PRESENT LAW AND BACKGROUND RELATING TO TAX TREATMENT OF BUSINESS DEBT

A REPORT TO THE
JOINT COMMITTEE ON TAXATION

Prepared by the Staff
of the
JOINT COMMITTEE ON TAXATION

July 11, 2011
JCX-41-11

CONTENTS

INTRODUCTION AND SUMMARY

Introduction

This document[1] has been prepared by the staff of the Joint Committee on Taxation, in response to the request of the Chairman and Vice Chairman of the Joint Committee on Taxation for a report of Federal tax rules relating to the use of leverage by households and businesses in the United States.[2]

There has been concern about the level of debt in the U.S. economy. Below is a table illustrating corporate debt, household debt, and Federal debt as a percentage of gross national product (GNP), 1987-2010. This document relates to business debt; corporate data is shown in column one of Table 1, below.

Table 1.−Corporate Debt, Household Debt, and Federal Debt, as a Percentage of Gross National Product (GNP), 1987-2010

Year	Corporate Debt[1] as a Percentage of GNP	Household Debt[2] as a Percentage of GNP	Federal Debt[3] as a Percentage of GNP
1987	42.8	57.9	41.0
1990	43.6	61.4	42.8
1995	39.5	65.0	48.9
2000	46.4	69.9	33.9
2005	43.0	92.4	36.9
2010	48.3	90.2	63.2

[1] Corporate debt of nonfinancial C corporations and S corporations excluding farms.
[2] Household debt includes debt of personal trusts, nonprofit organizations, partnerships and sole proprietorships.
[3] Federal debt excludes federal debt held by Federal agency trust funds.

Sources: Debt levels from The Board of Governors of the Federal Reserve System *Flow of Funds Accounts of the United States: Flows and Outstandings First Quarter 2011* Table D.3. GNP levels from the Federal Reserve Bank of St. Louis.

The first part of this document presents an overview of Federal income tax rules relating to debt and equity, and some of the statutory limitations on the benefits of each. The overview includes the treatment of issuers as well as holders, and the treatment of each in the event of a business downturn in which the instrument becomes worthless.

---

[1] This document may be cited as follows: Joint Committee on Taxation, *Present Law and Background Relating to Tax Treatment of Business Debt* (JCX-41-11), July 11, 2011. This document can be found on our website at www.jct.gov.

[2] The request was made at the 112th Congress Organizational Meeting of the Joint Committee on Taxation on March 15, 2011.

The second part of this document presents data regarding nonfinancial business sector debt and other business debt over several decades.

The third part of this document describes incentives for debt or equity that exist in the absence of tax considerations, a discussion of the incentives that may be created by the present-law tax treatment of instruments as debt or as equity.

A companion document[3] provides economic data with respect to household debt and provides a description of Federal tax rules governing household debt and economic incentives under present law.

Summary

Business enterprises and their investors have business reasons to structure capital investment as either debt or equity. For example, investors may prefer varying levels of risk. Investors may seek different levels of priority in the event of bankruptcy of the business. Businesses can issue interests to investors that have varying levels of control over the enterprise and degrees of participation in profitability or growth of the enterprise.

The tax law generally contains no fixed definition of debt or equity. Taxpayers have considerable flexibility to design instruments treated as either debt or equity but which blend features traditionally associated with both.

The Federal income tax treatment of debt and of equity creates incentives to utilize one or the other depending on the tax characteristics of the issuer and of the particular investor. In general, a corporate issuer is not subject to corporate tax on amounts that it deducts as interest on debt. By contrast, dividends, which are not deductible by the payor, come out of after-tax income of the corporation.

Debt instruments can permit the accrual of the interest deduction along with the inclusion in income by the holder at a time prior to the payment of cash. Interest income may be taxed at a higher rate to a taxable holder than the holder's dividends or capital gains attributable to corporate retained earnings (to which lower tax rates currently apply). However, some forms of debt investments are not subject to U.S. tax or are taxed at reduced rates in the hands of a tax-exempt or foreign investor. A number of special rules in the Code are designed to limit the tax benefits that can be obtained from interest deductions to protect the corporate tax base.

To the extent that debt finances assets that produce tax-exempt or otherwise tax-favored income, the interest deduction is available to offset other income taxed at higher rates. The resulting tax arbitrage can shelter otherwise taxable income. A number of special rules in the Code are directed at limiting this effect.

---

[3] Joint Committee on Taxation, *Present Law and Background Relating to Tax Treatment of Household Debt* (JCX-40-11), July 11, 2011 (hereinafter "*Tax Treatment of Household Debt*"). This document can be found on our website at www.jct.gov.

In addition to the tax benefits of interest deductibility, debt permits owners of business or investment assets to extract cash or to obtain a higher basis in the leveraged asset without an additional equity investment. A higher basis in a leveraged asset that is depreciable, for example, can increase depreciation deductions. This effect may in some situations create an incentive for a business to borrow.

In the event of financial difficulty, the discharge or restructuring of debt can cause the issuer to recognize discharge of indebtedness income or alternatively, gain with respect to the satisfaction of nonrecourse indebtedness for less than the outstanding amount. The income tax treatment of debt discharge depends on whether the debt is recourse or nonrecourse, the nature of the borrower's assets and of the borrowing, and the circumstances of the restructuring or discharge. In a number of instances, no current income is recognized, though tax attributes such as net operating losses, credits, or the basis of assets may be reduced. By contrast, the failure to pay dividends or return an equity investment in full does not cause income or gain to be recognized by the issuer.

In classifying an instrument as debt or equity, many factors have been applied by courts. In general, a debt instrument requires a fixed obligation to pay a certain amount at a specified date. Debt instruments provide for remedies including priorities in bankruptcy in the event of default. However, an instrument designated and respected as debt for tax purposes might have features that make it less likely to cause bankruptcy in the event of a downturn − for example, a delayed period before payment is due, the ability to miss scheduled payments over a long period of time before default occurs, the ability to satisfy required payments with instruments other than cash, thin capitalization of the issuer, or ownership of the debt by equity owners who may be willing to modify its terms rather than cause bankruptcy. Conversely, an instrument designated and respected as equity for tax purposes may have features that are more economically burdensome to the issuer, such as significantly increased dividend payment requirements after a specified period, puts and calls having the effect of requiring a cash redemption by a specified date, or provisions giving the holders certain corporate governance rights in the event scheduled payments are not made.

Equity can be beneficial for tax purposes in certain cases. Although corporate distributions and sales of corporate stock subject the holder to tax in addition to any tax paid by the corporation, reduced tax rates apply to holders with respect to such distributions or gain. Dividends on corporate equity are largely excludable by corporate holders (currently resulting in a maximum 10.5-percent tax rate under the 70-percent dividends received deduction). For individual shareholders, both dividends and capital gains on the sale of corporate stock are generally subject to a maximum 15 percent rate (compared to the top individual rate of 35 percent).[4] The present value of the shareholder-level tax on corporate earnings may be reduced to the extent earnings are retained and to the extent shareholders do not sell their stock. This second level of tax and may be eliminated entirely to the extent non-dividend-paying stock is

[4] The top individual rate on dividends of individuals is scheduled to increase to 39.6 percent after 2012, as is the top rate on other individual ordinary income. The top rate on long term capital gains of individuals is scheduled to increase to 20 percent after 2012.

held until the death of the owner. Receipt of equity also permits tax-free business combinations and distributions, both in the case of corporations and partnerships.

The treatment of an instrument for purposes of financial reporting, for regulatory capital purposes in a regulated industry (such as an insurance or banking), for ratings agency purposes, and under foreign tax and nontax laws, may differ from it's Federal income tax treatment. These differences may result in more favorable overall business treatment when the benefits of debt or of equity for a Federal income tax purpose are combined with the benefits of a different treatment for another purpose.

I. PRESENT LAW AND LEGISLATIVE BACKGROUND

A. General Rules

1. Issuer treatment of debt and equity

Interest and dividend payments

Interest paid or accrued by a business is generally deductible, subject to a number of limitations.[5] By contrast, dividends or other returns to equity are not deductible.

Timing of interest deduction

Interest generally is deducted as it is paid or accrues. However, interest can be deducted in advance of actual payment or other accrual under the terms of the instrument when the amount to be paid at the maturity of a debt instrument exceeds the issue price by more than a *de minimis* amount. In such cases, a portion of the amount to be paid at maturity is treated as interest accruing on a constant yield basis over the life of the instrument and is thus deducted in advance of actual payment.[6] Such interest is referred to as original issue discount ("OID").

Principal payments and return of equity capital

Principal payments on business debt are not generally deductible.[7] The return of capital to investors in an equity investment likewise is not deductible.

Receipt of cash from debt or equity investors

The issuance of a debt or equity instrument for cash is not a taxable event to the issuer**.**

Basis of assets purchased with debt or equity

Purchased assets generally have a cost basis for purposes of determining deprecation or gain or loss on sale, regardless of whether the purchase was financed with debt (including nonrecourse debt) or equity.

Effect of entity level debt on partnership and S corporation equity holders

Equity investors in a partnership or an S corporation[8] can deduct their allocable share of partnership deductions (including depreciation, interest, or loss, for example.) only to the extent

[5] Sec. 163(a). Some of these limitations are discussed below.

[6] Secs. 1273-1275.

[7] There is an exception for certain debt incurred through a leveraged employee stock ownership plan ("ESOP"). ESOPs are discussed at Part I.G.1.

the basis of their interest in the partnership or S corporation.[9] A partner's share of entity level debt is included in the partner's basis in his partnership interest. An S corporation shareholder does not include entity level debt in his S corporation stock basis. However, the S corporation shareholder may deduct losses to the extent of his basis in stock and his basis in debt that the corporation owes to him.

Nonpayments on equity compared to discharge or restructuring of indebtedness

If dividends are not paid on equity, or the capital contributed by an equity holder is not returned, there is generally no taxable income, gain, or other consequence to the issuer.[10]

The effects to the issuer if debt is modified, cancelled, or repurchased depend upon the type of debt, the nature of the holder, and whether or not the debt (or property given in exchange for it) is traded on an established securities market. If debt is cancelled, modified, or repurchased, the borrower generally realizes income from the discharge of indebtedness. Exceptions to this income inclusion are provided for bankruptcy and insolvency, for other situations including seller financing of purchased property, qualified farm indebtedness, qualified real property business indebtedness, and contributions of debt by an equity holder. The exceptions usually require the taxpayer to reduce the basis of property, or to reduce tax attributes such as net operating losses.[11] If nonrecourse debt is satisfied by foreclosure on the assets securing the debt, the borrower generally realizes gain from the disposition of the assets for the amount of the debt (even if the assets are not worth that amount).[12]

Recourse indebtedness

If a taxpayer's recourse debt is discharged, the taxpayer generally recognizes income from the discharge of indebtedness at that time.[13] A satisfaction of the debt with property worth less than the debt,[14] or a repurchase of debt for less than its face amount by the taxpayer or a

---

[8] An S corporation is a corporation that has only one class of stock, has no more than 100 shareholders (after applying attribution rules), meets specific other requirements, and makes an election enabling its income and deductions to pass through to its shareholders without entity level tax. Sec. 1371 *et seq*.

[9] Other limitations on a partner's or S corporation shareholder's deductions also can apply, such as the limitation on passive activity losses (sec. 469), or the at-risk limitation (sec. 465).

[10] Under certain circumstances an additional tax at the maximum individual rate on dividends (in addition to the corporate income tax) applies to certain unreasonably accumulated income and to certain undistributed income of a closely held corporation whose income is largely passive. Secs. 531-537 and secs. 541-547.

[11] Sec. 108. The rules relating to debt cancellation are discussed more fully at Part III.B. 2.

[12] *Commissioner v. Tufts*, 461 U.S. 300 (1983); *cf., Crane v. Commissioner*, 331 U.S. 1 (1947).

[13] Sec. 108.

[14] For example, if a creditor contributes its debt to a corporation and receives corporate stock in exchange, the corporation generally recognizes cancellation of indebtedness income to the extent the value of the stock given is less than the amount of the debt cancelled. However, if the debt was held by a person that was also a shareholder,

related party, is treated as a discharge of the taxpayer's debt to the extent of the difference between the outstanding debt and (generally) the value of the property.[15]

A significant modification of a debt instrument is treated as the disposition of the old instrument in exchange for the new instrument.[16] Such modifications include a change in the obligor, a change in term or interest rate; a change in principal amount, and certain modifications of security. The modification of a debt instrument can thus cause the issuer to recognize discharge of indebtedness income, measured by the difference between the adjusted issue price of the old debt and the fair market value (or other applicable issue price) of the new debt.[17] If the debt instrument is publicly traded or is issued in exchange for property (including other debt) that is publicly traded, then the issue price of the new debt is deemed to be the fair market value of the debt or other property that is publicly traded. [18] If neither the old nor the new debt instrument is traded on an established securities market the issue price of the new debt is generally the stated principal amount unless there is inadequate stated interest (i.e., interest less than the Treasury rate for an instrument of comparable term).[19] Thus, in such traded situations, discharge of indebtedness income is likely to be recognized if troubled debt is modified or satisfied with other debt instruments. However, in private situations there may be no discharge of indebtedness income.

In 2008, special temporary rules were enacted allowing any taxpayer that experiences discharge of indebtedness income arising from the reacquisition of its debt (including modifications treated as a reacquisition) to defer including that income for a period of years and then recognize the income ratably over a number of subsequent years. These rules applied to any debt issued by a corporate taxpayer and to debt issued by any other taxpayer in connection with the conduct of trade or business. They expired at the end of 2010.[20]

---

the debt may be considered contributed in a nontaxable contribution to capital, not creating discharge of indebtedness income.

[15] Sec. 249.

[16] Treas. Reg. sec. 1.1001-3.

[17] The discharge of indebtedness income is taken into income at the time of the exchange. The new debt may be deemed to be issued with original issue discount (to the extent the amount payable at maturity exceeds the issue price) that the issuer can deduct, which can offset the amount of debt discharge income, but the deductions occur in the future over the period of the new debt, while the income is recognized immediately.

[18] Thus, if a distressed debt instrument is modified and the transaction is treated as an exchange of the old instrument for the new one, the debtor can experience discharge of indebtedness income in the amount of the difference between the adjusted issue price of the old debt and its fair market value at the time of the modification.

[19] In certain "potentially abusive" cases, the principal amount of debt given in exchange for other property (including other debt) is the fair market value of the property exchanged.

[20] Pub. L. No.111-5, sec. 1231. Section 1232 gives the Treasury Department authority to suspend the AHYDO rules or modify the rate for determining what is an AHYDO in certain distressed debt capital market conditions.

Special rules allow a taxpayer not to recognize discharge of indebtedness income if the taxpayer is in bankruptcy or is insolvent. These rules permit such taxpayers to reduce net operating loss carryovers, depreciable asset basis, and other tax attributes that would provide tax benefits in the future, in lieu of recognizing current income from the discharge of indebtedness. The rules differ depending on whether the issuer is insolvent or is in a bankruptcy or similar proceeding.

If the discharge of indebtedness occurs in a Title 11 bankruptcy case, the full amount of any debt discharged is excluded from income. If the taxpayer is insolvent, cancellation of debt income is excludable only to the extent of the insolvency. In either case, if the tax attributes subject to reduction are insufficient to cover the amount of the discharge, there is no inclusion of debt discharge income for the excess. In the case of an entity that is taxed as a partnership, the determinations whether the discharge occurs in a Title 11 bankruptcy case, whether the taxpayer is insolvent, and the reduction of tax attributes, all occur at the partner level.

Tax attributes are generally reduced in the following order: (1) net operating losses, (2) general business credits, (3) minimum tax credits, (4) capital loss carryovers, (5) basis reduction of property, (6) passive activity loss and credit carryovers, and (7) foreign tax credits. A taxpayer may elect to apply the reduction first against the basis of depreciable property.

Other special rules allow a taxpayer that is not in bankruptcy or insolvent to exclude discharge of indebtedness income and instead reduce the basis of certain real property. These rules apply only for discharge of certain qualified real estate indebtedness or qualified farm indebtedness. The rules relating to qualified real estate indebtedness are available only to noncorporate taxpayers.

Purchase money financing

If debt that is discharged was seller-financing for a purchase of property by the debtor, and if the debtor is not insolvent or in a bankruptcy proceeding, then instead of income from the discharge of indebtedness, the debtor-purchaser has a purchase price reduction (which reduces the basis of the property acquired).

Nonrecourse indebtedness

Nonrecourse debt is subject to different rules than recourse debt.[21] Because the taxpayer is not personally liable on the debt, there is no cancellation of indebtedness income. However, if the creditor forecloses or otherwise takes the property securing the debt, the borrower treats the transaction as a sale of the property for a price equal to the outstanding indebtedness (even if the

[21] The distinction between recourse and nonrecourse debt may be less obvious than it would appear. Recourse debt might be issued by an entity that has limited liability and limited assets, while nonrecourse debt might be oversecured.

property securing the debt is worth less than the debt at the time of foreclosure).[22] Such a transaction generally produces capital gain (rather than ordinary income) to the debtor.

