation's debt to a third party, which a shareholder guarantees, is really the obligation of the shareholder, who is treated as contributing equity to the corporation. Because this rule does not consider the corporation as the borrower, the corporation cannot deduct the interest paid.

A thinly capitalized U.S. corporation's debt to an unrelated third party, which the foreign investor guarantees, is really the obligation of the foreign investor, who the provision treats as contributing equity to the U.S. corporation. Because the U.S. corporation is not treated as borrowing money, it does not have interest to deduct, thereby avoiding the provision. Any regulations based on the Conference Committee's theory will unreasonably result in the double penalization of a U.S. corporation: the corporation would not be able to deduct interest paid, but it must characterize the interest paid as disqualified interest. It does not make economic sense for the corporation to incur both penalties.

Another problem involves subjecting financial institutions, including banks, to the provision. The legislative history indicates that Congress was concerned only with non-financial corporations. The apparently inadvertent failure of Congress to specifically exclude financial corporations harms banks because most of their liabilities are deposits that lead to interest payments, which are tax exempt when paid to a foreign depositor. Even though deposits are not the type of abusive liability that the thin capitalization problem poses, a bank may find that its deposits and consequential interest payments result in disallowed interest deductions. Other liabilities should not pose a

232. See infra notes 280-82 and accompanying text.
236. Id. at 722.
thin capitalization problem because the Comptroller of the Currency\textsuperscript{238} and the Federal Reserve system\textsuperscript{239} stringently regulate bank solvency.

Finally, the provision does not deal with the thin capitalization problem in a symmetrical fashion. If the investment is not debt, it is equity. Likewise, if the payment is not interest, it is a dividend. The provision carries forward the disallowed interest deduction\textsuperscript{240} instead of treating it as a dividend. The problem, however, is that a thinly capitalized corporation may never have a chance to deduct the previously disallowed interest, which is really a dividend in disguise that would decrease earnings and profits.

\textbf{VI. PROPOSALS FOR CHANGE}

Not only is the earnings stripping provision bad law, but by designing a provision that strains to solve the problems LBOs cause by attacking thin capitalization, Congress chose not to use an existing Code section. Section 482\textsuperscript{241} provides sufficient authority for the Service to write regulations dealing with thin capitalization. Unfortunately, the Service has not chosen to implement section 482 in that manner. The Service merely provides guidance for determining the arm’s-length rate of interest,\textsuperscript{242} instead of determining the arm’s-length amount of debt and interest payments.

Section 482 allows the Service to allocate gross income and deductions among related entities. Although section 482 also applies in domestic circumstances, the Service primarily applies section 482 to international transactions. Similarly, the Service could apply section 482 to a U.S. corporation that a foreign investor thinly capitalizes.

For example, suppose the Service determines that the large amount of debt financing of a U.S. corporation results in excessive interest payments to a foreign investor. The Service could then reallocate the interest received by the foreign investor, “gross income,” to the U.S. corporation. This would decrease the U.S. corporation’s net interest deduction. The taxation of the foreign investor would be left to the foreign country’s revenue laws.

\textsuperscript{238} The Comptroller of the Currency examines banks to ensure that:
(1) the bank is granting loans on a sound and collectable basis,
(2) the bank’s funds are invested profitably to protect the bank’s shareholders and depositors, and
(3) loans are properly valued on the balance sheets. \textit{Hearing, supra} note 32, at 132 (testimony of Robert L. Clarke).


\textsuperscript{241} I.R.C. § 482 (1988).

\textsuperscript{242} Treas. Reg. § 1.482-2(a) (1988).
The regulations already contain the skeletal framework for this type of adjustment. They provide that the adjustment may involve a decrease in deductions, which would include a decrease in interest deductions. The regulations also provide for a correlative adjustment to the other party and to the foreign investor when the adjustment would affect their U.S. income tax liability. Under this example, the adjustment to the U.S. corporation would cause the foreign investor to receive a dividend, which the Code and the treaties may tax differently than interest, resulting in the Service making a correlative adjustment. The Service should augment the regulations by specifically providing for this type of situation.

