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International Tax

United States Tax Alert

August 1, 2014

"Stop Corporate Earnings Stripping Act of 2014"

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In response to the multiple announcements of international acquisitions facilitating the global growth of U.S. businesses (politically referred to as inversions), Rep. Sander Levin (D-Mich.), the ranking Democrat on the taxwriting House Ways and Means Committee, is developing a legislative proposal tentatively titled the "Stop Corporate Earnings Stripping Act of 2014" which is intended to complement the "Stop Corporate Inversions Act of 2014" that he introduced on May 20, 2014. (For a discussion of the Stop Corporate Inversions Act of 2014 see United States Tax alert dated May 21, 2014.) This alert describes the current draft of the proposal, although we understand that Rep. Levin intends to make further changes before releasing a discussion draft in the coming weeks.

According to draft explanatory materials that have been circulated, the measure is intended to reduce the U.S. tax benefits available to a U.S-based multinational whose ultimate parent shifts from being a U.S. corporation to a foreign corporation pursuant to an international acquisition (an "expatriated" U.S.-based multinational). However, as contemplated in the discussion draft, the proposed rules will apply to both expatriated U.S.-based multinationals *and* historical non-U.S.-based multinationals with U.S. operations. The discussion draft proposes changes to both the Subpart F regime and to the earnings stripping rules of section 163(j).

Proposed Changes to Section 956

The discussion draft proposes to change the section 956 regime to treat as constructive distributions under section 951(a)(1)(IB) not only investments in U.S. property (under current law, generally limited to investments in the debt or equity of related U.S. persons with anti-abuse rules to address conduits), but also investments in specified foreign group property and indirect guarantees. Specifically,

- The term "foreign group property" is to be defined, in general, as stock or obligations of *any* foreign person that is held by a controlled foreign corporation (CFC) that itself is a member of an expanded affiliated group headed by a non-U.S. corporation other than stock or obligations of (i) a CFC, (ii) a foreign person that is less than 25% related to any member of the expanded affiliated group, or (iii) otherwise within the limited exceptions of section 956(c)(2)(C), (I), (J) or (K).

    - The term “expanded affiliated group” is defined as it is for purposes of section 7874, but without the requirement that the group include an “expatriated entity” or to have otherwise implemented an inversion transaction under section 7874. Thus, this definition would include *any* group of companies headed by a non-U.S.-based multinational.

- With respect to indirect guarantees, the discussion draft proposes that a CFC will be deemed to hold an “obligation” of a foreign person (which would then trigger the prior proposed change) if that obligation is supported by a guarantee or pledge of the CFC *or, to the extent provided in regulations, by a guarantee or pledge of the U.S. shareholder of the CFC.*

Proposed Changes to CFC Status

Although the discussion draft does not yet provide suggested statutory language, the draft suggests that the Stop Corporate Earnings Stripping Act of 2014 will address the ability of a CFC to be de-controlled below the 50% threshold for CFC status under section 957 as a means to avoid the Subpart F regime (including section 956). It is unclear whether the draft intends to reduce the ownership requirement of section 957 or if it will use other means to counter de-control.

Proposed Changes to Section 163(j)

The discussion draft proposes several changes to the section 163(j) earnings stripping regime for both expatriated U.S.-based multinationals and historical non-U.S.-based multinationals. Specifically, the discussion draft proposes to

- Limit the amount of related party interest expense to 25% of adjusted taxable income,
- Limit the carry forward of excess related party interest expense to 5 years,
- Remove the 1:5:1 debt to equity safe harbor, and
- Remove the carry forward for unused limitation.

Effective Dates

The discussion draft states that the proposed changes will be effective for taxable years ending after the date of enactment, resulting in some retroactivity depending upon the date of enactment. Additionally, the draft legislation does not include any grandfather provisions for structures in place prior to enactment, or for a sunset of the proposed changes.

Comment/Outlook

Inversion transactions are an issue of much current debate, with substantial policy and political implications. Rep. Levin is not the first member to suggest that Congress’ response to these transactions should include modifications of the tax rules seen as providing benefits to inverted companies. For example, during a hearing at the Senate Finance Committee last week, Sen. Chuck Schumer (D-NY) indicated that he will introduce legislation shortly that will tighten current law rules on interest stripping codified in section 163(j). In addition, a former Department of the Treasury official in the Obama administration this week

suggested the administration could curb inversion transactions without Congressional action by amending the rules related to the deductibility of interest for inverted companies using their existing regulatory authority.

To this point, it is not knowable whether Congress will enact legislation to directly or indirectly curb inversion transactions. Nevertheless, the political contours of the inversion issue are highly volatile, and the outlook for legislation could change suddenly and unpredictably.