2. Holder treatment of debt and equity

Current income and sales of interests

Taxable investors

Interest on debt is taxed to a taxable individual or corporate holder at the ordinary income tax rate of the holder (currently, up to 35 percent).[23] Dividends paid by a taxable C corporation,[24] are generally taxed to a taxable individual shareholder at a maximum rate of 15 percent.[25] Such dividends are generally taxed to a taxable C corporation shareholder at a maximum rate of 10.5 percent (or less, depending on the percentage ownership the corporate shareholder has in the issuing corporation).[26] Gain on the sale of an equity interest in a C corporation or in an S corporation is generally capital gain. If the stock has been held for at least one year, such gain is generally taxable to a taxable individual shareholder at a maximum rate of 15 percent.[27] Gain on the sale of C corporation stock[28] is taxed to a taxable corporate shareholder[29] at regular corporate rates (generally 35 percent). Gain on the sale of an equity

[22] *Commissioner v. Tufts*, 461 U.S. 300 (1983); *cf., Crane v. Commissioner*, 331 U.S. 1 (1947).

[23] The ordinary income rate for individuals is scheduled to increase to 39.6 percent after 2012.

[24] A C corporation is defined by reference to subchapter C of the Code (tax rules relating to corporations and shareholders) and is taxable as a separate entity with no deduction for dividends or other equity distributions. For purposes of the discussion in this document,, such corporations are distinguished from certain corporations that meet specific tests relating to organization, functions, assets, and income types can deduct dividends and certain other equity distributions to shareholders, (e.g., real estate investment trusts (REITs) or regulated investment companies (RICs)). A C corporation is also distinguished from an S corporation, governed by the additional rules of subchapter S. An S corporation is a corporation that has only one class of stock, has no more than 100 shareholders (after applying attribution rules), meets other specific requirements, and makes an election enabling its income and deductions to pass through to its shareholders without entity level tax. Sec. 1371 et seq.

[25] The maximum 15 percent rate on dividends of individuals is scheduled to increase to 39.6 percent after 2012.

[26] The lower rate on dividends received by a corporate shareholder results from the corporate "dividends received deduction," which is generally 70 percent of the dividend received if the shareholder owns below 20 percent of the issuer, 80 percent of the dividend received if the shareholder owns at least 20 percent and less than 80 percent of the issuer, and 100 percent of the dividend if the shareholder owns 80 percent of more of the issuer (sec. 243). A corporation subject to the maximum 35 percent corporate tax rate and entitled to deduction 70 percent of a dividend would pay a maximum tax on the dividend of 10.5 percent (the 30 percent of the dividend that is taxable, multiplied by the 35 percent tax rate).

[27] The maximum 15 percent rate on long-term capital gains of individuals is scheduled to increase to 20 percent after 2012.

[28] A corporate shareholder cannot own S corporation stock.

interest in a partnership is generally also capital gain of the partner, except for amounts attributable to unrealized receivables and inventory items of the partnership, which are taxable as ordinary income.[30]

Interest is generally taxable when paid or accrued. Interest generally is includable in income, and thus taxable, before any cash payment if the original issue discount rules apply. Dividends are generally not taxable until paid. However, in limited circumstances certain preferred stock dividends may be accrued under rules similar to the rules for debt. Also, a shareholder may be treated as having received a dividend if his percentage stock ownership increases as a result of the payment of dividends to other shareholders.[31]

Tax-exempt investors

A tax-exempt investor (for example, a university endowment fund or a pension plan investor) is generally not taxed on investment interest, subject to certain unrelated business income tax (UBTI) rules for debt-financed income.[32] This is true whether the debt is issued by a C corporation or by any other entity.

Tax-exempt investors also are generally not subject to tax on sale of C corporation stock, unless the stock investment is debt-financed.

However, tax-exempt equity investors in a partnership are taxed as engaged in an unrelated trade or business on their distributive share of partnership income from such a business, as if they had conducted the business directly. And tax-exempt equity investors in an S corporation (other than an ESOP investor) are taxed on their entire share of S corporation income or gain on sale of the stock.[33]

Foreign investors

Debt interests in U.S. entities

Although U.S.-source interest paid to a foreign investor is generally subject to a 30-percent gross basis withholding tax, various exceptions exist in the Code and in bilateral income

[29] A C corporation is not an eligible S corporation shareholder and therefore cannot own S corporation stock.

[30] Sec. 751.

[31] Sec. 305(c). Certain situations in which some shareholders receive cash and others experience an increase in their percentage ownership can also cause both groups of shareholders to be treated as receiving a dividend under that section.

[32] Secs. 512, 514.

[33] Sec. 512(b).

tax treaties.[34] Interest is generally derived from U.S. sources if it is paid by the United States or any agency or instrumentality thereof, a State or any political subdivision thereof, or the District of Columbia. Interest is also from U.S. sources if it is paid by a noncorporate resident or a domestic corporation on a bond, note, or other interest-bearing obligation.[35] For this purpose, a noncorporate resident includes a domestic partnership which at any time during the year was engaged in a U.S. trade or business.[36] Additionally, interest paid by the U.S. branch of a foreign corporation is also treated as U.S.-source income.[37]

Statutory exceptions to this general rule apply for interest on bank deposits as well as portfolio interest. Interest on bank deposits may qualify for exemption on two grounds, depending on where the underlying principal is held on deposit. Interest paid with respect to deposits with domestic banks and savings and loan associations, and certain amounts held by insurance companies, are U.S.-source income but are not subject to the U.S. withholding tax when paid to a foreign person, unless the interest is effectively connected with a U.S. trade or business of the recipient.[38] Interest on deposits with foreign branches of domestic banks and domestic savings and loan associations is not treated as U.S.-source income and is thus exempt from U.S. withholding tax (regardless of whether the recipient is a U.S. or foreign person).[39] Similarly, interest and original issue discount on certain short-term obligations is also exempt from U.S. withholding tax when paid to a foreign person.[40]

Portfolio interest received by a nonresident individual or foreign corporation from sources within the United States is exempt from U.S. withholding tax.[41] For obligations issued before March 19, 2012, the term "portfolio interest" means any interest (including original issue

---

[34] Where a foreign investor is engaged in a U.S. trade or business, any U.S. source interest income or U.S. source dividend income (see "Equity interest in U.S. Entities" below) derived from assets used in or held for use in the conduct of the U.S. trade or business where the activities of the trade or business were material factor in the realization of such income will be treated as effectively connected with that U.S. trade or business. Sec. 864(a)(2).

[35] Sec. 861(a)(1); Treas. Reg. sec. 1.861-2(a)(1). However, special rules apply to treat as foreign source certain amounts paid on deposits with foreign commercial banking branches of U.S. corporations or partnerships and certain other amounts paid by foreign branches of domestic financial institutions. Sec. 861(a)(1). Prior to January 1, 2011, all (or a portion) of a payment of interest by a resident alien individual or domestic corporation was treated as foreign source if such individual or corporation met an 80-percent foreign business requirement. This provision was generally repealed for tax years beginning after December 31, 2010.

[36] Treas. Reg. sec. 1.861-2(a)(2).

[37] Sec. 884(f)(1).

[38] Secs. 871(i)(2)(A), 881(d); Treas. Reg. sec. 1.1441-1(b)(4)(ii).

[39] Sec. 861(a)(1)(B); Treas. Reg. sec. 1.1441-1(b)(4)(iii).

[40] Secs. 871(g)(1)(B), 881(a)(3); Treas. Reg. sec. 1.1441-1(b)(4)(iv).

[41] Secs. 871(h), 881(c). In 1984, to facilitate access to the global market for U.S. dollar-denominated debt obligations, Congress repealed the withholding tax on portfolio interest paid on debt obligations issued by U.S. persons. See Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984* (JCS-41-84), December 31, 1984, pp. 391-92.

discount) that is paid on an obligation that is in registered form and for which the beneficial owner has provided to the U.S. withholding agent a statement certifying that the beneficial owner is not a U.S. person, as well as interest paid on an obligation that is not in registered form and that meets the foreign targeting requirements of section 163(f)(2)(B). Portfolio interest, however, does not include interest received by a 10-percent shareholder,[42] certain contingent interest,[43] interest received by a controlled foreign corporation from a related person,[44] or interest received by a bank on an extension of credit made pursuant to a loan agreement entered into in the ordinary course of its trade or business.[45]

For obligations issued after March 18, 2012, the term "portfolio interest" no longer includes interest paid with respect to an obligation not in registered form. This narrowing of the scope of the portfolio interest exemption is a result of the repeal of the exception to the registration requirements for foreign targeted securities in 2010, effective for obligations issued two years after enactment.[46]

U.S.-source interest payments that do not qualify for a statutory exemption from the 30-percent withholding tax often are exempt from withholding under U.S. bilateral income tax treaties. Many treaties, including, for example, those with Canada, Germany, and the United Kingdom, broadly eliminate the withholding tax on U.S.-source interest payments. The result is that large volumes of interest payments are exempt from withholding under the Code or a treaty.

Equity interests in U.S. entities

A foreign equity investor's receipt of U.S.-source dividend income from a U.S. domestic corporation is generally subject to a 30-percent gross basis withholding tax. Dividend income is generally sourced by reference to the payor's place of incorporation such that dividends paid by a domestic corporation are generally treated as entirely U.S.-source income.[47] As with interest, the 30-percent withholding tax on dividends received by foreign investors may be reduced or eliminated under U.S. bilateral income tax treaties. In general, the dividend withholding tax rates in treaties vary based on the percentage of stock of the dividend-paying company owned by the recipient of the dividend. Treaties typically provide lower withholding tax rates (five percent, for example) at ownership levels of ten percent and greater. Twelve treaties, including those with Germany, Japan, and the United Kingdom, eliminate the withholding tax on dividends in circumstances in which, among other requirements, the foreign treaty resident is a company that owns at least 80 percent (in the case of Japan, 50 percent) of the U.S. corporation paying the dividend.

---

[42] Sec. 871(h)(3).

[43] Sec. 871(h)(4).

[44] Sec. 881(c)(3)(C).

[45] Sec. 881(c)(3)(A).

[46] Hiring Incentives to Restore Employment Law of 2010, Pub. L. No. 111-147, sec. 502(b).

[47] Secs. 861(a)(2), 862(a)(2).

Foreign investors also are not generally subject to tax on the sale of C corporation stock.[48]

In contrast, a foreign equity investor in a partnership is taxed on its distributable share of income effectively connected with the conduct of a U.S. trade or business, as if it had conducted that business directly. S corporations are not permitted to have foreign investors.

Treatment if investment becomes worthless

A taxable holder of either debt or equity held as an investment generally recognizes a capital loss if the instrument is sold to an unrelated party at a loss.[49] Capital losses can generally offset only capital gains; however, an individual may deduct up to $3,000 per year of capital loss against ordinary income.

A taxable holder of investment equity or debt also generally realizes a capital loss if the instrument becomes worthless. Certain other transactions, such as liquidating a subsidiary,[50] can permit recognition of a stock loss without a sale to an unrelated party.

In certain circumstances, an individual holder of debt that is not a security may take an ordinary bad debt loss.[51]

3. Acquisitions and dispositions

The Code permits certain corporate acquisitions and dispositions to occur without recognition of gain or loss, generally so long as only equity interests are received or any securities received do not exceed the amount surrendered.[52] Similarly, the Code permits certain contributions and distributions of property to and from partnerships without tax if made with respect to an equity interest.[53]

---

[48] Secs. 871 and 881, applicable to income not connected with a U.S. business. The exemption does not apply to a foreign individual who is present in the U.S. for 183 days or more during the taxable year. Foreign investors may be subject to tax if the stock is a U.S. real property interest under the Foreign Investment in Real Property Tax Act of 1980 ("FIRPTA"). Sec. 897.

[49] Up to $50,000 of loss on certain small business company stock ($100,000 for a couple filing a joint return) can be deducted as an ordinary loss. Sec. 1244.

[50] See Sec. 267(a)(1), second sentence.

[51] Sec. 166.

[52] Secs. 351-368 and sec. 1032.

[53] Secs. 721 and 731.

A transfer of property to a corporation or partnership in exchange for debt of the entity is generally treated as a sale of the property.[54] Gain or loss is recognized, except that loss may be deferred if the transfer is to a related party.[55]

[54] Sec. 1001. Special rules may apply if the transfer is considered part of a larger transaction such as an otherwise tax-free corporate reorganization.

[55] Secs. 267 and 707.

B. Definition of Debt and Equity

1. Distinguishing debt from equity

In general

The characterization of an instrument as debt or equity for Federal income tax purposes is generally determined by the substance of the investor's investment. An instrument's characterization depends upon the terms of the instrument and all the surrounding facts and circumstances analyzed in terms of economic and practical realities. Neither the form of the instrument nor the taxpayer's characterization of the interest is necessarily determinative of the instrument's treatment for Federal income tax purposes. Nonetheless, between the extremes of instruments that are clearly debt or clearly equity, taxpayers have some latitude to structure instruments incorporating both debt- and equity-like features (commonly referred to as "hybrid securities").[56]

There is currently no definition in the Code or Treasury regulations that can be used to determine whether an interest in a corporation constitutes debt or equity for tax purposes. Moreover, the IRS will ordinarily not provide individual taxpayers guidance on whether an interest in a corporation is debt or equity for tax purposes because, in its view, the issue is primarily one of fact.[57]

In the absence of statutory or regulatory standards, a substantial body of Federal common law is the principal source of guidance for distinguishing debt and equity. Courts generally agree that the proper characterization of an instrument requires a facts and circumstances analysis, the primary goal of which is to determine whether, in both substance and form, an instrument represents risk capital entirely subject to the fortunes of the venture (equity),[58] or an unqualified promise to pay a sum certain on a specified date with fixed interest (debt).[59] The determination

---

[56] See *Kraft Foods Co. v. Commissioner*, 232 F.2d 118, 123 (2d Cir. 1956) (noting that "[t]he vast majority of these cases have involved 'hybrid securities' - instruments which had some of the characteristics of a conventional debt issue and some of the characteristics of a conventional equity issue.").

[57] Rev. Proc. 2011-3, sec. 4.02(1), 2011-1 I.R.B. 111. The IRS has identified factors to weigh in determining whether a particular instrument should be treated as debt or equity. See, e.g., Notice 94-47, 1994-1 C.B. 357.

[58] See, e.g., *United States v. Title Guarantee & Trust Co.*, 133 F.2d 990, 993 (6th Cir. 1943) (noting that "[t]he essential difference between a stockholder and a creditor is that the stockholder's intention is to embark upon the corporate adventure, taking the risks of loss attendant upon it, so that he may enjoy the chances of profit."); *Farley Realty Corp. v. Commissioner*, 279 F.2d 701 (2d Cir. 1960); *Commissioner v. O.P.P. Holding Corp.*, 76 F.2d 11, 12 (2d Cir. 1935) (noting that that the distinction between the shareholder and the creditor is that "[t]he shareholder is an adventurer in the corporate business; he takes the risk and profits from success [while] [t]he creditor, in compensation for not sharing the profits, is to be paid independently of the risk of success, and gets a right to dip into the capital when the payment date arrives.").

[59] *Gilbert v. Commissioner*, 248 F.2d 399, 402 (2d Cir. 1957) (noting that debt involves "an unqualified obligation to pay a sum certain at a reasonably close fixed maturity date along with a fixed percentage in interest payable regardless of the debtor's income or the lack thereof."); sec. 385(b)(1) ("a written unconditional promise to pay on demand or an a specified date a sum certain in money in return for an adequate consideration in money or

of whether an interest constitutes debt or equity is generally made by analyzing and weighing the relevant facts and circumstances of each case.[60]

Courts have created differing (though generally similar) lists of factors[61] to distinguish debt from equity with no one factor controlling or more important than any other.[62] One commentator provides a list of thirty factors along with the Circuit courts that have considered these factors.[63] Another commentator groups the factors discussed in the cases into four categories: (1) those involving the formal rights and remedies of the parties; (2) those bearing on the genuineness of the alleged intention to create a debtor-creditor relationship; (3) those bearing on the reasonableness or economic reality of that intention (the risk element); and (4) those which are merely rhetorical expressions of a result, having no proper evidentiary weight in themselves.[64]

Some commonly cited factors considered, among others, are:

1. whether there is an unconditional promise to pay a sum certain on demand or at a fixed maturity date in the reasonably foreseeable future;

2. whether the holder possesses the right to enforce the payment of principal and interest;

3. whether there is subordination to, or preference over, any indebtedness of the issuer, including general creditors;

---

money's worth, and to pay a fixed rate of interest"); Treas. Reg. sec. 1.165-5(a)(3) (defines security as an evidence of indebtedness to pay a fixed or determinable sum of money); sec. 1361(c)(5)(B) (straight-debt safe harbor for subchapter S purposes).

[60] *John Kelley Co. v. Commissioner*, 326 U.S. 489 (1943) (stating "[t]here is no one characteristic, not even the exclusion from management, which can be said to be decisive in the determination of whether the obligations are risk investments in the corporations or debts.").

[61] See, e.g., *Fin Hay Realty Realty Co. v. United States*, 398 F.2d 694 (3d Cir. 1968) (sixteen factors); *Estate of Mixon v. United States*, 464 F.2d 394 (5th Cir. 1972) (thirteen factors); *Roth Steel Tube Co. v. Commissioner*, 800 F.2d 625 (6th Cir. 1986) (eleven factors); *United States v. Uneco Inc.*, 532 F.2d 1204 (8th Cir. 1976) (ten factors).

[62] *Tyler v. Tomlinson*, 414 F.2d 844, 848 (5th Cir. 1969) (noting that "[t]he object of the inquiry is not to count factors, but to evaluate them"); *Estate of Mixon v. United States*, 464 F.2d 394, 402 (5th Cir. 1972) (noting that the factors are not of equal significance and that no one factor is controlling).