Section 482 has other advantages over the earnings stripping provision as an instrument for reform. The section has a flexible standard to determine related parties through the owned or controlled standard. Its use of comparable ratios, when available, could accommodate different industries and different stages of the corporate life cycle. Furthermore, the OBRA penalty increases should sufficiently deter those who might not comply with section 482. Although the section 482 litigation would increase, use of the section remains administratively more efficient than the burdensome record keeping requirement of the earnings stripping provision.

The Service's use of section 482 would comply with U.S. treaty obligations. Because the section is based on the arm's-length standard, it does not override either the associated enterprises article or the nondiscrimination of deductions paragraph. Furthermore, section 482 applies to both domestic and international taxpayers. Hence, it does not override the other nondiscrimination paragraphs.

Theoretically, section 482 could solve many weaknesses inherent in the earnings stripping provision, while avoiding many of its problems. Unfortunately, Congress is not planning to repeal the earnings stripping provision. The best hope is that the Treasury Department and the Service will write regulations to solve the many problems inherent in the section. Although the regulations cannot solve the treaty override problems, they can match the provision to the economic consequences of corporate finance.

243. Id. § 1.482-1(d)(1).
244. Id. § 1.482-1(d)(2).
245. Id. § 1.482-2(e)(2); see also E.I. DuPont de Nemours & Co. v. United States, 608 F.2d 445, 450 (Ct. Cl. 1979).
246. OBRA also resulted in the enactment of section 6662(a), which increased the negligence penalty from 5% to 20%. I.R.C. § 6662(a) (West Supp. 1990).
247. The provision is in effect for the first time this taxable year. Consequently, the actual tax forms have not yet been issued.
248. Kevin Dolan, the former Associate Chief Counsel (International), writes that the current trend of legislation aimed at foreign investments in the United States, which are commonly known as inbound transactions, will continue in the near future. Dolan, Foreword to M.M. Levey, FOREIGN INVESTMENT IN THE UNITED STATES: LAW, TAXATION, FINANCE xliiv (1989).
A. Regulation Proposals for Determining the Debt-to-Equity Ratio

When drafting the debt-to-equity regulations, the Service should define debt based on the maturity of the obligation. The regulations defining debt should exclude short-term debt, but include long-term debt and any unsecured debt. Under this proposal, short-term debt would be debt with a maturity of less than one year.

The maturity distinction stems from the premise that a shareholder who owns enough shares to be a related party is not looking for a quick return. Instead, his ownership interest lacks a fixed maturity date, lasting in perpetuity. Because the thin capitalization problem deals with investors disguising their equity as debt, long-term debt is more similar to equity than short-term debt. This approach is consistent with the case law, which favors treating a contribution as equity if there is either a long time until maturity or no maturity date.249

This proposed regulation would exclude most short term debt from the debt-to-equity ratio. Short-term debt includes spontaneous liabilities,250 secured and unsecured short-term financing. With the exception of secured short-term financing, the duration of these transactions usually involves a time period of less than one year. Moreover, the transactions are frequently structured in such a way that thin capitalization does not result.

The most common type of spontaneous liabilities is the account payable. An account payable usually involves an open book account that is not documented by any formal financial agreements. As payables arise in the ordinary course of business, they are considered a form of payment rather than a form of financing. A growing business will have a high amount of payables, because the amount directly correlates with the fluctuation of business.251 The Treasury Department has indicated that it will tie the treatment of payables to the treatment of receivables. Although Treasury officials have not indicated the direction in which they will write the regulations, they have stated that excluding both will help corporations because payable accounts are usually larger than receivable accounts.252

Other types of spontaneous debt include accruals and advance payments. Accruals are expenses that the taxpayer has incurred, but not yet paid, such as wages, taxes, and royalties. Advance payments include rent and utilities,

249. See, e.g., Segal v. Commissioner, 89 T.C. 816, 833 (1987); National Farmers Union Service Corp. v. United States, 400 F.2d 483, 486 (10th Cir. 1968).
251. Major suppliers are often willing to start a growing business by informally allowing general credit terms to establish its lines in a promising market.
which are paid before the expenses are incurred.\textsuperscript{253} The inclusion of any of these as debt does not result in the thin capitalization problem because they are forms of payment, as opposed to loans.

Additionally, the regulations should exclude other short-term debt, such as unsecured bank loans, from the definition of debt. These loans generally do not create the same problem of thin capitalization as the long-term capital debts. Bankers make these loans, looking at the short-term solvency instead of the long-term solvency of the corporation. Consequently, these loans are self-liquidating.\textsuperscript{254} Furthermore, these loans have brief maturity because corporations use them primarily to finance seasonal purchases, and are expected to pay them back at the end of the season.\textsuperscript{255} The brief maturity of these loans makes them more similar to an account payable than to a bond.

The only potential abuse from excluding these types of short-term debts is the rolling over of loans. Rolling over sometimes occurs when a foreign investor thinly capitalizes a U.S. corporation with short-term loans that it renews or relends when the old short-term loans mature. The Service dealt with a similar abuse in Revenue Ruling \textsuperscript{256}89-73.\textsuperscript{256} The ruling addressed a foreign parent which continually lent money to its U.S. subsidiary. The money was repaid at the end of each year and relent at the start of the next year in order to avoid debt on the U.S. subsidiary's books at the end of each year. The Service used a substance over form rationale to collapse the two loans, placing them as a single debt on the U.S. subsidiary's books at the end of each year. The Service can similarly use the substance over form approach\textsuperscript{257} to attack the abuse of a foreign investor continually rolling over unsecured bank loans at the end of the year.

The regulations should, however, include short term secured debt in the debt-to-equity ratio computation. Unlike other types of short term debt, these loans are secured because the borrower has reached the limit of his unsecured borrowing capacity.\textsuperscript{258} The permanence of security in the form of tangible property and the endless litigation over the security on default give this type of debt long-term characteristics.

Long-term debt includes both term loans and bonds.\textsuperscript{259} The time length involved, typically ranging from one to twenty years, makes the debt similar to equity.

\textsuperscript{253} B. Kolb, \textit{supra} note 250, at 246.
\textsuperscript{254} \textit{Id.} at 257.
\textsuperscript{255} \textit{Id.}
\textsuperscript{256} Rev. Rul. 89-73, 1989-1 C.B. 258.
\textsuperscript{257} \textit{See, e.g.}, Gregory v. Helvering, 293 U.S. 465, 470 (1935).
\textsuperscript{258} B. Kolb, \textit{supra} note 250, at 268.
\textsuperscript{259} With a bond, which may be either secured or unsecured (an unsecured bond is called a debenture), the lender promises to abide by various provisions of the bond indenture, a lengthy document, containing conditions that the trustee watches throughout the term to protect the bondholders. The covenants in the indenture usually contain protective provisions, such as (1) a constraint on dividends to prevent shareholders from reducing liquidity by bleeding the corporation with excessive dividends;
Three types of transactions deserve special analysis: leases, bonds that are convertible into common stock, and warrants.

A lease contract grants the lessee the right to use the lessor's property provided that the lessee makes a periodic payment. A lease with an exercised option to buy is economically equivalent to simultaneously purchasing and financing a fixed asset. The regulations should exclude leases from debt if the leases are short-term, because short-term leases are merely a form of payment. These leases are commonly known as operating leases, where the lessor bears the benefits and risks of ownership such as insurance, taxes, and asset maintenance.

On the other hand, the regulations should classify a long-term lease as debt because it is an obligation for obtaining property over a long period of time. A long-term lease also resembles debt because part of the lease payments parallel the interest that a corporation would pay on a loan taken to purchase the asset. The proposed one year rule for distinguishing includible from excludible debt would not apply to leases. Instead, the lease should be debt if the term of the lease is seventy-five percent or more of the useful life of the asset.