[63] Christensen, "The Case for Reviewing Debt/Equity Determinations for Abuse of Discretion," 74 *University of Chicago Law Review* 1309, 1313 (2007).

[64] Plumb, "The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal," 26 *Tax Law Review* 369, 411-412 (1971). According to a study of 126 Tax Court opinions issued from 1955 to 1987, seven factors were found to be conclusive of debt classification 97 percent of the time. Robertson, "Daughtrey & Burckel, Debt or Equity? An Empirical Analysis of Tax Court Classification During the Period 1955-1987," 47 *Tax Notes* 707 (1990).

4. the intent of the parties, including the name given the instrument by the parties and its treatment for nontax purposes including financial accounting, regulatory, and rating agency purposes;

5. the issuer's debt to equity ratio;

6. whether the instrument holder is at risk of loss or has the opportunity to participate in future profits;

7. whether the instrument provides the holder the right to participate in the management of the issuer;

8. the availability and terms of other credit sources;

9. the independence (or identity) between holders of equity and the holders of the instrument in question;

10. whether there are requirements for collateral or other security to ensure the payment of interest and principal; and

11. the holder's expectation of repayment.

2. Regulatory authority pursuant to section 385

Section 385 authorizes the Secretary of the Treasury to prescribe such regulations as may be necessary or appropriate to determine whether an interest in a corporation should be characterized as debt or equity (or as in part debt and in part equity) for Federal income tax purposes. Section 385(b) lists five factors which "may" be included in regulations prescribed under the section as relevant to the debt/equity analysis. Section 385(b) lists the factors as:

1. whether there is an unconditional written 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 corporation's debt to equity ratio;

4. whether the interest is convertible into stock of the corporation; and

5. the relationship between the holdings of stock in the corporation and holdings of the interest in question.

As detailed below, regulations under section 385 were promulgated but withdrawn without ever having taken effect. The withdrawn regulations are not legally binding on the IRS or taxpayers.

Section 385(c) provides that an issuer's characterization of an instrument (at the time of issuance) is binding on the issuer and any holder, but not the Secretary. However, the holder of an instrument may treat an instrument differently than the issuer provided the holder discloses the inconsistent treatment on his return.

Legislative Background

Section 385 was enacted by the Tax Reform Act of 1969.[65] The Senate Finance Committee noted that:

> "In view of the uncertainties and difficulties which the distinction between debt and equity has produced in numerous situations other than those involving corporate acquisitions, the committee further believes that it would be desirable to provide rules for distinguishing debt from equity in the variety of contexts in which this problem can arise. The differing circumstances which characterize these situations, however, would make it difficult for the committee to provide comprehensive and specific statutory rules of universal and equal applicability. In view of this, the committee believes it is appropriate to specifically authorize the Secretary of the Treasury to prescribe the appropriate rules for distinguishing debt from equity in these different situations."[66]

The Treasury promulgated proposed regulations under section 385 in March of 1980[67] and final regulations on December 31, 1980, with an effective date of April 30, 1981. The effective date was extended twice.[68] The Treasury promulgated proposed amendments to the regulations in 1982.[69] The effective date of the proposed amendments, and the final regulations,

---

[65] Pub. L. No. 91-172.

[66] S. Rep. No. 91-552 (November 21, 1969). The Senate Finance Committee previously considered whether to define debt and equity in the context of creating the Internal Revenue Code of 1954. At that time the issue was whether the Senate should adopt the House of Representatives' draft version of the Code which defined participating stock (common stock) and nonparticipating stock (preferred stock) and defined the term security. The Senate Finance Committee ultimately recommended that these definitions be dropped, noting:

> Your committee believes that any attempt to write into the statute precise definitions which will classify for tax purposes the many types of corporate stocks and securities will be frustrated by the numerous characteristics of an interchangeable nature which can be given to these instruments. Accordingly, your committee has returned to the use of the terms "stock," "common stock," "securities," etc., and, as is the case under existing law, has not attempted to define them in the statute. S. Rep. No. 1622, 83 Cong., 2d Sess. 42 (1954).

[67] 45 F.R. 18957.

[68] T.D. 7747, 45 F.R. 86438; T.D. 7774, 46 F.R. 24945; T.D. 7801, 47 F.R. 147.

[69] See 47 F.R. 164.

were again postponed.[70] The final regulations were withdrawn in 1983 without ever having taken effect.[71]

Section 385 was amended by the Omnibus Budget Reconciliation Act of 1989[72] to specifically add authority for the Secretary to treat an interest in a corporation as part stock and part debt.[73] In 1992, section 385 was amended to add section 385(c) regarding the effect of an issuer's classification.[74]

[70] T.D. 7822, 47 F.R. 28915.

[71] T.D. 7920, 48 F.R. 50711. One commentator suggests that the regulations were not finalized because tax planners could design instruments contained all of the essential features of equity but which qualify as debt under the regulations. As an example, he noted that an instrument would be classified as debt if its debt features accounted for more than half of its value and that as a result of this rule, hybrid instruments such as adjustable rate convertible notes began appearing that provided for guaranteed payments having a present value just greater than half of the issue price, variable payments tied to the issuer's common-stock dividends, and an option to convert these instruments into shares of the issuer's stock. Adam O. Emmerich, "Hybrid Instruments and the Debt-Equity Distinction in Corporate Taxation," 52 *University of Chicago Law Review* 118, 129-131 (1985).

[72] Pub. L. No. 101-239.

[73] Section 7208(a)(2) of Pub. L. No. 101-239 provides that the authority granted to bifurcate an interest in a corporation may not be applied retroactively.

[74] Energy Policy Act of 1992, Pub. L. No. 102-486.

C. Rules to Address Stripping of U.S. Corporate Tax Base in the Case of Nontaxed Holders

A taxable corporation may reduce its Federal income tax through the payment of deductible amounts such as interest, rents, royalties, premiums, management fees to an affiliate not subject to Federal income tax. Sheltering or offsetting income otherwise subject to Federal income tax in this manner is known as "earnings stripping." Several provisions of present law limit taxpayers' ability to strip earnings. Following is a brief description of certain rules designed to limit the ability of corporations to strip earnings using payments of interest.

1. Earnings stripping

Present Law

Section 163(j) may disallow a deduction for disqualified interest paid or accrued by a corporation in a taxable year if two threshold tests are satisfied: the payor's debt-to-equity ratio exceeds 1.5 to 1 (the safe harbor ratio); and the payor's net interest expense exceeds 50 percent of its adjusted taxable income (generally, taxable income computed without regard to deductions for net interest expense, net operating losses, domestic production activities under section 199, depreciation, amortization, and depletion). Disqualified interest includes interest paid or accrued to: (1) related parties when no Federal income tax is imposed with respect to such interest;[75] (2) unrelated parties in certain instances in which a related party guarantees the debt; or (3) to a real estate investment trust ("REIT") by a taxable REIT subsidiary of that trust.[76] Interest amounts disallowed under these rules can be carried forward indefinitely.[77] In addition, any excess limitation (i.e., the excess, if any, of 50 percent of the adjusted taxable income of the payor over the payor's net interest expense) can be carried forward three years.[78]

The operation of these rules is illustrated by the following example. ForCo, a corporation organized in country A, wholly owns USCo, a corporation organized in the United States. ForCo's investment in USCo stock totals $6.5 million. In addition, USCo has borrowed $8 million from ForCo and $5 million from Bank, an unrelated bank. In 2010, USCo's first year of operation, USCo's adjusted taxable income is $1 million (none of which is from interest income), and it also pays $400,000 of interest to ForCo and $300,000 of interest to the unrelated bank. Under the U.S.-country A income tax treaty, no tax is owed to the United States on the interest payments made by USCo to ForCo.

---

[75] If a tax treaty reduces the rate of tax on interest paid or accrued by the taxpayer, the interest is treated as interest on which no Federal income tax is imposed to the extent of the same proportion of such interest as the rate of tax imposed without regard to the treaty, reduced by the rate of tax imposed by the treaty, bears to the rate of tax imposed without regard to the treaty. Sec. 163(j)(5)(B).

[76] Sec. 163(j)(3).

[77] Sec. 163(j)(1)(B).

[78] Sec. 163(j)(2)(B)(ii).

- USCo has a 2:1 debt-to-equity ratio (total borrowings of $13 million ($8 million + $5 million) and total equity of $6.5 million), so USCo's deduction for the $700,000 ($400,000 + $300,000) of interest it paid may be limited.

- USCo's disqualified interest is $400,000 (the amount of interest paid to a related party on which no Federal income tax is imposed).

- USCo's excess interest expense is $200,000 ($700,000 - ($1 million x 50%)).

- Accordingly, USCo may deduct only $500,000 ($700,000 - $200,000) for interest expense in year 2010.

The $200,000 of excess interest expense may be carried forward and deducted in a subsequent tax year with excess limitation.

Legislative Background

Section 163(j) was enacted in 1989 in response to Congressional concerns over earnings stripping.[79] Congress believed it was "appropriate to limit the deduction for interest that a taxable person pays or accrues to a tax-exempt entity whose economic interests coincide with those of the payor. To allow an unlimited deduction for such interest permits significant erosion of the tax base."[80]

In 1993, the earnings stripping rules were amended so that they applied to interest paid on unrelated party loans if guaranteed by a related party under certain circumstances.[81] Congress made this change because it was concerned about the distinction made under the existing earnings stripping rules between the situation in which unrelated creditors all lend to the parent of a group, which in turn lends to the U.S. subsidiary, and the situation in which the creditors lend directly to the U.S. subsidiary with a guarantee from the parent.[82] The existing rules applied to the first situation but not the second situation, even though the "same 'excess' interest deductions, and the same resultant 'shifting' of net income out of U.S. taxing jurisdiction, is obtainable through borrowing by U.S. corporations on [the parent's] credit."[83]

[79] Revenue Reconciliation Act of 1989, Pub. L. No. 101-239, sec. 7210.

[80] H.R. Rep. No. 101-247, p. 1241 (1989).

[81] Revenue Reconciliation Act of 1993, Pub. L. No. 103-66, sec. 13228.

[82] H.R. Rep. No. 103-111, p. 683 (1993).

[83] *Ibid.,* p. 682.

The definition of disqualified interest was expanded in 1999 to include interest paid or accrued by a taxable REIT subsidiary to a related REIT.[84]

In 2006, the earnings stripping rules were modified to apply to corporate owners of partnership interests.[85] Specifically, the modifications provided that for purposes of applying the earnings stripping rules when a corporation owns an interest in a partnership, (1) the corporation's share of partnership liabilities are treated as liabilities of the corporation, and (2) the corporation's distributive share of interest income and interest expense of the partnership is treated as interest income or interest expense, respectively, of the corporation. Treasury was also granted expanded regulatory authority to reallocate shares of partnership debt, or distributive shares of the partnership's interest income or interest expense.

The American Jobs Creation Act of 2004 required the Secretary of the Treasury to submit a report to the Congress by June 30, 2005, examining the effectiveness of the earnings stripping provisions of present law, including specific recommendations to improve the provisions of the Code applicable to earnings stripping.[86] The Treasury Department submitted its report to Congress on November 28, 2007.[87] In summary, the report concludes that "[t]here is strong evidence that [inverted corporations][88] are stripping a significant amount of earnings out of their U.S. operations and, consequently, it would appear that section 163(j) is ineffective in preventing them from engaging in earnings stripping."[89] The report also concludes, however, that the evidence that other foreign-controlled domestic corporations are engaged in earnings stripping is not conclusive, and that it is not possible to determine with precision whether section 163(j) is effective generally in preventing earnings stripping by foreign-controlled domestic corporations.[90]

---

[84] Tax Relief Extension Act of 1999, Pub. L. No. 106-170, sec. 544. Technical corrections were also made in 1996 and 2005. Small Business Job Protection Act of 1996, Pub. L. No. 104-188, secs. 1703(n)(4), 1704(f)(2); Gulf Opportunity Zone Act of 2005, Pub. L. No. 109-135, sec. 403(a)(15).

[85] Tax Increase Prevention and Reconciliation Act of 2005, Pub. L. No. 109-222, sec. 501 (2006).

[86] Pub. L. No. 108-357, sec. 424.

[87] U.S. Department of the Treasury, *Report to Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties* (2007). For a detailed discussion of the report, including an analysis of its methodology and conclusions, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2012 Budget Proposal* (JCS-3-11), June 2011, pp. 259-65.

[88] An "inverted corporation" is a former U.S.-based multinational that restructured to replace a U.S. parent corporation with a new foreign parent for the group. For purposes of the Treasury report, inverted corporations are a subset of foreign-controlled domestic corporations.

[89] U.S. Department of the Treasury, *Report to Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties* (2007), p. 26.

[90] *Ibid.,* pp. 25-26.

Subsequent to its 2007 report on earnings stripping, the Treasury Department created a new tax form, Form 8926 Disqualified Corporate Interest Expense Disallowed Under Section 163(j) and Related Information, to collect information related to earnings stripping. Form 8926 must be filed by a corporation (other than an S corporation) if it paid or accrued disqualified interest during the taxable year or had a carryforward of disqualified interest from a previous tax year.

2. Tax treatment of certain payments to controlling exempt organizations

Present Law

Although tax-exempt organizations described under section 501(c) are generally exempt from Federal income tax,[91] such organizations may be subject to the unrelated business income tax (UBIT)[92] on interest and other income received from the organization's controlled subsidiaries.[93] Section 512(b)(13) subjects interest income (as well as rent, royalty, and annuity income) to UBIT if such income is received from a taxable or tax-exempt subsidiary that is 50-percent controlled by the parent tax-exempt organization to the extent the payment reduces the net unrelated income (or increases any net unrelated loss) of the controlled entity (determined as if the entity were tax-exempt).[94]

A special rule relaxes the general rule of section 512(b)(13) for qualifying specified payments made pursuant to a binding written contract that was in effect on August 17, 2006 (or renewal of such a contract on substantially similar terms).[95] The special rule applies to payments received or accrued before January 1, 2012.

---

[91] Sec. 501(a).

[92] Secs. 511-514. In general, UBIT taxes income derived from a regularly carried on trade or business that is not substantially related to the organization's exempt purposes. Certain categories of income—such as interest, dividends, royalties, and rent—are generally exempt from UBIT. For example, tax-exempt organizations are not taxed on interest income they receive from investments in debt or other obligations.

[93] Tax-exempt organizations subject to UBIT include those described in section 501(c) (except for U.S. instrumentalities and certain charitable trusts), qualified pension, profit-sharing, and stock bonus plans described in section 401(a), and certain State colleges and universities. Sec. 511(a)(2). Organizations liable for UBIT may be liable for alternative minimum tax determined after taking into account adjustments and tax preference items.

[94] In the case of a stock subsidiary, "control" means ownership by vote or value of more than 50 percent of the stock. In the case of a partnership or other entity, "control" means ownership of more than 50 percent of the profits, capital, or beneficial interests. In addition, present law applies the constructive ownership rules of section 318 for purposes of section 512(b)(13). Thus, a parent exempt organization is deemed to control any subsidiary in which it holds more than 50 percent of the voting power or value, directly (as in the case of a first-tier subsidiary) or indirectly (as in the case of a second-tier subsidiary).

[95] Sec. 512(b)(13)(E). For such payments covered by the special rule, the general inclusion rule of section 512(b)(13) applies only to the portion of payments received or accrued in a taxable year that exceeds the amount of the payment that would have been paid or accrued if the amount of such payment had been determined under the principles of section 482 (i.e., at arm's length). In addition, the special rule imposes a 20-percent penalty on the larger of such excess determined without regard to any amendment or supplement to a return of tax, or such excess determined with regard to all such amendments and supplements.

Legislative Background

Congress enacted section 512(b)(13) as part of the Tax Reform Act of 1969[96] for the purpose of preventing organizations from avoiding taxation through arrangements in which a taxable organization controlled by a tax-exempt organization would make deductible payments of interest, rent, annuities, or royalties to the tax-exempt organization to reduce taxable income.[97] Congress amended section 512(b)(13) in 1997 to broaden the definition of control to capture arrangements using constructive ownership and second-tier subsidiaries.[98]

The Pension Protection Act of 2006 enacted the special rule for qualifying specified payments under section 512(b)(13)(E).[99] The Tax Extenders and Alternative Minimum Tax Relief Act of 2008 extended the special rule to such payments received or accrued before January 1, 2009,[100] and the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010[101] extends the special rule to such payments received or accrued before January 1, 2012.

[96] Pub. L. No. 91-172.

[97] See H.R. Rep. No. 413, 91st Cong., 1st Sess. 49 (1969).

[98] Tax Relief Act of 1997, Pub. L. No. 105-34.

[99] Pub. L. No. 109-280.

[100] Pub. L. No. 110-343.

[101] Pub. L. No. 111-312.

D. Rules to Address Corporate Base Erosion Without Regard to Holders' Tax Status

Several present-law rules limit interest deductions in circumstances in which it appears a deduction would not be appropriate, for example, because the instrument more closely resembles equity or because deductibility would otherwise allow an inappropriate reduction of the corporate tax base. The inappropriate reduction of the corporate tax base through the use of deductible payments or other planning techniques is commonly referred to a "base erosion." Some limitations on the deductibility of interest expense are linked to whether the recipient of the interest is exempt from Federal tax (e.g., the earnings stripping limitation of section 163(j)) while others consider the timing of the borrower's deduction matches the timing of the lender's corresponding income inclusion (e.g., the interest and OID rules of sections 267(a)(3) and 163(e)(3)). Other interest deduction limitations apply without regard to holder's tax status. Following is a brief description of some of these limitations.