Convertible bonds provide a foreign owner with the opportunity for thin capitalization abuse. A holder of a convertible bond may convert the bond into shares of the issuer’s common stock. This gives the holder the opportunity to hold debt that provides a steady interest cash flow, while also giving

(2) a limit on dividend payments to earnings accruing after the corporation has issued the bonds; and
(3) reducing liquidity by repurchasing its stock.

*Id.* at 521.

260. The cash flow effects of a lease with a yearly rental payment of $12,000 for 10 years with an exercised option to buy at the end of the term for $100,000 are equivalent to borrowing $100,000 for 10 years at a 12% interest rate to purchase a building today.

<table>
<thead>
<tr>
<th>Year</th>
<th>Cash flow</th>
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<tbody>
<tr>
<td>1</td>
<td>($12,000)</td>
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<td>2</td>
<td>($12,000)</td>
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<td>3</td>
<td>($12,000)</td>
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<td>4</td>
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<td>($12,000)</td>
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<tr>
<td>9</td>
<td>($12,000)</td>
</tr>
<tr>
<td>10</td>
<td>($112,000)</td>
</tr>
</tbody>
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See Oesterreich v. Commissioner, 226 F.2d 798, 801 (9th Cir. 1955) (finding payment of $12,000 for 10 years “not a lease, but in effect an installment sale of realty”).


262. This is the test detailed by Statement No. 13, Financial Accounting Standards Board, November 1976, which the Board propounded so that balance sheets would objectively characterize a lease, which is really a purchase financed by a loan from the seller, as debt. *H.R. Rep.*, *supra* note 147, at 850, 854, 871.
him the opportunity to share in any appreciation of the corporation through later conversion of the bonds into common stock. Convertible bonds are tailor made for the foreign investor trying to thinly capitalize his U.S. corporation, which can deduct the interest payments as the stock appreciates until the time that the foreign owner wants to convert. When determining whether a convertible bond is debt or equity, the Service currently uses a likelihood of conversion test, characterizing the convertible bond as equity if the holder will likely convert. Because of the potential abuse convertible bonds pose, this test is not strong enough.

A U.S. corporation trying to decrease its ratio below 1.5 to 1 might claim that the holders are likely to convert the bonds into stock. Then, if the corporation has a ratio well below 1.5 to 1 in a later year, the corporation would claim that the convertible is debt so it can deduct the interest payments. The regulations should require the corporation to irrevocably classify a convertible as debt or equity in the year of issuance. This approach resembles the one that section 279(d)(2) and the old section 385 regulations advocate, which deny a corporation the opportunity to recharacterize a convertible after the year of issuance. If the corporation classifies the convertible as equity to get below the ratio, it cannot later take a deduction for interest paid to the convertible bondholders. By requiring the corporation to make an early decision, the regulations would prevent the corporation from having its cake and eating it too.

Warrants offer an even greater potential for thin capitalization abuse than convertible bonds. Often issued with bonds, warrants are rights to purchase stock at a later date at a reduced rate. A bondholder who exercises his warrants can continue to obtain the benefits of a cash flow, while owning an equity interest that shares in corporate appreciation. Meanwhile, the corporation continues to strip earnings through the interest deduction. Because warrants are only rights to purchase stock, and not stock, the regulations should specifically eliminate them from the debt-to-equity computation.

B. Regulation Proposals for Determining Taxable Income

The adjustments to taxable income will determine if the U.S. corporation passes the second test. The Joint Committee's study proposed a standard

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264. The likelihood of conversion depends upon the value of the bond, the stock, and the conversion price. The conversion price is the effective price paid per common share if the stock is obtained through conversion. See B. KOLB, supra note 250, at 600.
267. This differs from the treatment of warrants pursuant to Generally Accepted Accounting Principles, which allocates part of the issue price of the bond to warrants based on relative fair market values. Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants, Accounting Principles Board, Opinion No. 14.
of either taxable income or current earnings and profits.\textsuperscript{269} Despite testimony favoring a cash flow measure, Ways and Means eventually chose taxable income without providing any rationale for the choice.