1. Corporate Equity Reduction Transactions

Present Law

A net operating loss ("NOL") is the amount by which a taxpayer's business deductions exceed its income. In general, an NOL may generally be carried back two years and carried forward 20 years to offset taxable income in such years.[102] NOLs offset taxable income in the order of the taxable years to which the NOLs are carried.[103]

Sections 172(b)(1)(E) and 172(h) limit the NOL carrybacks of a C corporation involved in a corporate equity reduction transaction (a "CERT") to the extent such NOL carryback is attributable to interest deductions allocable to a CERT and is incurred (1) in the taxable year in which the CERT occurs or (2) in either of the two succeeding taxable years. The portion of the corporation's NOL carryback that is limited is the lesser of (a) the corporation's interest expense allocable to the CERT, or (b) the excess of the corporation's interest expense in the loss limitation year over the average of the corporation's interest expense for the three taxable years prior to the CERT taxable year. Any portion of an NOL that cannot be carried back under the provision may be carried forward as otherwise allowed.

Except to the extent provided in regulations, interest is allocated to a CERT using the "avoided cost" method of allocating interest in lieu of a direct tracing rule.[104] That is, the amount of indebtedness treated as incurred or continued to finance the CERT is based on the amount of interest expense that would have been avoided if the CERT had not been undertaken and the amounts expended for the CERT were used to repay indebtedness.

---

[102] Sec. 172(b)(1)(A).

[103] Sec. 172(b)(2).

[104] Sec. 172(h)(2)(B) (adopting the avoided cost allocation method described in section 263A(f)(2)(A)(ii) and not the direct tracing method described in section 263A(f)(2)(A)(i)).

A corporate equity reduction transaction means either a major stock acquisition or an excess distribution. A major stock acquisition is the acquisition by a corporation (or any group of persons acting in concert with such corporation) of stock in another corporation representing 50 percent or more (by vote or value) of the stock of another corporation.[105] A major stock acquisition does not include a qualified stock purchase to which a section 338 election applies.[106] An excess distribution is the excess of the aggregate distributions and redemptions made by a corporation during the taxable year with respect to its stock (other than certain preferred stock described in section 1504(a)(4)), over the greater of (a) 150 percent of the average of such distributions and redemptions for the preceding three taxable years, or (b) 10 percent of the fair market value of the stock of such corporation as of the beginning of such taxable year. The amount of distributions and redemptions made by a corporation during a taxable year are reduced by stock issued by the corporation during the applicable period in exchange for money or property other than stock in the corporation.

A corporation is treated as being involved in a CERT if it is either the acquired or acquiring corporation, or successor thereto (in the case of a major stock acquisition) or the distributing or redeeming corporation, or successor thereto (in the case of an excess distribution).

Legislative Background

The CERT provisions were added to the Code by the Omnibus Budget Reconciliation Act of 1989[107] because Congress believed that the ability of corporations to carry back NOLs created by certain debt-financed transactions is contrary to the purpose of the NOL rules. The NOL carryover rules generally serve the purpose of smoothing swings in taxable income that can result from business cycle fluctuations and unexpected financial reverses. Congress believed that the underlying nature of a corporation is substantially altered by a CERT, and that the interest expense associated with such transaction lacks a sufficient nexus with prior period operations to justify the carryback of NOLs attributable to such expense.[108] The definition of a CERT was expanded by the Omnibus Budget Reconciliation Act of 1990[109] to include the acquisition of 50 percent or more of the vote or value of the stock of any corporation, regardless of whether the corporation was a member of an affiliated group (unless an election under section 338 were made).

---

[105] Secs. 172(h)(3)(A)(i) and 172(h)(3)(B).

[106] Sec. 172(h)(3)(B)(ii). A section 338 election allows taxpayers to treat a qualifying stock acquisitions as an asset acquisition for tax purposes.

[107] Pub. L. No. 101-239.

[108] H.R. Rep. No. 101-247.

[109] Pub. L. No. 101-508.

2. Debt expected to be paid in equity

Present Law

Section 163(l) generally disallows a deduction for interest or OID on a debt instrument issued by a corporation (or issued by a partnership to the extent of its corporate partners) that is payable in equity of the issuer or a related party (within the meaning of sections 267(b) and 707(b)), or equity held by the issuer (or a related party) in any other person.

For this purpose, debt is treated as payable in equity if a substantial amount of the principal or interest is mandatorily convertible or convertible at the issuer's option into such equity. In addition, a debt instrument is treated as payable in equity if a substantial portion of the principal or interest is required to be determined, or may be determined at the option of the issuer or related party, by reference to the value of such equity.[110] A debt instrument also is treated as payable in equity if it is part of an arrangement that is reasonably expected to result in the payment of the debt instrument with or by reference to such equity, such as in the case of certain issuances of a forward contract in connection with the issuance of debt, nonrecourse debt that is secured principally by such equity, or certain debt instruments that are paid in, converted to, or determined with reference to the value of equity if it may be so required at the option of the holder or a related party and there is a substantial certainty that the option will be exercised.[111] An exception is provided for debt issued by a dealer in securities (within the meaning of section 475) or a related party which is payable in, or by reference to, equity (not of the issuer or related party) held in its capacity as a dealer in securities.[112]

Application of section 163(l) to an instrument will generally disallow the issuer's interest or OID deductions, but the provision does not alter the treatment of amounts paid or accrued to the holder.[113]

Legislative Background

Section 163(l) was enacted by the Taxpayer Relief Act of 1997[114] in response to Congressional concern that corporate taxpayers could issue instruments denominated as debt, but that more closely resembled equity for which an interest deduction is not appropriate.[115]

The American Jobs Creation Act of 2004[116] expanded the provision to disallow interest deductions on certain corporate debt that is payable in, or by reference to the value of, any equity

---

[110] Sec. 163(l)(3)(B).

[111] Sec. 163(l)(3)(C).

[112] Sec. 163(l)(5).

[113] See H.R. Conf. Rep. 105-220.

[114] Pub. L. No. 105-34.

[115] H.R. Rep. No. 105-148.

held by the issuer (or any related party) in any other person, but provided for the dealers in securities exception. Prior to AJCA, section 163(l) operated to disallow a deduction with respect to an instrument payable in stock of the issuer or an a related party (using a more than 50 percent ownership test). Expansion of the scope of section 163(l) was prompted, at least in part, by transactions undertaken by Enron Corporation to effectively monetize affiliate stock.[117] For example, in 1995 Enron issued investment unit securities which provided for an amount payable at maturity in stock of a more than 50-percent owned Enron affiliate. In 1999, after the enactment of section 163(l), Enron issued similar investment unit securities with respect to the same corporate affiliate. Enron took the position that section 163(l), however, did not apply because Enron's ownership of the affiliate had decreased below the 50-percent threshold.[118] Congress believed the Enron transactions cast doubt on the rule excluding stock ownership interests of 50-percent or less. Congress believed that eliminating the related party threshold furthered the tax policy objective of similar tax treatment for economically similar transactions.[119]

3. Applicable high-yield discount obligations

Present Law

In general, the issuer of a debt instrument with OID may deduct the portion of such OID equal to the aggregate daily portions of the OID for days during the taxable year.[120] However, in the case of an applicable high-yield discount obligation (an AHYDO) issued by a corporate issuer, (1) no deduction is allowed for the "disqualified portion" of the OID on such obligation, and (2) the remainder of the OID on any such obligation is not allowable as a deduction until paid by the issuer.[121]

An AHYDO is any debt instrument if (1) the maturity date on such instrument is more than five years from the date of issue; (2) the yield to maturity on such instrument exceeds the sum of (a) the applicable Federal rate in effect under section 1274(d) for the calendar month in which the obligation is issued and (b) five percentage points, and (3) such instrument has significant original issue discount.[122] An instrument is treated as having significant OID if the

---

[116] Pub. L. No. 108-357.

[117] See S. Rep. No. 108-192.

[118] For a discussion of the Enron transactions, see Joint Committee on Taxation, *Report of Investigation of Enron Corporation and Related Entities Regarding Federal Tax and Compensation Issues, and Policy Recommendations* (JCS-3-03), February 2003, pp. 333-345.

[119] S. Rep. No. 108-192.

[120] Sec. 163(e)(1). For purposes of section 163(e)(1), the daily portion of the original issue discount for any day is determined under section 1272(a) (without regard to paragraph (7) thereof and without regard to section 1273(a)(3)).

[121] Sec. 163(e)(5).

[122] Sec. 163(i)(1).

aggregate amount of interest that would be includible in the gross income of the holder with respect to such instrument for periods before the close of any accrual period (as defined in section 1272(a)(5)) ending after the date five years after the date of issue exceeds the sum of (1) the aggregate amount of interest to be paid under the instrument before the close of such accrual period, and (2) the product of the issue price of such instrument (as defined in sections 1273(b) and 1274(a)) and its yield to maturity.[123] The disqualified portion of the OID on an AHYDO is the lesser of (1) the amount of OID with respect to such obligation or (2) the portion of the total return on such obligation which bears the same ratio to such total return as the disqualified yield (i.e., the excess of the yield to maturity on the obligation over the applicable Federal rate plus six percentage points) on such obligation bears to the yield to maturity on such obligation.[124] The term total return means the amount which would have been the original issue discount of the obligation if interest described in section 1273(a)(2) were included in the stated redemption to maturity.[125] A corporate holder treats the disqualified portion of OID as a stock distribution for purposes of the dividend received deduction.[126]

Legislative Background

Sections 163(i) and 163(e)(5) were enacted by the Omnibus Budget Reconciliation Act of 1989,[127] following a series of Congressional hearings on corporate leverage. Congress enacted the AHYDO rules because it believed that a portion of the return on certain high-yield OID obligations is similar to a non-deductible distribution of corporate earnings paid with respect to equity rather than a deductible payment of interest.[128]

The American Recovery and Reinvestment Tax Act of 2009 ("ARRA")[129] suspended the deduction denial and deferral rules of section 163(e)(5) for certain obligations issued in debt-for-debt exchanges (including deemed exchanges resulting from a significant modification) after August 31, 2008 and before January 1, 2010. ARRA also provided authority to the Secretary to (1) apply the suspension rule for periods after December 31, 2009, where the Secretary determines that such application is appropriate in light of distressed conditions in the debt capital markets, and (2) use a rate that is higher than the applicable Federal rate for purposes of applying section 165(e)(5) for obligations issued after December 31, 2009, in taxable years ending after such date if the Secretary determines that such higher rate is appropriate in light of distressed debt capital market conditions.

---

[123] Sec. 163(i)(2).

[124] Sec. 163(e)(5)(C).

[125] Sec. 163(e)(5)(C)(ii).

[126] Sec. 163(e)(5)(B).

[127] Pub. L. No. 101-239.

[128] H.R. Conf. Rep. 101-386 (November 21, 1989).

[129] Pub. L. No. 111-5.

4. Interest on certain acquisition indebtedness

Present Law

Section 279 denies a deduction for interest on "corporate acquisition indebtedness." The limitation applies to interest in excess of $5 million per year incurred by a corporation with respect to debt obligations issued to provide consideration for the acquisition of stock, or two thirds of the assets, of another corporation, if each of the following conditions exists: (1) the debt is substantially subordinated;[130] (2) the debt carries an equity participation feature[131] (e.g., includes warrants to purchase stock of the issuer or is convertible into stock of the issuer); and (3) either the issuer is thinly capitalized (i.e., has a debt-to-equity ratio that exceeds 2 to 1)[132] or projected annual earnings do not exceed three times annual interest costs (paid or incurred).[133]

Legislative Background

Section 279 was enacted by the Tax Reform Act of 1969[134] in response to concerns over increased corporate acquisitions and the use of debt for such corporate acquisitions.[135] In 1976, the section was amended to delete the provision which would deny a deduction for interest on corporate acquisition indebtedness where a corporation which had acquired at least 50 percent of the total combined voting power of all classes of stock of another corporation by October 9, 1969, incurred acquisition indebtedness in increasing its control over the acquired corporation to 80 percent or more.[136]

---

[130] Subordinated to the claims of trade creditors generally, or expressly subordinated in right of payment of any substantial amount of unsecured indebtedness, whether outstanding or subsequently issued (sec. 279(b)(2)(A) and (B)).

[131] Convertible directly or indirectly into the stock of the issuing corporation or part of an investment unit or other arrangement which includes an option to acquire, directly or indirectly, stock in the issuing corporation (sec. 279(b)(3)(A) and (B)).

[132] Sec. 279(b)(4)(A).

[133] Sec. 279(b)(4)(B).

[134] Pub. L. No. 91-172.

[135] S. Rep. No. 91-552 (November 21, 1969). See also, Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1969* (JCS-16-70), December 3, 1970, p. 123.

[136] Pub. L. No. 94-514.

E. Rules to Address Tax Arbitrage in the Case of Borrowing to Fund Untaxed Income

When debt is used to finance an investment that produces income exempt from tax, taxed at preferential rates, or carrying associated tax credits, the deduction for interest on the debt financing can be used to offset other, unrelated income. In addition, certain leveraged transactions by entities exempt from tax may present the opportunity for taxpayers to engage in transactions on terms they might not have in the absence of the tax-exemption. These outcomes are commonly referred to as "tax arbitrage." Following is a brief discussion of certain rules that attempt to limit the ability of taxpayers to engage in these types of transactions.

1. Interest related to tax-exempt income

Present Law

Section 265 disallows a deduction for interest on indebtedness incurred or continued to purchase or carry obligations the interest on which is wholly exempt from Federal income tax ("tax-exempt obligations"). This rule applies to tax-exempt obligations held by individual and corporate taxpayers.[137] The rule also applies to certain cases in which a taxpayer incurs or carries indebtedness and a related person acquires or holds tax-exempt obligations.[138] Generally, there are two methods for determining the amount of the disallowance. One method asks whether a taxpayer's borrowing can be traced to its holding of exempt obligations. A second method disallows interest deductions based on the pro rata percentage of a taxpayer's assets comprised of tax-exempt obligations.

The interest expense disallowance rules are intended to prevent taxpayers from engaging in tax arbitrage by deducting interest on indebtedness that is used to purchase tax-exempt obligations, so that the interest is available to offset other taxable income of the taxpayer

General rules

Debt is traced to tax-exempt obligations if the proceeds of the indebtedness are used for, and are directly traceable to, the purchase of tax-exempt obligations. For example, this rule applies if tax-exempt obligations are used as collateral for indebtedness. In general terms, the tracing rule applies only if the facts and circumstances establish a sufficiently direct relationship between the borrowing and the investment in tax-exempt obligations.

---

[137] The rules applicable to individual taxpayers are discussed in the companion document, *Tax Treatment of Household Debt*.

[138] Section 7701(f) provides that the Secretary of the Treasury will prescribe regulations necessary or appropriate to prevent the avoidance of any income tax rules that deal with the use of related persons, pass-through entities, or other intermediaries in (1) the linking of borrowing to investment or (2) diminishing risks. See *H Enterprises International, Inc. v. Commissioner,* T.C.M. 1998-97, *aff'd.* 183 F.3d 907 (8th Cir. 1999) (Code section 265(a)(2) applied where a subsidiary borrowed funds on behalf of a parent and the parent used the funds to buy, among other investments, tax-exempt securities).

Within the general framework of section 265, there are special rules for individuals, dealers in tax-exempt obligations, corporations that are not dealers, and certain financial institutions.

Dealers in tax-exempt obligations

In the case of a dealer in tax-exempt obligations (whether a corporation, partnership or sole proprietorship), if the proceeds are directly traceable to the purchase of tax-exempt obligations, no interest on the indebtedness is deductible.[139] If the use of the proceeds cannot be directly traced, an allocable portion of the interest deduction is disallowed. The amount of interest disallowed is determined by the ratio of (1) the dealer's average amount of tax-exempt obligations held during the taxable year to (2) the average amount of the dealer's total assets less the amount of any indebtedness the interest on which is not subject to disallowance to any extent under the provision.[140]

Corporations that are not dealers in tax-exempt obligations

In the case of a business that is not a dealer in tax-exempt obligations, if there is direct evidence of the purpose to purchase or carry tax-exempt obligations with the proceeds of indebtedness, then no interest on the indebtedness is deductible. In the absence of such direct evidence, the IRS provides specific inference rules. Generally, the purpose to purchase or carry tax-exempt obligations will not be inferred with respect to indebtedness incurred to provide funds for an active trade or business unless the borrowing is in excess of business needs.[141] In contrast, the purpose to carry tax-exempt obligations will be inferred (unless rebutted by other evidence) where a taxpayer could reasonably have foreseen at the time of purchasing tax-exempt obligations that indebtedness would have been incurred to meet future economic needs of an ordinary, recurrent variety.[142]

De minimis exception

In the absence of direct evidence linking an individual taxpayer's indebtedness with the purchase or carrying of tax-exempt obligations, taxpayers other than dealers may benefit from a de minimis exception.[143] The IRS takes the position that it will ordinarily not infer a purpose to purchase or carry tax-exempt obligations if a taxpayer's investment therein is "insubstantial."[144]

---

[139] Rev. Proc. 72-18, sec. 5.02.

[140] *Ibid.*, secs. 5.02 and 7.02.

[141] Rev. Proc. 72-18, sec. 6.01.

[142] Rev. Proc. 72-18, sec. 6.02.

[143] Rev. Proc. 72-18, sec. 3.05 provides that the insubstantial holding safe harbor is not available to dealers in tax-exempt obligations.

[144] Rev. Proc. 72-18, 1972-1 C.B. 740.

A corporation's holdings of tax-exempt obligations are presumed to be insubstantial if the average adjusted basis of the corporation's tax-exempt obligations is two percent or less of the average adjusted basis of all assets held in the active conduct of the corporation's trade or business.

If a corporation holds tax-exempt obligations (installment obligations, for example) acquired in the ordinary course of its business in payment for services performed for, or goods supplied to, State or local governments, and if those obligations are nonsalable, the interest deduction disallowance rule generally does not apply.[145] The theory underlying this rule is that a corporation holding tax-exempt obligations in these circumstances has not incurred or carried indebtedness for the purpose of acquiring those obligations.

Financial institutions

After taking into account any interest disallowance rules under general rules applicable to other taxpayers,[146] Section 265(b)(2) disallows a portion of a financial institution's otherwise allowable interest expense that is allocable to tax-exempt interest. The amount of interest that is disallowed is an amount of interest expense that equals the ratio of the financial institution's average adjusted bases of tax-exempt obligations acquired after August 7, 1986 to the average adjusted bases of all the taxpayer's assets (the "pro rata rule").[147] This allocation rule is mandatory and cannot be rebutted by the taxpayer. A financial institution, for this purpose, is any person who accepts deposits from the public in the ordinary course of such person's trade or business, and is subject to Federal or State supervision as a financial institution or is a bank as defined in section 585(a)(2).

Exception for certain obligations of qualified small issuers

The general rule in section 265(b) denying financial institutions' interest expense deductions allocable to tax-exempt obligations does not apply to "qualified tax-exempt obligations." Instead, only 20 percent of the interest expense allocable to such qualified tax-exempt obligations is disallowed.[148] A qualified tax-exempt obligation is a tax-exempt obligation that is (1) issued after August 7, 1986, by a qualified small issuer, (2) is not a private

[145] Rev. Proc. 72-18, as modified by Rev. Proc. 87-53, 1987-2 C.B. 669.

[146] Including section 265(a) (see, sec. 265(b)(6)(A) and Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986*, (JCS-10-87), p. 563), but section 265(b)(6)(B) specifies that the disallowance rule of section 265 is applied before the capitalization rule of section 263A (relating to the capitalization of certain expenditures discussed above).

[147] Sec. 265(b).

[148] Secs. 265(b)(3) and 291(a)(3). Section 291(a)(3) reduces by 20 percent the amount allowable as a deduction with respect to any financial institution preference item. Financial institution preference items include interest on debt to carry tax-exempt obligations acquired after December 31, 1982, and before August 8, 1986. Section 265(b)(3) treats qualified tax-exempt obligations as if they were acquired on August 7, 1986. As a result, the amount allowable as a deduction by a financial institution with respect to interest incurred to carry a qualified tax-exempt obligation is reduced by 20 percent.

activity bond, and (3) is designated by the issuer as qualifying for the exception. A qualified small issuer is an issuer that reasonably anticipates that the amount of tax-exempt obligations that it will issue during the calendar year will be $10 million or less. The Code specifies circumstances under which an issuer and all subordinate entities are aggregated.[149] The special rule for qualified small issuers also applies to certain aggregated issuances of tax-exempt obligations in which more than one governmental entity receives benefits.[150]

Composite issues (i.e., combined issues of bonds for different entities) qualify for the "qualified tax-exempt obligation" exception only if the requirements of the exception are met with respect to (1) the composite issue as a whole (determined by treating the composite issue as a single issue) and (2) each separate lot of obligations that is part of the issue (determined by treating each separate lot of obligations as a separate issue).[151] Thus a composite issue may qualify for the exception only if the composite issue itself does not exceed $10 million, and if each issuer benefitting from the composite issue reasonably anticipates that it will not issue more than $10 million of tax-exempt obligations during the calendar year, including through the composite arrangement.

Special rules for obligations issued in 2009 and 2010

The American Recovery and Reinvestment Act of 2009 ("ARRA") modified certain provisions of section 265. Tax-exempt obligations issued during 2009 or 2010 and held by a financial institution, in an amount not to exceed two percent of the adjusted basis of the financial institution's assets, are not taken into account for the purpose of determining the portion of the financial institution's interest expense subject to the pro rata interest disallowance rule of section 265(b).

In connection with this change, ARRA also amended section 291(e) to provide that tax-exempt obligations issued during 2009 and 2010, and not taken into account for purposes of the calculation of a financial institution's interest expense subject to the pro rata interest disallowance rule, are treated as having been acquired on August 7, 1986. As a result, such obligations are financial institution preference items, and the amount allowable as a deduction by a financial institution with respect to interest incurred to carry such obligations is reduced by 20 percent.

With respect to tax-exempt obligations issued during 2009 and 2010, ARRA relaxed several rules related to qualified small issuers.

Legislative Background

A provision denying a deduction for interest incurred in connection with tax-exempt obligations has been a part of the U.S. tax system since the Revenue Act of 1917, which allowed

[149] Sec. 265(b)(3)(E).

[150] Sec. 265(b)(3)(C)(iii).

[151] Sec. 265(b)(3)(F).

a deduction for "all interest paid within the year on his indebtedness except on indebtedness incurred for the purchase of obligations or securities the interest upon which is exempt from taxation under this title."[152] Prior to 1986, banks were largely exempted from section 265 pursuant to IRS rulings providing, inter alia, that interest paid to depositors was not interest incurred or continued to carry tax-exempt obligations[153] and that section 265 would generally not apply to interest on indebtedness incurred by banks in the ordinary course of business absent a direct connection between the borrowing and the tax-exempt investment.[154]

As part of the Tax Reform Act of 1986,[155] Congress amended section 265 to deny financial institutions an interest deduction in direct proportion to their tax-exempt holdings. Congress believed that allowing financial institutions to deduct interest payments regardless of tax-exempt holdings discriminated in favor of financial institutions at the expense of other taxpayers, and Congress was concerned that financial institutions could drastically reduce their tax liability using such rules. Congress believed that a proportional disallowance rule was appropriate because of the difficulty of tracing funds within a financial institution and the near impossibility of assessing a financial institution's purpose in accepting particular deposits.[156]

2. Debt with respect to certain insurance products

Present Law

No Federal income tax generally is imposed on a policyholder with respect to the earnings under a life insurance contract[157] ("inside buildup").[158] Further, an exclusion from

---

[152] Section 1201(1) of the Revenue Act of 1917. For a history of section 265, see George Craven, "Disallowance of Interest Deduction to Owner of Tax-Exempt Bonds," 24 *Tax Lawyer* 287 (1971).

[153] Rev. Rul. 61-222, 1961-2 C.B. 58.

[154] Rev. Proc. 70-20.

[155] Pub. L. No. 99-514.

[156] See Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986* (JCS-10-87), May 4, 1987, pp. 562-3.

[157] By contrast to the treatment of life insurance contracts, if a deferred annuity contract is held by a corporation or by any other person that is not a natural person, the income on the contract is treated as ordinary income accrued by the contract owner and is subject to current taxation. The contract is not treated as an annuity contract (sec. 72(u)).

[158] This favorable tax treatment is available only if a life insurance contract meets certain requirements designed to limit the investment character of the contract (sec. 7702). Distributions from a life insurance contract (other than a modified endowment contract) that are made prior to the death of the insured generally are includible in income, to the extent that the amounts distributed exceed the taxpayer's basis in the contract for purposes of determining income taxes, other than those imposed on insurance companies such distributions generally are treated first as a tax-free recovery of basis, and then as income (sec. 72(e)). In the case of a modified endowment contract, however, in general, distributions are treated as income first, loans are treated as distributions (i.e., income rather than basis recovery first), and an additional 10-percent tax is imposed on the income portion of distributions made before age 59 1/2 and in certain other circumstances (secs. 72(e) and (v)). A modified endowment contract is a life

Federal income tax is provided for amounts received under a life insurance contract paid by reason of the death of the insured.[159]

Present law imposes limitations on the deductibility of interest on debt with respect to life insurance contracts. These limitations address the potential for arbitrage that could arise in the event that deductible interest expense relates to amounts excludable as inside buildup and as death benefits under a life insurance contract.

Interest paid or accrued with respect to the contract

No deduction is allowed for any amount paid or accrued on debt incurred or continued to purchase or carry a single premium life insurance, annuity, or endowment contract (the "single premium" deduction limitation).[160] A contract is treated as a single premium contract if substantially all the premiums on the contract are paid within a period of four years from the date on which the contract is purchased or if an amount for payment of a substantial number of future premiums is deposited with the insurer.[161]

In addition, no deduction is allowed for any amount paid or accrued on debt incurred or continued to purchase or carry a life insurance, annuity, or endowment contract pursuant to a plan of purchase that contemplates the systematic direct or indirect borrowing of part or all of the increases in the cash value of the contract (either from the insurer or otherwise).[162] Several exceptions are provided for this rule. The deduction denial does not apply if (1) no part of four of the annual premiums due during the initial seven year period is paid by means of such debt; (2) if the total amounts to which the provision would apply in a taxable year does not exceed $100; (3) if the amounts are paid or accrued because of financial hardship; or (4) if the indebtedness is incurred in connection with the taxpayer's trade or business.[163]

Finally, no deduction is allowed for interest paid or accrued on any debt with respect to a life insurance, annuity, or endowment contract covering the life of any individual,[164] with a key person insurance exception.[165]

---

insurance contract that does not meet a statutory "7-pay" test, i.e., generally is funded more rapidly than a policy that would provide paid-up future benefits after the payment of seven annual level premiums (sec. 7702A).

[159] Sec. 101(a).

[160] Sec. 264(a)(2).

[161] Sec. 264(c).

[162] Sec. 264(a)(3).

[163] Sec. 264(d).

[164] Sec. 264(a)(4).

[165] This provision limits interest deductibility in the case of such a contract covering any individual in whom the taxpayer has an insurable interest under applicable State law when the contract is first issued, except as otherwise provided under special rules with respect to key persons and pre-1986 contracts. Under the key person

Pro rata interest deduction limitation

A pro rata interest deduction disallowance rule also applies. This rule applies to interest for which a deduction is not disallowed under the other interest deduction disallowance rules relating to life insurance including, for example, interest on third-party debt that is not with respect to a life insurance, annuity, or endowment contract. Under this rule, in the case of a taxpayer other than a natural person,[166] no deduction is allowed for the portion of the taxpayer's interest expense that is allocable to unborrowed policy cash surrender values.[167] Interest expense is allocable to unborrowed policy cash values based on the ratio of (1) the taxpayer's average unborrowed policy cash values of life insurance, annuity and endowment contracts, to (2) the sum of the average unborrowed cash values of life insurance, annuity, and endowment contracts, plus the average adjusted bases of other assets.

Under the pro rata interest disallowance rule, an exception is provided for any contract owned by an entity engaged in a trade or business, if the contract covers only one individual who is an employee or is an officer, director, or 20-percent owner of the entity of the trade or business.[168] The exception also applies to a joint-life contract covering a 20-percent owner and his or her spouse.

An employer may exclude the death benefit under a contract insuring the life of an employee if the insured was an employee at any time during the 12-month period before his or her death, or if the insured is among the highest paid 35 percent of all employees. Notice and consent requirements must be satisfied.

Legislative Background

A limitation has applied to the deductibility of interest with respect to single premium life insurance contracts since 1942.[169] Additional interest deduction limitations with respect to life insurance, annuity, and endowment contracts were added in 1964 and 1986.[170] More recently,

---

exception (sec. 264(e)), otherwise nondeductible interest may be deductible, so long as it is interest paid or accrued on debt with respect to a life insurance contract covering an individual who is a key person, to the extent that the aggregate amount of the debt does not exceed $50,000. Other special rules apply.

[166] See sec. 264(f)(5).

[167] Sec. 264(f). This applies to any life insurance, annuity or endowment contract issued after June 8, 1997.

[168] Sec. 264(f)(4).

[169] Current sec. 264(a)(2) (former sec. 24(a)(6) of the 1939 Code), enacted in the Revenue Act of 1942, Pub. L. No. 753, 56 Stat. 798, sec. 129, 77th Cong., 2d Sess., October 21, 1942.

[170] Sec. 264(a)(3), enacted in the Revenue Act of 1964, Pub. L. No. 88-272, sec. 215, 88th Cong., 2d Sess., 1964; sec. 264(a)(4) and (e)(1) (subsequently modified), enacted in the Tax Reform Act of 1986, Pub. L. No. 99-514, sec. 1003, 99th Cong., 2d Sess., October 22, 1986. In addition to interest deduction limitations, limitations are imposed on the deductibility of premiums with respect to life insurance, annuity, and endowment contracts (sec. 264(a)(1)).

further interest deduction limitations with respect to such insurance contracts were added in 1996 and again in 1997.[171] In general, these interest deduction limitations have been based in part on concern over the opportunity for tax arbitrage, that is, the deductibility of interest expense with respect to untaxed investment income (inside buildup) of the insurance contract.[172]

For example, in enacting the interest deduction limitations in 1997, Congress expressed concern about the tax arbitrage of deducting interest expense that funds untaxed income:

> In addition, the Committee understands that taxpayers may be seeking new means of deducting interest on debt that in substance funds the tax-free inside build-up of life insurance or the tax-deferred inside buildup of annuity and endowment contracts. The Committee believes that present law was not intended to promote tax arbitrage by allowing financial or other businesses that have the ongoing ability to borrow funds from depositors, bondholders, investors or other lenders to concurrently invest a portion of their assets in cash value life insurance contracts, or endowment or annuity contracts. Therefore, the bill provides that for taxpayers other than natural persons, no deduction is allowed for the portion of the taxpayer's interest expense that is allocable to unborrowed policy cash values of any life insurance policy or annuity or endowment contract issued after June 8, 1997.[173]

In 2006, additional rules for excludability of death benefits under a life insurance contract were added in the case of employer-owned life insurance contracts[174] (generally, those contracts insuring employees that are excepted from the pro rata interest deduction limitation).[175]

---

[171] Current sec. 264(e), enacted in the Health Insurance Portability and Accountability Act of 1996, Pub. L. No. 104-191, sec. 501, 104th Cong., 2d. Sess., July 31, 1996; and sec. 264(f), enacted in the Taxpayer Relief Act of 1997, Pub. L. No. 105-34, sec. 1084, 105th Cong., 1st Sess., July 30, 1997.

[172] For example, in enacting the 1964 interest deduction limitation, Congress stated, "The annual increase in the cash value of the insurance policy to reflect interest earnings, which generally is not taxable to the taxpayer either currently or otherwise, is likely to equal or exceed the net interest charges the taxpayer pays. Thus, for taxpayers in higher brackets, where the annual increment in the value of the policy, apart from the premiums, exceeds the net interest cost of the borrowing, such policies can actually result in a net profit for those insured." Revenue Act of 1963, Report of the Committee on Ways and Means, H.R. Rep. No. 749, 88th Cong., 1st Sess., page 61, September 13, 1963. As a further example, following enactment of the 1986 interest deduction limitation, the reasons for change included this statement: "This provision provides a cap on the deductibility of such interest, rather than phasing out deductibility. The provision was structured in this manner to allow small businesses to use loans on life insurance policies for their employees as a source of short-term capital when necessary. Congress did not intend to allow these loans to be an unlimited tax shelter as under prior law." Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986*, JCS-10-87, p. 579, May 4, 1987.

[173] Revenue Reconciliation Act of 1997 (as Reported by the Senate Committee on Finance), S. Rep. No. 105-33, 105th Cong., 1st Sess., p. 187, June 20, 1997 (footnotes omitted).

[174] Sec. 101(j).

[175] Pension Protection Act of 2006, Pub. L. No. 109-280.

3. Debt-financed income of tax-exempt organizations

Present Law

Although tax-exempt organizations described under section 501(c) are generally exempt from Federal income tax,[176] such organizations may be subject to the unrelated business income tax ("UBIT")[177] on income derived from property financed with debt.[178]

In general, income of a tax-exempt organization that is produced by debt-financed property is treated as unrelated business taxable income in proportion to the amount of acquisition indebtedness on the income-producing property.[179] Certain educational organizations, pension funds, title holding companies, and retirement income accounts are eligible for an exception to the debt-financed income rules for investments in real property.[180]

Legislative Background

Until the introduction of the UBIT in 1950, there was no statutory limitation on the amount of business activity an exempt organization could conduct so long as the earnings from the business were used for exempt purposes. In response to certain abusive transactions,[181]

---

[176] Sec. 501(a).

[177] Secs. 511-514. In general, UBIT taxes income derived from a regularly carried on trade or business that is not substantially related to the organization's exempt purposes. Certain categories of income—such as interest, dividends, royalties, and rent—are generally exempt from UBIT. For example, tax-exempt organizations are not taxed on interest income they receive from investments in debt or other obligations.

[178] Tax-exempt organizations subject to UBIT include those described in section 501(c) (except for U.S. instrumentalities and certain charitable trusts), qualified pension, profit-sharing, and stock bonus plans described in section 401(a), and certain State colleges and universities. Sec. 511(a)(2). Organizations liable for UBIT may be liable for alternative minimum tax determined after taking into account adjustments and tax preference items.

[179] Acquisition indebtedness generally means the amount of unpaid indebtedness incurred by an organization in acquiring or improving the property and indebtedness incurred either before or after acquisition or improvement that would not have been incurred but for the acquisition or improvement of the property. Sec. 514(c)(1).