Earnings and profits makes better economic sense. Earnings and profits more clearly measure economic income because it deletes non-cash flow items from the measure, giving an aggregate of the annual non-capital increases or decreases in the net worth of the corporation.\textsuperscript{270} These non-cash flow items that pervade taxable income result from policies not having any effect on economic income.

A corporation starts with taxable income to compute current earnings and profits. Because Congress gave the Service the regulatory authority to make adjustments to taxable income, the Service can transform adjusted taxable income into the earnings and profits described in section 312.\textsuperscript{271}

Although the Conference Committee Report states that adjusted taxable income should disregard the proceeds of certain capital asset dispositions,\textsuperscript{272} the Conference Committee did not specifically exclude capital gains from the provision. The two leading commentators on the provision, the New York State Bar Association (NYSBA) and the American Bar Association (ABA)

\begin{itemize}
  \item \textsuperscript{269} TAX ASPECTS, supra note 27, at 106-07.
  \item \textsuperscript{270} Id. at 106.
  \item \textsuperscript{271} I.R.C. § 312 (1988). The corporation, which must compute earnings and profits for dividend purposes, makes the following adjustments to taxable income to determine earnings and profits:
    \begin{enumerate}
      \item \textit{Add back items excluded from taxable income.} These represent true financial gain but are exempt from tax, such as municipal bond interest, life insurance proceeds, and federal tax refunds. Items that are realized, but not recognized, such as like-kind exchanges, section 351 transactions, and section 1033 involuntary conversions should not be added back.
      \item \textit{Add back items deductible from taxable income} that do not decrease corporate wealth, such as the dividends received deduction and depreciation.
      \item \textit{Subtract certain non deductible items.} These are actual expenses that reduce the ability to pay dividends but do not reduce taxable income, such as expenses allocable to tax exempt income, I.R.C. § 265 (1988), amounts paid in connection with insurance companies, I.R.C. § 264 (1988), losses between related taxpayers, I.R.C. § 267 (1988), indirect contributions to political parties, I.R.C. § 276 (1988), travel and entertainment expenses, I.R.C. § 274 (1988), charitable contributions in excess of the percentage limitation, and net operating loss and capital losses in the year incurred.
      \item \textit{Add back certain timing adjustments.} These would include items that artificially accelerate deductions, such as the excess of the accelerated cost recovery system depreciation over straight line depreciation, amortization of section 179 expenses over five years, and the capitalization of otherwise deductible interest, taxes, and research and development expenses. These would also include items that artificially defer income, such as gains currently realized but deferred under section 453 and costing of inventory by a first-in, first-out method instead of a last-in, first-out method.
    \end{enumerate}
  \item \textsuperscript{272} See supra note 226.
\end{itemize}
tenuously assume that the proceeds of certain capital asset dispositions language means that adjusted taxable income generally includes capital gains. Without any supporting rationale, they further postulate that adjusted taxable income excludes capital gains only to the extent of depreciation recapture.

Both the NYSBA and the ABA incorrectly perceive the provision. Allowing the addition of capital gains to adjusted taxable income permits a U.S. corporation to sell low basis assets to its foreign investor, or even an unrelated party, in order to increase adjusted taxable income. The regulations should clarify this matter, generally excluding capital gains and losses, but specifically providing an averaging device to include part of the excess of capital gains over losses. This averaging device would allow the U.S. corporation to compute an average yearly gain for the number of years it held the asset, which it would then add to adjusted taxable income for the same number of years in the future. Similarly, the regulations should require the U.S. corporation to deduct an average of any excess capital losses over capital gains. The regulations should further prevent sweetheart deals by excluding any part of a capital gain on the disposition of an asset to a related party.