[180] Sec. 514(c)(9)(A). Additional requirements must be met for the real property exception to apply where the real property is held by a partnership in which a qualified organization is a partner. In addition to the real property exception, acquisition indebtedness does not include (1) certain indebtedness incurred in the performance or exercise of a purpose or function constituting the basis of the organization's exemption, (2) obligations to pay certain types of annuities, and (3) an obligation, to the extent it is insured by the Federal Housing Administration, to finance the purchase, rehabilitation, or construction of housing for low- and moderate-income persons. See secs. 514(c)(4), (5), and (6), respectively.

[181] For example, in one type of transaction, a tax-exempt organization borrows the entire purchase price of real property, purchases the property and leases it back to the seller under a long-term lease, and services the loan with tax-free rental income from the lease. H.R. Rep. No. 2319, 81st Cong., 2d Sess. 38-39 (1950); S. Rep. No. 2375, 81st Cong., 2d Sess. 31-32 (1950).

Congress subjected charitable organizations (not including churches) and certain other exempt organizations to tax on their unrelated business income as part of the Revenue Act of 1950.[182]

The 1950 Act taxed as unrelated business income certain rents received in connection with the leveraged sale and leaseback of real estate.[183] This provision was a precursor to the present-law tax on unrelated debt-financed income.

In the Tax Reform Act of 1969, Congress extended UBIT to all tax-exempt organizations described in section 501(c) and 401(a) (except United States instrumentalities).[184] In addition, the 1969 Act expanded the tax on debt-financed income beyond rents from debt-financed acquisitions of real property to encompass debt-financed income from interest, dividends, other rents, royalties, and certain gains and losses from any type of property.[185]

In the Miscellaneous Revenue Act of 1980, Congress enacted an exception to the debt-financed income rules for certain real property investments by qualified pension trusts (the progenitor of the real property exception).[186]

In the Deficit Reduction Act of 1984, Congress extended the real property exception to educational organizations and layered on additional conditions, including an absolute bar on seller financing and an anti-abuse rule in the case of qualified organizations that were partners in partnerships investing in debt-financed real property.[187] In 1987, Congress further modified the restrictions on partnerships of qualified organizations investing in debt-financed real property by

---

[182] Revenue Act of 1950, Pub. L. No. 81-814, sec. 301. In 1951, Congress extended the UBIT to the income of State colleges and universities. Sec. 511(a)(2)(B).

[183] There was an exception for rental income from a lease of five years or less. For a discussion of Congress's objections to such transactions, see H.R. Rep. No. 2319, 81st Cong., 2d Sess. 38-39 (1950); S. Rep. No. 2375, 81st Cong., 2d Sess. 31-32 (1950).

[184] Pub. L. No. 91-172. The tax also applies to certain State colleges and universities and their wholly owned subsidiaries. Sec. 511(a)(2)(B).

[185] For a discussion of the reason for the expanding the debt-financed income rules in 1969, see Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1969* (JCS-16-70), December 3, 1970, at 62.

[186] Pub. L. No. 96-605. Congress believed that such an exception was warranted because "the exemption for investment income of qualified retirement trusts is an essential tax incentive which is provided to tax-qualified plans in order to enable them to accumulate funds to satisfy their exempt purpose—the payment of employee benefits." S. Rep. No. 96-1036, 96th Cong., 2d Sess. 29 (1980). In addition, the exemption provided to pension trusts was appropriate because, unlike other exempt organizations, the assets of such trusts eventually would be "used to pay taxable benefits to individual recipients whereas the investment assets of other [exempt] organizations . . . are not likely to be used for the purpose of providing benefits taxable at individual rates." *Ibid*. In other words, the exemption for qualified trusts generally results only in deferral of tax; unlike the exemption for other organizations.

[187] Pub. L. No. 38-369. See Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984* (JCS-41-84), December 31, 1984, at 1151.

enacting the fractions rule.[188] In 1993, Congress relaxed some of the conditions required to meet the real property exception.[189]

4. Dividends received deduction reduction for debt-financed portfolio stock

Present Law

In general, a corporate shareholder is allowed a deduction equal to (1) 100 percent of certain qualifying dividends received from a corporation in the same affiliated group as the recipient;[190] (2) 80 percent of the dividends received from a corporation if it owns at least 20 percent of the payee's stock (by vote and value); and (3) 70 percent of dividends received from other corporations.[191] The purpose of the dividends received deduction is to reduce multiple corporate-level taxation of income as it flows from the corporation that earns it to the ultimate noncorporate shareholder.

However, if dividends are paid on debt-financed stock, the combination of the dividends received deduction and the interest deduction would enable corporate taxpayers to shelter unrelated income. Therefore, section 246A generally reduces the 80 percent and 70 percent dividends received deduction so that the deduction is available, in effect, only with respect to dividends attributable to that portion of the stock which is not debt-financed.[192] Under regulations prescribed by the Secretary, any reduction in the amount allowable as a dividends received deduction under the rule is limited to the amount of the interest allocable to the dividend.[193]

---

[188] Sec. 514(c)(9)(B)(vi) & (E), enacted in section 10214 of The Revenue Act of 1987, Pub. L. No. 100-203. The fractions rule generally is intended to prevent the shifting of disproportionate income or gains to tax-exempt partners of the partnership or the shifting of disproportionate deductions, losses, or credits to taxable partners. See H.R. Rep. No. 100-391, H.R. 3545, Report to accompany recommendations from the Committee on Ways and Means, House of Representatives, October 26, 1987, p. 1076. Under the fractions rule, the allocation of items to any partner that is a qualified organization cannot result in such partner having a share of the overall partnership income for any taxable year greater than such partner's share of overall partnership loss for the taxable year for which such partner's loss share will be the smallest. Sec. 514(c)(9)(E)(i)(I). A partnership generally must satisfy the fractions rule both currently and for each taxable year of the partnership in which it holds debt-financed property and has at least one partner that is a qualified organization. Treas. Reg. sec. 1.514(c)-2(b)(2)(i).

[189] See Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66.

[190] Sec. 243(a)(3) and (b). An affiliated group generally consists of a common parent corporation and one or more other corporations at least 80 percent of the stock of which (by vote and value) is owned by the common parent or another member of the group.

[191] Sec. 243. Section 245 allows a 70 percent, 80 percent and 100 percent deduction for a specified portion of dividends received from certain foreign corporations. Section 244 allows a dividends received deduction on certain preferred stock of public utilities.

[192] The reduction of the dividends received deduction may be viewed as a surrogate for limiting the interest deduction.

[193] Sec. 246A(e). Treasury has not issued regulations under section 246A.

Section 246A applies to dividends on debt-financed "portfolio stock" of the recipient corporation. Stock of a corporation is portfolio stock unless specifically excluded. Stock is not portfolio stock if, as of the beginning of the ex-dividend date for the dividend involved, the taxpayer owns stock (1) possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote, and (2) having a value equal to at least 50 percent of the value of all the stock, of such corporation.[194] Portfolio stock is debt-financed if there is a direct relationship between indebtedness and the portfolio stock. The provision does not incorporate any allocation or apportionment formula or fungibility concept.

Legislative Background

Section 246A was enacted by the Deficit Reduction Act of 1984,[195] in response to concern that corporate taxpayers were borrowing money (giving rise to deductible interest payments) to purchase portfolio stock that paid dividends (partially excluded from income by the dividends received deduction), thus allowing such taxpayers to use the deduction for dividends paid or accrued to shelter unrelated income. Congress did not believe these two deductions were intended to provide such shelter.[196]

[194] The 50 percent threshold is reduced to 20 percent if five or fewer corporate stockholders own, directly or indirectly, stock possessing at least 50 percent of the voting power and value of all the stock of such corporation. This rule was intended to exempt certain corporate joint ventures from the provision. See, Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984* (JCS-41-84), December 31, 1984.

[195] Pub. L. No. 98-369.

[196] See Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984* (JCS-41-84), December 31, 1984, p. 128.

F. Rules to Match Timing of Tax Deduction and Income Inclusion Relating to Debt

Statutory limitations on the deductibility of interest expense apply in some cases in which an immediate deduction would produce a mismatching of income and expense. If the full interest deduction is not permitted on a current basis, the deduction may be disallowed, deferred until a later time, or required to be capitalized into the basis of related property. Following is a brief description of some rules designed to match the timing of income and deductions related to debt.

1. Interest and OID on amounts payable to related foreign lenders

Present Law

Special rules apply to a debt instrument issuer's deduction for accrued but unpaid interest, and accrued OID, owed to certain related persons. These rules are generally designed to match the issuer's deduction with the holder's corresponding income inclusion.

Accrued but unpaid interest

A number of rules limit deductions for losses, expenses, and interest with respect to transactions between related persons. In the case of unpaid stated interest and expenses of related persons, where, by reason of a payee's method of accounting, an amount is not includible in the payee's gross income until it is paid, but the unpaid amounts are deductible currently by the payor, the amount generally is allowable as a deduction when such amount is includible in the gross income of the payee.[197] This rule is intended to prevent the mismatch of, for example, a deduction for interest accrued by a taxpayer on the accrual method of accounting that is payable to a related person on a cash method of accounting. In the absence of this rule, the issuer would take a deduction upon accrual of the obligation to pay interest (whether or not the interest was actually paid), but a related holder would not take the interest into income until it is paid.

U.S.-source "fixed or determinable annual or periodical" income, including dividends, interest, rents, royalties, and other similar income, is subject to a 30-percent gross-basis withholding tax when paid to a foreign person.[198] This withholding tax can create a mismatch where, for example, a U.S. accrual-method taxpayer borrows amounts from a foreign corporation. In the absence of a special rule, the U.S. taxpayer would be allowed a deduction for accrued interest annually even if no interest were actually paid, and the foreign corporate lender would be subject to the 30-percent gross-basis withholding tax only when the interest was paid. The Code directs the Treasury Secretary to issue regulations applying the matching principle in this circumstance and other circumstances involving payments to related foreign persons.[199]

---

[197] Sec. 267(a)(2).

[198] Secs. 871, 881, 1441, 1442.

[199] Section 267(a)(3)(A).

With respect to stated interest and other expenses owed to related foreign corporations, Treasury regulations require a taxpayer to use the cash method of accounting in deducting amounts owed to related foreign persons (with an exception for income of a related foreign person that is effectively connected with the conduct of a U.S. trade or business and that is not exempt from taxation or subject to a reduced rate of taxation under a treaty obligation).[200]

A foreign corporation's foreign-source active business income generally is subject to U.S. tax only when such income is distributed to any U.S. person owning stock of such corporation. Accordingly, a U.S. person conducting foreign operations through a foreign corporation generally is subject to U.S. tax on the foreign corporation's income only when the income is repatriated to the United States through a dividend distribution. However, certain anti-deferral regimes may cause the U.S. person to be taxed on a current basis in the United States with respect to certain categories of passive or highly mobile income earned by the foreign corporations in which a U.S. person holds stock. The main anti-deferral rules are the controlled foreign corporation ("CFC") rules of subpart F[201] and the passive foreign investment company ("PFIC") rules.[202] Section 267(a)(3)(B) provides special rules for items payable to a CFC or a PFIC. In general, with respect to any item payable to a related CFC or a PFIC, deductions for amounts accrued but unpaid (whether by U.S. or foreign persons) are allowable only to the extent that the amounts accrued by the payor are, for U.S. tax purposes, currently includible in the income of the direct or indirect U.S. owners of the related foreign corporation under the relevant inclusion rules. Deductions that have accrued but are not allowable under this special rule are allowed when the amounts are actually paid.

Original issue discount

Rules similar to those discussed above apply in the case of OID on debt instruments held by a related foreign person. In such case, section 163(e)(3)(A) disallows a deduction for any portion of such OID until paid by the issuer (the "related-foreign-person rule").[203] This related-foreign-person rule does not apply to the extent that the OID is effectively connected with the foreign related person's conduct of a U.S. trade or business (unless such OID is exempt from taxation or is subject to a reduced rate of taxation under a treaty obligation).[204]

In the case of any OID debt instrument held by a related foreign person which is a CFC or a PFIC, deductions for accrued but unpaid OID are similarly allowable only to the extent that

[200] Treas. Reg. sec. 1.267(a)-3(b)(1), -3(c).

[201] Secs. 951 – 964.

[202] Secs. 1291 – 1298.

[203] Sec. 163(e)(3)(A).

[204] Sec. 163(e)(3)(A).

such OID is, for U.S. tax purposes, currently includible in the income of the direct or indirect U.S. owners of the related foreign corporation.[205]

Legislative Background

Section 163(e)(3) was enacted by the Deficit Reduction Act of 1984[206] to address the mismatch that occurred if a current deduction was allowed for the accrual of interest on an OID instrument before the interest was actually paid. The Conference Report notes that "there is no justification for mismatching in the case of related-party OID debt. Such mismatching allows an economic entity that has divided itself into more than one legal entity to contract with itself at the expense of the U.S. Government."[207]

The section 267(a)(3) rule directing the Secretary of the Treasury to issue regulations extending the matching principle to payments made to a non-U.S. person was enacted in the Tax Reform Act of 1986.

In 2004, as part of AJCA, Congress added the special rules for CFCs and PFICs because prior law (which assumed there would be little material distortion in the matching of income and deductions in the context of the these anti-deferral regimes) failed to take into account the situation in which amounts are included in the income of a related foreign corporation but are not currently included in the income of the foreign corporation's U.S. shareholder(s).

2. Construction period interest

Present Law

Section 263A generally denies a deduction for costs incurred in manufacturing or constructing tangible property, requiring that such costs be capitalized. In particular, section 263A(f) provides that interest paid or incurred during the production period of certain types of property, and that is allocable to the production of the property, must be capitalized into the adjusted basis of such property. Interest is allocable to the production of property for these purposes if it is interest on debt that can be specifically traced to production expenditures. If production expenditures exceed the amount of the specifically traceable debt, then other interest expense that the taxpayer would have avoided if amounts incurred for production expenditures instead had been used to repay the debt also is treated as allocable to the production of property (the "avoided cost" method of allocating interest). Section 263A(f) requires the capitalization of interest on debt that is allocable to property which has a long useful life,[208] an estimated

[205] Sec. 163(e)(3)(B).

[206] Pub. L. No. 98-369.

[207] H.R. Conf. Rep. 98-861.

[208] Property has a long useful life for this purpose if such property is real property or is property with a class life of 20 years or more (as determined under section 168) (sec. 263A(f)(4)(A)).

production period exceeding two years, or an estimated production period exceeding one year and a cost exceeding $1 million.[209]

By requiring that certain interest expense be capitalized, section 263A effectively defers the deduction for interest paid until the related income is recognized.

Legislative Background

Section 263A was enacted by the Tax Reform Act of 1986.[210] Congress believed that a comprehensive set of rules governing the capitalization of costs of producing, acquiring, and holding property, including interest expense, was advisable to reflect income more accurately, and to alleviate distortions in the allocation of economic resources and the manner in which certain activities are organized.[211] The Technical and Miscellaneous Revenue Act of 1988[212] clarified the application of the interest allocation rule.

3. Interest in the case of straddles

Present Law

A straddle generally refers to offsetting positions with respect to actively traded personal property.[213] Positions are offsetting if there is a substantial diminution in the risk of loss from holding one or more other positions in personal property.[214]

Section 263(g) requires taxpayers to capitalize certain otherwise deductible expenditures allocable to personal property that is part of a straddle. Thus, these expenditures effectively reduce the gain or increase the loss recognized upon disposition of the property. Expenditures subject to this requirement are interest on indebtedness incurred or continued to carry property (including any amount paid or incurred in connection with personal property used in a short sale) as well as other amounts paid or incurred to carry the property, including insurance, storage or transportation charges ("carrying charges"). The amount of expenditures to be capitalized is reduced by certain income amounts with respect to the personal property.[215]

---

[209] Sec. 263A(f)(1)(B).

[210] Pub. L. No. 99-514.

[211] See Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986* (JCS-10-87), May 4, 1987, pp. 508-509.

[212] Pub. L. No. 100-647.

[213] Secs. 1092(c)(1) and 1092(d)(1).

[214] Sec. 1092(c)(2).

[215] Sec. 263(g)(2)(B)(i) - (iv).

Legislative Background

The limitation on deductibility of straddle interest and carrying charges (along with the straddle rules more generally[216]) was enacted in 1981[217] in response to the use of certain straddles, which were executed with deductible financing and carrying charges, to defer ordinary income and to convert it into long-term capital gain (referred to as "cash and carry" shelters). Such shelters typically involved the debt-financed purchase of a physical commodity, for example silver, and an offsetting futures contract to deliver the silver in a subsequent taxable year. The taxpayer would deduct interest expense, storage and insurance costs in the first year, offsetting ordinary investment income. After 12 months, if the price of silver declined, the taxpayer could deliver the silver to satisfy the futures contract, realizing a gain on the silver. If the price of silver had increased, the taxpayer could sell the silver, producing long-term capital gain, and close out the short futures position, creating a short-term capital loss. In either event, the net gain on the two positions would approximately equal the carrying charges, but would be reported as capital gain. By requiring the capitalization of financing and carrying charges Congress sought to discourage these transactions.[218]

In 1984, the straddle rules were expanded to include exchange traded stock options in response to transactions exploiting the exemption of stock and exchange-traded stock options from the straddle rules.[219] For example, such transactions used offsetting deep-in-the-money options on stock, the value of which could be expected to move in roughly opposite directions.[220]

In 1986, section 263(g)(2) was amended to include in the definition of interest and carrying charges any amount which is a payment with respect to a securities loan.[221]

In 2004 the straddle rules were broadened to include actively traded stock. The same legislation provided, among other things, that at the time a taxpayer acquires a straddle the taxpayer is permitted to identify the straddle as an 'identified straddle' and thereby subject the positions composing the straddle to a basis adjustment rule rather than to the general loss deferral rule of section 1092(a)(1).