C. Regulation Proposals for Determining Net Interest Expense

The earnings stripping provision also provides for regulations regarding the determination of net interest expense. A symmetric tax system would include as net interest expense any payments that a corporation makes on debt instruments as defined by the provision's debt-to-equity regulations. This system would recharacterize, for example, part of the payments for a long term lease as interest.

The regulations should specifically deal with interest that is not currently deducted, focusing on interest that is capitalized and later deducted as depreciation or as cost of goods sold. The Ways and Means report indicates that this interest becomes net interest expense when later deducted.

The Service should write regulations excluding capitalized interest from net interest expense. Interest is the cost of the use of money for a period of


276. Section 263A provides for the capitalization of interest expense on the underlying property. Id. § 263A(f) (West Supp. 1990).

277. See supra text accompanying note 228.
time. If the corporation cannot deduct the amount of interest paid for use over a period of time, it is not an interest deduction. Because a corporation may deduct capitalized interest upon the occurrence of a non-time related economic event, such as the sale of goods or depreciation deductions, the deduction is not for the use of money and is not interest. Furthermore, requiring corporations to continually trace their interest to goods sold or depreciation would result in unwarranted accounting burdens.

D. Regulation Proposals to Carry Out Appropriately the Provision

The earnings stripping provision provides for regulations to facilitate its implementation, including the prevention of avoiding the provision. The Service should cover several issues when writing regulations pursuant to this catchall authority. The regulations should provide a tough standard to make it difficult for foreign shareholders to avoid the provision with abusive back-to-back loan schemes. This standard should follow the recent development of the law.

In *Aiken Industries, Inc. v. Commissioner*, the Tax Court ruled that it would not collapse back-to-back loans, even if the parties intended to avoid tax, provided there was some kind of business motive. However, in Revenue Rulings 84-152 and 84-153, the Service collapsed back-to-back loans where the parties intended tax avoidance regardless of whether the arrangement had a valid business purpose. The Service affirmed its tough philosophy in Revenue Ruling 87-89, allowing back-to-back loans to stand only if the foreign intermediary would loan the money without the foreign parent loaning money to the foreign intermediary.

The Service should continue the tightened standards of these recent rulings. The House Report specifically mentioned these three Revenue Rulings and did not mention the *Aiken* business purpose standard. Although the business purpose standard is theoretically sound, it is administratively impractical because the courts have too readily accepted the foreign business purposes of taxpayers for other litigated issues; thus, they are likely to accept alleged business purposes here. The economic reality that the arrangements are loans from a foreign investor to a U.S. corporation demands that the Service collapse these arrangements.

280. 56 T.C. 925 (1971).
THIN CAPITALIZATION

The Service will have difficulty writing regulations for scenarios where a foreign investor guarantees a loan an unrelated foreign intermediary makes to a U.S. corporation as a device to avoid the provision. It does not appear that Congress understood the harsh ramifications of treating interest paid as disqualified interest while applying Plantation Patterns v. Commissioner\(^{285}\) to prevent any interest deductions. Instead, the Service should suspend writing regulations for guarantees until it receives further guidance from Congress. If, however, the Service feels compelled to write regulations regarding guarantees, it should state that guarantees will not result in disqualified interest and that the rule in Plantation Patterns is the sole deterrent against the abuse of guarantees. More specifically, guarantees prevent erosion of the corporate tax base by lowering interest rates, lowering interest payments, and increasing taxable income.

The regulations should exempt banks from the provision. Although the debt-to-equity ratio of financial corporations has remained low during the 1980s,\(^{286}\) U.S. banks are susceptible to the provision because foreigners own twenty-seven percent of them.\(^{287}\) Nevertheless, Congress did not design this provision for banks, as the legislative history is replete with numerous statistical charts, tables, and commentary regarding non-financial corporations.\(^{288}\)

If the Service does not write regulations completely exempting banks\(^{289}\) from the provision, it could at least write regulations that only apply the provision to banks under the most extraordinary circumstances. These regulations could be similar to the regulations for section 279,\(^{290}\) which reduce the debt-to-equity ratio by excluding deposits from the liabilities and excluding an equal amount of assets from the equity amount.\(^{291}\) The regulations should further decrease the net interest expense by the ratio derived from dividing deposits over the amount of total liabilities.\(^{292}\)


\(^{286}\) The ratio has remained between .62 and .76. Hearing, supra note 32, at 242 (Statement of Alan J. Auerbach, Professor, University of Pennsylvania).

\(^{287}\) N.Y. Times, July 7, 1988, at C24, col. 2 (nat’l ed.).

\(^{288}\) See Tax Aspects, supra note 27; Hearing, supra note 32; Conference Report, supra note 62.

\(^{289}\) Section 581 defines a bank as

a bank or trust company incorporated and doing business under the laws of the United States . . . or of any State, a substantial part of the business which consists of receiving deposits and making loans and discounts, or of exercising fiduciary powers similar to those permitted to national banks under authority of the Comptroller of the Currency, and which is subject by law to supervision and examination by State, or Federal authority having supervision over banking institutions. Such term also means a domestic building and loan association.


\(^{290}\) Id. § 279.


\(^{292}\) Id. § 1.279-5(g)(1)(ii).
The regulations should provide symmetry to the thin capitalization problem by treating dividends disguised as interest as dividends that reduce earnings and profits. In addition to the carryforward of disallowed interest,\textsuperscript{293} the catchall regulations should give the corporation the option to irrevocably elect dividend treatment for any outstanding debt, which will reduce earnings and profits. If the corporation fails to timely make the election by the date the return is due for the first year the corporation pays interest to the debtholders, the corporation will lose the right to make the election. If the Service does not want to provide such an election, it could merely specify that disallowed interest reduces earnings and profits in the year of payment instead of the eventual year of deduction.

Although the provision does not suggest economic problems when interacting with Controlled Foreign Corporations (CFCs), affiliated corporations,\textsuperscript{294} and the branch tax,\textsuperscript{295} there is room for regulatory guidance. The regulations should deal with interest paid to a CFC, which the Code defines as a foreign corporation that is more than fifty percent owned by U.S. shareholders.\textsuperscript{296} In general, the Subpart F income\textsuperscript{297} of a CFC, without the necessity of a distribution, flows directly through the CFC to each U.S. shareholder owning ten percent of the CFC.\textsuperscript{298} Because the provision applies to any corporation, it applies to any interest a U.S. corporation pays to a CFC.

If a U.S. corporation pays exempt interest to its CFC, that interest would appear to be disqualified interest.\textsuperscript{299} However, because the U.S. corporation includes its share of the CFC's income, including the interest it pays to the CFC, the U.S. corporation will pay tax on a percentage of the interest it pays to its CFC. The regulations should exclude this interest from the definition of disqualified interest because it does not escape U.S. tax.

Conversely, a U.S. shareholder\textsuperscript{300} owning less than ten percent would not include his share of the CFC's net income in his income calculation. If,

\begin{itemize}
  \item \textsuperscript{293} I.R.C. § 163(j)(1)(B) (West Supp. 1990).
  \item \textsuperscript{294} Id. § 163(j)(7)(B).
  \item \textsuperscript{295} Id. § 163(j)(7)(C).
  \item \textsuperscript{296} I.R.C. § 951(b) (1988).
  \item \textsuperscript{297} The definition of Subpart F income is in section 952(a) which includes foreign base company income. I.R.C. § 952(a) (West Supp. 1990). Section 954(a) defines foreign base company income as including:
    \begin{enumerate}
      \item foreign personal holding company income,
      \item foreign base company sale income,
      \item foreign base company services income,
      \item foreign base company shipping income, and
      \item foreign base oil related income.
    \end{enumerate}
  \item \textsuperscript{298} I.R.C. § 951(a)(1) (1988).
  \item \textsuperscript{299} I.R.C. § 163(j)(3) (West Supp. 1990).
  \item \textsuperscript{300} The term "U.S. shareholder" refers to any shareholder who is a U.S. person as defined by section 957(c). Id. § 957(c). This should be distinguished from the section 951(b) definition of a U.S. shareholder who owns 10% or more of a CFC. I.R.C. § 951(b) (1988).
\end{itemize}
for example, a minority U.S. shareholder owns only five percent, five percent of the CFC's interest income is free from U.S. tax.