---

[216] Sec. 1092. The straddle rules generally defer a loss on a position that is part of a straddle to the extent the amount of the loss does not exceed the amount unrecognized gain on offsetting positions in the straddle.

[217] Economic Recovery Tax Act of 1981, Pub. L. No. 97-37.

[218] See Joint Committee on Taxation, *General Explanation of the Economic Recovery Tax Act of 1981* (JCS-71-81), December 29, 1981, pp. 292-293.

[219] Deficit Reduction Act of 1984, Pub. L. No. 98-369. See also, Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984* (JCS-41-84), December 31, 1984.

[220] See, e.g., Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984* (JCS-41-84), December 31, 1984, pp. 306-308.

[221] Tax Reform Act of 1986, Pub. L. No. 99-514.

G. Other Rules Relating to Business Debt and Equity

1. Employee Stock Ownership Plans

Present Law

In general

An employee stock ownership plan ("ESOP") generally is a type of qualified retirement plan that is designed to invest primarily in securities of the employer maintaining the plan.[222] An ESOP can be maintained by either a C corporation or an S corporation. An employer corporation may lend money to an ESOP, or the employer corporation may guarantee a loan made by a third-party lender to the ESOP, to finance the ESOPs purchase of employer securities. An ESOP that borrows funds to acquire employer securities generally is called a leveraged ESOP. In the case of an ESOP maintained by a C corporation, payments of principal on the ESOP acquisition loan are deductible to the extent permitted under the general deduction limits for contributions to qualified retirement plans (which generally limit the deduction for contribution to a defined contribution plan for a year to 25 percent of the participants' compensation),[223] and interest payments are deductible without regard to the limitation. In addition, dividends paid with respect the employer stock of a C corporation held by an ESOP that are passed through to participants or used to make acquisition loan payments generally may also be deductible.[224] This deduction is also allowed without regard to the general deduction limits on contributions to qualified plans. There is also a nonrecognition provision for sales of C corporation employer stock to an ESOP by a shareholder.

Because an ESOP is a qualified retirement plan, the assets of an ESOP, including the employer securities purchased with the loan are held in a tax-exempt trust. For an S corporation maintaining an ESOP, the trust of the ESOP is also exempt from UBIT.[225] There are restrictions

---

[222] Under section 4975(e)(7), in order to be an ESOP (as opposed to another type of qualified retirement plan), the plan must satisfy certain other requirements. The employer securities must be qualified employer securities as defined in section 409(l) (which generally requires use of readily tradable securities, if available, or common stock with the greatest voting power and dividend rights). The plan must satisfy the distribution and put option requirements of section 409(h) and (o) (which generally require distributions be available in employer stock for other than S corporation stock, and distributions of stock that is not readily tradable to be able to put to the employer), the voting rights requirements of section 409(e) (which require that voting rights on shares held by the ESOP be passed through to ESOP plan participants in certain circumstances), and the nonallocation requirements of section 409(n) (which apply if the seller of stock to an ESOP claims nonrecognition treatment) and 409(p) (which apply in the case of ESOP maintained by an S corporation). The plan also must satisfy other requirements provided in Treasury regulations.

[223] Sec. 404(a)(9)(B).

[224] Sec. 404(k). If the dividend is paid with respect to stock allocated to a participant's accounts, the plan must allocate employer securities with a fair market value of not less than the amount of such dividend to the participant's account for the year in which such dividend would have been allocated to such participant.

[225] Sec. 512(e)(3).

that limit the grant of stock options by an S corporation that maintains an ESOP but it is possible in certain circumstances to grant options or warrants for S corporation stock that, when combined with the outstanding shares of the S corporation, are options for up to 49 percent of the stock.[226]

Because an ESOP is a qualified retirement plan, it must satisfy the rules applicable to qualified plans generally (that are designed to protect the interest of participants and limit the amount of deferred compensation that is permitted in the plan) as well as a number of rules that only apply to leveraged ESOPs (to protect the plan against fiduciary self-dealing and to ensure that employees actually enjoy the benefits of stock ownership).

Prohibited transaction exemption for ESOPs

Prohibited transaction rules

In order to prevent persons with a close relationship to a qualified retirement plan from using that relationship to the detriment of plan participants and beneficiaries, the Code and ERISA prohibit certain transactions between a qualified retirement plan and a disqualified person.[227] A disqualified person includes any fiduciary, a person providing services to the plan, an employer any of whose employees are covered by the plan, an employee organization of which any members are covered by the plan, and certain persons related to such disqualified persons. Transactions prohibited between the plan and a disqualified person include among others (1) the sale or exchange, or leasing of property; (2) the lending of money or other extension of credit; and (3) the furnishing of goods, service, or facilities.

Exemptions for leveraged ESOPs

Two statutory exemptions to the prohibited transaction rules permit the existence of leveraged ESOPS. First, qualified plans are allowed to acquire qualifying employer securities for "adequate consideration."[228] Second, an ESOP (but not any other qualified retirement plan) is permitted to borrow from the employer or other disqualified person, or the employer is permitted to guarantee a loan to an ESOP by a third party lender, to acquire employer securities.[229]

To qualify for the loan exemption, the loan must be primarily for the benefit of participants and beneficiaries of the plan. The loan must be for a specific term and the interest

[226] See the nonallocation rules under section 409(p) for the limits on stock options and other synthetic equity, provided by an S corporation that maintains an ESOP, and section 4976A for the excise tax consequences.

[227] Section 4975 of the Code and section 406 of ERISA. The Code imposes a two-tier excise tax on prohibited transactions. The initial level tax is equal to 5 percent of the amount involved with respect to the transaction.

[228] Sec. 408(e) of ERISA and section 4975(e)(13) of the Code..

[229] Sec. 408(b)(3) of ERISA and sec. 4975(d)(3) of the Code.

rate for the loan must not be in excess of a reasonable rate.[230] Any collateral given to a disqualified person by the plan in connection with the loan must consist only of qualifying employer securities and generally only those acquired with the proceeds of the loan.[231] The shares are held in a suspense account under the plan but must be released and allocated to participants as the loan is repaid under one of two specific methods provided in the regulations.[232] In the event of default on the loan, the value of plan assets transferred in satisfaction of the loan must not exceed the amount of default.[233]

In the case of a distribution of cash by an S corporation (as described in section 1368(a)) to a leveraged ESOP with respect to its stock, the ESOP is permitted to use distributions with respect to unallocated shares held in the suspense account to make payments (principal and interest) on the acquisition loan.[234] Such use of the distribution is not a prohibited transaction and will not cause the plan to violate the qualification requirements.

Nonrecognition of gain for certain sales of stock to an ESOP

A taxpayer selling certain qualifying employer securities to an ESOP may elect to defer recognition of gain on the sale to the extent that the taxpayer reinvests the proceeds in qualified replacement property within a replacement period.[235] Gain is recognized upon the disposition of the qualified replacement property, with the basis in employer securities carrying over to the qualified replacement property.[236] The only qualifying employer securities that are eligible for this gain deferral are securities that are (1) issued by a domestic C corporation that, immediately after the sale and for at least one year before the sale, has no readily tradable securities outstanding,[237] (2) have been held by the seller for more than one year, and (3) have not been received by the seller as a distribution from a qualified plan or as a transfer pursuant to an option or similar right to acquire stock granted to an employee by an employer (other than stock acquired for full consideration). In order for the seller to be eligible for nonrecognition treatment, the ESOP must own, immediately after the sale, at least 30 percent of each class of outstanding

[230] Treas. Reg. sec. 54.4975-7(b)(7).

[231] Treas. Reg. sec. 54.4975-7(b)(5).

[232] Treas. Reg. sec. 54.4975-7(b)(8).

[233] Treas. Reg. sec. 54.4975-7(b)(6).

[234] Sec. 4975(f)(7). If the distribution is paid with respect to allocated stock purchased with the loan being repaid and is used to repay the acquisition loan, the plan must allocate employer securities with a fair market value of not less than the amount of such distribution to the participant for the year in which such distribution would have been allocated to such participant.

[235] Sec. 1042(a) and (b)

[236] Sec. 1042(e).

[237] See Notice 2011-19, 2011-11 I.R.B. 550, for the definition of readily tradable securities. For the same period, the domestic corporation that issued the employer securities must not be a member of a controlled group of corporations that has readily tradable securities outstanding.

stock, or the total value of all outstanding stock of the corporation issuing the qualified securities.[238]

After purchasing the stock, in order for the plan to remain an ESOP, the plan must preclude allocation of assets attributable to qualified securities to any taxpayer who makes an election to defer gain on the sale for at least 10 years after the date if the sale of the qualified securities to the plan or, if later, the date of the plan allocation attributable to the final payment of the acquisition indebtedness for the securities.[239]

Legislative Background

In general

The term "employee stock ownership plan" was added to the Code by the Employee Retirement Income Security Act of 1974 ("ERISA"). However, prior to ERISA, stock bonus plans could be structured to be the equivalent of a leveraged ESOP.[240]

The Tax Reform Act of 1984[241] and Tax Reform Act of 1986[242] added most of the present law special deduction and nonrecognition of gain provisions with respect to leveraged ESOPs.

S corporations

Prior to 1998, trusts of retirement plan qualified under section 401(a) were not permitted as shareholders of S corporations. Thus, prior to 1998, ESOPs could be maintained only by C corporations. The Small Business Job Protection Act of 1996 ("SBJPA") amended section 1361 to allow trusts qualified under section 401(a) to be S corporation shareholders. This change was specifically intended to allow S corporations to maintain ESOPs. Under SBJPA, the pass-through income from an S corporation to an ESOP as an S corporation shareholder was subject to UBIT. The Taxpayer Relief Act of 1997 amended section 512(e) to provide an exemption from UBIT for the pass-through income from an S corporation to an ESOP with respect to the S corporation shares held by the ESOP as qualified securities.[243] A qualified plan that is not an

---

[238] Subsequent to the sale, the ESOP must hold the qualified securities for at least three years. An excise tax applies for certain dispositions during that three- year period.

[239] Sec.409(n). This limitation generally also applies to any other person who owns 25 percent of the stock of the corporation.

[240] Specifically a stock bonus plan, a type of retirement plan qualified under section 401(a), could be structured as a plan invested primarily in employer securities acquired using funds borrowed by the plan.

[241] Pub. L. No. 98-369.

[242] Pub. L. No. 99-514.

[243] The exemption from UBIT treatment for an ESOP holding stock of an S corporation allowed an S corporation with one employee (or a very small number of employees) to establish an ESOP and transfer all their shares of S Corporation stock to the ESOP (possibly through a leveraged transaction that allowed the stock to be

ESOP continues to be subject to UBIT on the pass-through income on any shares of S corporation stock held in the plan's trust. The legislative history to the Taxpayer Relief Act of 1997[244] gives as the reason for the ESOP exemption from UBIT that subjecting S corporation ESOP income to UBIT is not appropriate because "such amounts would be subject to tax at the ESOP level and also again when benefits are distributed to ESOP participants." [245]

The Economic Growth and Tax Reconciliation Act of 2001[246] added section 409(p) which placed some limitations on the concentration of stock ownership through the ESOP and the use of synthetic equity, as defined in section 409(p)(6)(C) (which generally includes any stock option, warrant, restricted stock, deferred issuance stock right or similar interest or right to acquire or receive stock in the S corporation in the future, and certain other rights).

2. Nonqualified preferred stock not treated as stock for certain purposes

Present Law

In general

Under section 351 of the Code, a transfer of property to a corporation in exchange solely for stock of the transferee corporation is generally tax-free to each transferor. Neither gain nor loss is recognized with respect to the transferred property, provided that immediately after the transfer the transferors, in the aggregate, are in control (as defined in section 368(c)) of the corporation.[247]

---

held in a suspense account until they could be allocated to the participant's accounts). This allowed the creation of a tax-exempt S corporation with shares owned through the ESOP by a small number of individuals.

[244] Pub. L. No. 105-34, Senate Report 105-033.

[245] When the stock is redeemed or sold to provide distributions from the plan to plan participants, the pass-through income may ultimately be subject to tax as ordinary income. However, this may occur many years after the income was earned by the S corporation, a deferral that can significantly reduce the present value of the tax. Furthermore, if the stock declines in value such that the value of all the income allocations to the ESOP is not included in the amount distributed to plan participants, the S corporation income is never taxed to that extent.

[246] Pub. L No. 107-16.

[247] Control for this purpose means ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation. The IRS has ruled that "control" requires ownership of 80 percent of each class of stock that is not entitled to vote (Rev. Rul. 59-259, 1959-2 C.B. 115). Taxpayers may be able to construct stock that has a higher percentage of the vote than of value (or vice versa) and retain (or fail to retain) the amount of each class necessary to satisfy (or to fail to satisfy) this test in various circumstances.

The definition of control for this purpose is different from the definition for certain other purposes – for example, for purposes of allowing a tax-free liquidation of a subsidiary corporation into a parent (sec. 332), or for purposes of the rules treating certain transfers of stock between commonly controlled corporations as a contribution of the stock followed by a redemption distribution that is generally treated as a dividend (sec. 304).

If, in addition to stock, the transferor receives other property ("boot"), such as money or securities of the transferee corporation, then the transferor recognizes gain (but not loss) on the transfer (to the extent of the value of the other property).

The transferor recognizes gain or loss on a transfer of property, however, if the transfer fails to meet the requirements of the nonrecognition rules, for example, by failing the applicable control requirement,[248] or not receiving any stock in the exchange.

Since 1997, the Code has required nonqualified preferred stock ("NQPS") to be treated as if it were not stock for some purposes but not others unless the Secretary of the Treasury so prescribes.[249] In particular, section 351(g) provides that NQPS is not stock for purposes of section 351, with the result that NQPS received in an otherwise valid section 351 transaction is taxable boot.[250]

Definition of nonqualified preferred stock

Preferred stock is defined as stock which is limited and preferred as to dividends and does not participate in corporate growth to any significant extent.[251] Preferred stock is generally "nonqualified preferred stock" if (1) the holder has the right to require the issuer or a related person to redeem or purchase the stock within the 20-year period beginning on the issue date of the stock, and such right or obligation is not subject to a contingency which, as of the issue date, makes remote the likelihood of the redemption or purchase; (2) the issuer or a related person is required to redeem or purchase the stock within such 20-year period and such right or obligation is not subject to a contingency which as of the issue date makes remote the likelihood of redemption or repurchase; (3) the issuer or a related person has the right to redeem or purchase the stock within such 20-year period and, as of the issue date, it is more likely than not that such right will be exercised; or (4) the dividend rate on such stock varies in whole or in part (directly or indirectly) with reference to interest rates, commodity prices, or other similar indices.[252]

A right or obligation will not cause preferred stock to be NQPS, however, if (1) the stock relinquished or received is not in a corporation any of whose stock is, or is to become, publicly

---

[248] Certain prearranged dispositions of stock that would cause a failure of the control requirement may cause a transaction not to be within the scope of section 351, so that loss or gain on the transferred property is recognized. See, e.g., Rev. Rul. 54-96, 1954-1 C.B. 111 (prearranged plan caused loss of control); *Intermountain Lumber Co. v. Commissioner*, 65 T.C. 1025 (1976) (finding incorporator lacked requisite control under section 351 where, as part of the incorporation, he irrevocably contracted to sell 50 percent of the stock received).

[249] The Secretary of the Treasury has regulatory authority to prescribe the treatment of NQPS for any other purpose of the Code. The regulatory authority has never been exercised.

[250] For a discussion of certain incentives to use nonqualified preferred stock, and consideration of other aspects of present law taxpayers may use to accomplish similar results, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2012 Budget Proposal* (JCS-3-11), June 2011, pp. 385-394.

[251] Sec. 351(g)(3)(A).

[252] Sec. 351(g)(2)(A) and (B).

traded, and the right or obligation may be exercised only upon the death, disability, or mental incompetency of the holder, or (2) in the case of a right or obligation to redeem or purchase stock transferred in connection with the performance of services for the issuer or a related person (and which represents reasonable compensation), it may be exercised only upon the holder's separation from service from the issuer or a related person.[253]

Other consequences of nonqualified preferred stock

In addition to the rules dealing with transfers to a controlled corporation, other corporate tax rules also permit certain reorganizations, divisions, and recapitalizations of corporations to be accomplished without tax to the exchanging shareholders or the corporations involved, provided that certain requirements are met and only to the extent that certain permitted property is received. Under these rules, NQPS that is exchanged or received with respect to stock other than NQPS is generally not treated as permitted property (with an exception for certain recapitalizations of family-owned corporations) so that gain (but not loss) is generally recognized on certain exchanges of stock in one corporation for NQPS in another, where the basic requirements of a qualifying transaction are otherwise met. However, except as provided in regulations, unlike the case of the section 351 transaction, the NQPS is treated as stock for purposes of determining whether a transaction qualifies as a tax-free reorganization or division (apart from the rules for determining the extent of taxable boot received in such a transaction).[254]

Legislative Background

Section 351(g) was enacted by the Tax Relief Act of 1997.[255] The legislative history states that the Congressional concern leading to the adoption of the rules was that "certain preferred stocks have been widely used in corporate transactions to afford taxpayers non-recognition treatment, even though the taxpayer may receive relatively secure instruments in exchange for relatively risky instruments."[256]

In 2004, the statute was amended to add a statement that stock shall not be treated as so participating unless there is "a real and meaningful likelihood" of the shareholder actually participating in the earnings and growth of the corporation."[257] The change was made in response to Congressional concern that taxpayers might attempt to avoid the characterization of

---

[253] Sec. 351(g)(2)(C).