Several interested parties have complained that the regulations should exclude all interest paid to a CFC. They argue that the provision should attack interest deductions paid by domestic subsidiaries to foreign parents, not by domestic parents to foreign subsidiaries, such as CFCs. Their argument contradicts the House Report, which says that the interest CFCs pay can be disqualified interest to the extent that it avoids tax under Subpart F. The argument further ignores that the interest paid to the CFC is economic income to the minority shareholder that is currently untaxed. Finally, their argument would elevate treaty discrimination to new heights.

The Conference Report does not mention affiliated corporations, but the House Report indicates that corporations should compute net interest expense, adjusted taxable income, and disqualified interest on an aggregate basis for the affiliated group. The regulations should endorse the aggregation method. Money is fungible and a consolidated group can use money borrowed by one subsidiary to support another. This fungibility approach is the rationale behind other calculations under the foreign provisions of the Code.

Because the earnings stripping provision applies to any corporation, the provision controls foreign corporations operating through a U.S. branch. Congress gave the Service authority to write regulations coordinating the earnings stripping provision with the branch tax. The branch tax contains three additional taxing regimes imposed on the U.S. branch of a foreign corporation. By taxing remittances of U.S. branch profits to its foreign corporation, the branch then equivocates the taxation of a foreign corporation

301. Letter from Unocal Corp. to Senate Finance Committee, reprinted In Tax Notes Today, Oct. 5, 1989; see also Tax Notes Int'l, supra note 204.
303. House Conference Report, supra note 91, at 564.
307. Although a thorough review of the branch tax is beyond the scope of this article, the three different branch taxes are:

(1) A branch profits tax of 30% on the dividend equivalent amount, which is the earnings and profits from effectively connected income, less any increase in U.S. equity, plus any decrease in U.S. equity (a payment of interest from a U.S. branch to a foreigner would decrease U.S. equity), I.R.C. § 884(a) (1988);

(2) Any interest paid by a U.S. branch is deemed U.S. source, and is subject to withholding at a 30% rate, Id. §§ 884(f)(1)(A), 1441 (1988); and

(3) A 30% tax on the amount the interest deduction calculated pursuant to Treasury Regulation section 1.882-5 exceeds the amount of interest the U.S. branch actually paid. Id. § 884(f)(1)(B).
operating in the United States through a branch to a foreign corporation operating in the United States through a U.S. subsidiary.\textsuperscript{308}

The regulations should simply deem any interest paid to a foreigner as subject to U.S. taxation when the Service imposes the earnings stripping provision. Specifically, the interest will not escape U.S. tax because the U.S. branch will pay tax on the remittance.

\textbf{VII. CONCLUSION}

The earnings stripping provision of the 1989 Omnibus Budget Reconciliation Act is relatively ineffectual as law. It overrides two articles contained in most U.S. tax treaties. First, the provision contains a mechanical computation and overrides associated enterprises articles. Second, since the provision only applies to domestic subsidiaries and branches of foreign corporations, it overrides nondiscrimination articles. The provision further fails to follow the economics of corporate finance. Absent a repeal or a complete revision of the provision, the treaty override problems seem nonrectifiable. Fortunately, Congress has given the Internal Revenue Service broad regulatory discretion. The Service, therefore, has the power to provide a potentially palatable provision to solve the economic problems.