[254] Secs. 354(b)(2)(C), 355(a)(3)(D), and 356(e).

[255] Pub. L. No. 105-34.

[256] H.R. Rep. No. 105-148, June 24, 1997, p. 472; S. Rep. No. 105-33, June 20, 1997, p. 150. See, also, Martin D. Ginsburg and Jack S. Levin, *Mergers, Acquisitions, and Buyouts* (August 2010), ¶ 902.1 et seq., giving an example of a similar transaction that could have been impacted by the 1997 legislation. That example is based on the facts of the acquisition of National Starch & Chemical Corp. detailed in *National Starch & Chemical Corp. v. Commissioner*, 93 T.C. 67 (1978) *aff'd*, 918 F.2d 426 (3rd Cir. 1990) which refers to a private letter ruling dated June 28, 1978 (described by Ginsburg and Levin as PLR 7839060 (June 28, 1978)).

[257] Pub. L. No. 108-357, sec. 899(a), amending section 351(g)(3).

an instrument as NQPS by including illusory participation rights or including terms that taxpayers could argue create an "unlimited" dividend.[258] In 2005, the statute was amended again, to provide that "if there is not a real and meaningful likelihood that dividends beyond any limitation or preference will actually be paid, the possibility of such payments will be disregarded in determining whether stock is limited and preferred as to dividends."[259]

[258] S. Rep. No. 108-192.

[259] Pub. L. No. 109-135, sec. 403(kk), amending section 351(g)(3).

II. DATA WITH RESPECT TO BUSINESS DEBT

The following tables show selected data related to business debt, equity, and interest expense.

Table 2 provides an overall picture of the growth of non-financial corporate, household, and federal debt as a share of Gross National Product ("GNP") from 1987 to 2010. Non-financial corporate debt has grown more modestly than either household debt or Federal debt. Non-financial corporate debt as a share of GNP has grown about 13 percent since 1987, while household debt and Federal debt have each grown by more than 50 percent.

Table 3 shows the distribution of holdings of corporate equity and bonds by type of holder for the years 1990, 2000, and 2010. Over that 20-year period, the share of corporate equities held directly by the household sector has declined significantly while that held by mutual funds has risen significantly. Because most mutual fund shares are owned by the household sector, there appears to be little change in the combined share of corporate equities owned directly by the household sector or through mutual funds. The share of corporate equities held by insurance and pension funds has declined while that of foreign investors has risen substantially.

Over the same 20-year period, the share of corporate bonds held by the household and mutual fund sectors considered together has risen 62 percent, while the share of corporate bonds held by foreign investors has nearly doubled. The share of corporate bonds held by insurance and pension funds has declined by about 50 percent, from over 55 percent in 1990 to under 28 percent in 2010. The other notable change is the share of corporate bonds held by government sponsored enterprises and funding corporations, including financial stabilization programs, from zero percent of holdings in 1990 to 9.3 percent in 2010.

Table 4 shows debt-to-equity and debt to net worth ratios of nonfinancial C corporations and S corporations (excluding farms) from 1987 to 2010. For the former series, equity is measured as the market value of equities outstanding. For the latter, net worth is measured as total assets minus liabilities, with nonfinancial assets measured at market value in the case of real estate and at replacement cost in the case of inventories and equipment and software. The former series generally shows more volatility owing to its reliance on the market value measure of outstanding equities. The latter series shows that the debt-to-net-worth of nonfinancial corporations has been relatively stable over the 24-year period.

Table 5 shows interest expense and taxable income of nonfinancial corporations from 1987 to 2008 as reported on corporate income tax returns, from 1987 to 2008. The table also shows the interest expense as a percentage of taxable income before interest expense. Though interest expense fluctuates with the level of debt and interest rates, this percentage appears to primarily reflect the effects of the business cycle, as the percentage has peaks in 1990 and 2001, when taxable income declined. In addition to business cycle effects, other changes in tax policy that have an impact on taxable income affect this percentage. For example, bonus depreciation enacted in 2010 would lower otherwise reported taxable income in 2010, 2011 and 2012, and potentially increase otherwise reported taxable income in later years.

Table 6 shows interest and net income for corporations, S corporations, and partnerships from 1991 to 2008, and also shows the interest expense as a percentage of net income before interest expense. These data reflect similar business cycle effects as noted above, as well as showing a significant downward trend for S corporations in interest expense as a percentage of net income before interest expense. Table 6 also shows that C corporations' interest expense, in the aggregate and as a percentage of net income before interest expense, exceeds the comparable figures for partnerships and S corporations throughout this period. These data reflect the larger size of the C corporate sector, but C corporations may also have a Federal income tax incentive to incur debt, as interest is deductible in determining the corporate tax. By contrast, partnerships and S corporations are not subject to an entity-level tax.

Table 6 illustrates that partnership interest expense, in the aggregate and as a percentage of net income before interest expense, has exceeded S corporation interest since 1999. Among other factors, these differences may reflect the difference in tax rules for determining basis of partners' and S corporation shareholders' equity interests, respectively.

Lastly, Table 7 shows data for interest expense and net income for all corporations, separated into those with annual business receipts either above or below five million dollars. The data on interest expense as a percentage of net income before interest expense again appear to reflect business cycle effects of the 2000-2001 economic slowdown, regardless of the size of corporations.

Table 2.−Corporate Debt, Household Debt, and Federal Debt, as a Percentage of Gross National Product ("GNP"), 1987-2010

Year	Corporate Debt[1] as a Percentage of GNP	Household Debt[2] as a Percentage of GNP	Federal Debt[3] as a Percentage of GNP
1987……..	42.8	57.9	41.0
1988……..	43.6	59.4	41.1
1989……..	43.7	60.3	40.9
1990……..	43.6	61.4	42.8
1991……..	41.3	62.6	46.1
1992……..	39.4	62.3	48.3
1993……..	38.1	62.9	49.8
1994……..	37.8	63.7	49.1
1995……..	39.5	65.0	48.9
1996……..	39.9	65.8	48.1
1997……..	41.5	65.6	45.5
1998……..	43.7	67.0	42.6
1999……..	45.5	68.2	39.2
2000……..	46.4	69.9	33.9
2001……..	46.7	74.1	32.7
2002……..	45.5	79.3	34.0
2003……..	44.3	84.8	36.0
2004……..	43.2	88.4	36.8
2005……..	43.0	92.4	36.9
2006……..	44.1	96.1	36.3
2007……..	47.3	97.3	36.1
2008……..	47.8	95.2	43.7
2009……..	48.8	95.4	54.7
2010……..	48.3	90.2	63.2

[1]Corporate debt of nonfinancial C corporations and S corporations excluding farms.
[2]Household debt includes debt of personal trusts, nonprofit organizations, partnerships and sole proprietorships.
[3]Federal debt excludes Federal debt held by Federal agency trust funds.

Sources: Debt levels from The Board of Governors of the Federal Reserve System *Flow of Funds Accounts of the United States: Flows and Outstandings First Quarter 2011* Table D.3. GNP levels from the Federal Reserve Bank of St. Louis.

Table 3.−Holdings of Corporate Equity and Bonds in Billions of Nominal Dollars, 1990-2010
(Amounts in Billions of Dollars)

Sector	Year-End Balance, 1990	Percent of Total, 1990	Year-End Balance, 2000	Percent of Total, 2000	Year-End Balance, 2010	Percent of Total, 2010
Corporate Equities	**3,531**	**100.0**	**17,575**	**100.0**	**22,962**	**100.0**
Household Sector[1]	1,961	55.5	8,147	46.4	8,240	35.9
Mutual funds[1,2]	249	7.1	3,329	18.9	5,716	24.9
Foreign investors	243	6.9	1,483	8.4	3,071	13.4
State and local government excluding retirement funds	5	0.1	93	0.5	115	0.5
Federal government and monetary authority	0	0.0	0	0.0	68	0.3
Commercial banks	2	0.1	12	0.1	38	0.2
Mutual Savings banks	9	0.2	24	0.1	20	0.1
Insurance and Pension Funds	1,053	29.8	4,409	25.1	5,550	24.2
Life Insurance companies	82	2.3	892	5.1	1403	6.1
Private pension funds	606	17.2	1,971	11.2	2012	8.8
State and local government retirement funds	285	8.1	1,299	7.4	1783	7.8
Federal government retirement funds	0	0.0	57	0.3	134	0.6
Other insurance companies	80	2.3	191	1.1	220	1.0
Brokers and dealers	10	0.3	77	0.4	117	0.5
Funding corporations	0	0.0	0	0.0	26	0.1
Corporate bonds[3]	**1,733**	**100.0**	**4,827**	**100.0**	**11,332**	**100.0**
Household Sector[1]	238	13.7	551	11.4	1,763	15.6
Mutual funds[1,2]	77	4.4	549	11.4	1,551	13.7
Foreign investors	209	12.0	842	17.4	2,447	21.6
State and local government excluding retirement funds	16	0.9	84	1.7	161	1.4
Federal government	0	0.0	0	0.0	1	0.0
Commercial banks	89	5.1	266	5.5	747	6.6
Savings institutions and credit unions	76	4.4	109	2.3	74	0.7
Insurance and Pension Funds	956	55.2	1,983	41.1	3,149	27.8
Life Insurance companies	567	32.7	1,215	25.2	2,027	17.9
Private pension funds	158	9.1	266	5.5	484	4.3
State and local government retirement funds	142	8.2	314	6.5	312	2.8
Federal government retirement funds	0	0.0	1	0.0	3	0.0
Other insurance companies	89	5.1	188	3.9	323	2.8
Government-sponsored enterprises	0	0.0	131	2.7	294	2.6
Finance companies and REITs	44	2.6	183	3.8	201	1.8
Brokers and dealers	29	1.7	104	2.2	184	1.6
Funding corps. including financial stabilization programs	0	0.0	25	0.5	760	6.7

[1]The household sector and mutual funds includes assets invested in Individual Retirement Accounts (IRAs).
[2]The great majority of mutual fund shares are owned by the household sector.
[3]Corporate bonds include bonds issued by foreigners held by U.S. persons. Other types of debt, for example, trade debt, mortgages, and bank loans, are excluded.
Source: The Board of Governors of the Federal Reserve System *Flow of Funds Accounts of the United States: Flows and Outstandings First Quarter 2011* Tables L.212 and L.213.

Table 4.−Debt-to-Equity and Debt-to-Book Ratios of Nonfinancial C Corporations and S Corporations Excluding Farms, 1987-2010

Year	Ratio of Debt to Equity (Market) (Percent)	Ratio of Debt to Net Worth (Market) (Percent)
1987	89.0	45.3
1988	87.3	46.5
1989	76.8	48.5
1990	86.0	50.9
1991	62.2	51.5
1992	57.6	55.5
1993	52.7	54.4
1994	56.1	52.9
1995	45.9	53.4
1996	46.2	52.6
1997	40.0	52.3
1998	35.2	51.9
1999	29.5	51.7
2000	37.2	49.0
2001	44.4	51.4
2002	59.2	50.5
2003	45.8	48.3
2004	42.7	45.9
2005	43.1	41.5
2006	40.7	39.7
2007	42.6	42.5
2008	69.4	51.3
2009	55.8	54.5
2010	50.4	49.1

Source**:** The Board of Governors of the Federal Reserve System *Flow of Funds Accounts of the United States: Annual Flows and Outstandings Historical Data* Table B.102

Table 5.−Interest Expense of Nonfinancial Corporations, 1987-2008

Year	Interest Expense (billions of dollars)	Taxable Income (billions of dollars)	Interest as a Percentage of Taxable Income before Interest (Percent)
1987	314.9	261.0	54.7
1988	256.5	323.3	44.2
1989	309.7	306.2	50.3
1990	483.4	297.9	61.9
1991	309.0	269.2	53.4
1992	270.7	276.3	49.5
1993	253.4	312.3	44.8
1994	270.6	379.2	41.6
1995	311.3	418.0	42.7
1996	331.1	473.2	41.2
1997	365.4	502.8	42.1
1998[1]	621.7	549.5	53.1
1999	626.1	580.1	51.9
2000	797.4	637.5	55.6
2001	781.8	526.0	59.8
2002	621.0	483.0	56.3
2003	568.9	551.2	50.8
2004	596.9	694.1	46.2
2005	771.8	1,013.7	43.2
2006	1,036.1	1,069.0	49.2
2007	1,185.7	1,044.7	53.2
2008	987.8	862.2	53.4

[1]Results before 1998 are not directly comparable to those in 1998 and later due to changes in the IRS classification of Financial and Nonfinancial corporations.

Source: JCT staff tabulations, IRS Statistics of Income *Corporation Income Tax Returns* (various years).

Table 6.−Interest Expenses of Nonfinancial Business Entities, 1991-2008

Year	Corporations Other Than S Corporations, RICs and REITs			S Corporations			Partnerships		
	Interest Expense (billions of dollars)	Net Income (billions of dollars)	Interest as a Percentage of Net Income before Interest	Interest Expense (billions of dollars)	Net Income (billions of dollars)	Interest as a Percentage of Net Income Before Interest	Interest Expense (billions of dollars)	Net Income (billions of dollars)	Interest as a Percentage of Net Income before Interest
1991	266.5	160.7	62.4	21.3	29.8	41.6	20.9	34.2	38.0
1992	233.7	166.4	58.4	18.5	44.3	29.4	14.9	43.7	25.5
1993	217.0	210.9	50.7	18.2	51.0	26.3	14.8	51.4	22.4
1994	250.4	338.2	42.5	20.2	70.3	22.3	15.3	58.1	20.9
1995	286.4	385.0	42.7	24.9	72.4	25.6	18.2	62.3	22.6
1996	305.9	420.8	42.1	25.2	86.6	22.6	20.1	75.5	21.0
1997	337.5	437.8	43.5	27.8	104.1	21.1	24.0	73.3	24.7
1998[1]	574.3	429.2	57.2	31.6	154.8	17.0	30.9	83.2	27.0
1999	970.4	535.3	64.4	34.6	173.7	16.6	34.8	95.1	26.8
2000	1,216.0	517.9	70.1	40.3	171.2	19.1	41.9	117.7	26.2
2001	1,146.6	270.8	80.9	39.8	162.7	19.7	43.2	117.7	26.9
2002	867.3	258.7	77.0	33.2	157.6	17.4	44.5	181.4	19.7
2003	773.8	455.4	63.0	31.9	179.4	15.1	44.0	195.8	18.3
2004	550.6	546.8	50.2	33.1	233.8	12.4	46.8	248.8	15.8
2005	711.3	1,167.9	37.8	42.0	297.3	12.4	56.3	348.3	13.9
2006	961.5	1,007.9	48.8	55.2	333.0	14.2	69.1	385.0	15.2
2007	1,093.3	914.4	54.5	62.6	346.4	15.3	77.0	360.7	17.6
2008	903.8	582.5	60.8	55.9	276.4	16.8	82.2	239.5	25.6

[1]Results before 1998 are not directly comparable to those in 1998 and later due to changes in the IRS classification of Financial and Nonfinancial corporations.

Source: JCT staff tabulations, IRS Statistics of Income *Corporation Income Tax Returns* (various years).

Table 7.−Interest Expense of Nonfinancial Corporations by Size of Corporation, 1994-2008

Year	Corporations with Business Receipts under $5,000,000			Corporations with Business Receipts over $5,000,000		
	Interest Expense (billions of dollars)	Net Income (billions of dollars)	Interest as a Percentage of Net Income before Interest	Interest Expense (billions of dollars)	Net Income (billions of dollars)	Interest as a Percentage of Net Income before Interest
1994…….	22.5	23.6	0.49	248.1	384.4	0.39
1995…….	25.3	24.4	0.51	286.0	433.0	0.40
1996…….	25.5	29.0	0.47	305.6	478.3	0.39
1997…….	26.7	34.0	0.44	338.6	507.9	0.40
1998[1]…….	37.2	37.3	0.50	584.5	515.7	0.53
1999…….	37.7	33.2	0.53	588.3	535.1	0.52
2000…….	41.0	11.6	0.78	756.4	537.0	0.58
2001…….	43.6	5.9	0.88	738.2	329.6	0.69
2002…….	34.9	5.7	0.86	586.1	310.9	0.65
2003…….	34.1	30.1	0.53	534.9	446.9	0.54
2004…….	34.4	55.2	0.38	562.5	1,037.6	0.35
2005…….	38.1	96.2	0.28	733.7	13,51.9	0.35
2006…….	41.3	95.1	0.30	994.8	12,06.5	0.45
2007…….	54.2	122.3	0.31	1,131.5	11,13.5	0.50
2008…….	53.5	60.8	0.47	934.2	765.0	0.55

[1]Results before 1998 are not directly comparable to those in 1998 and later due to changes in the IRS classification of Financial and Nonfinancial corporations.

Note: Includes all active corporations filing a corporate income tax return, including S corporations, C corporations, RICs, and REITs.
Source: JCT staff tabulations, IRS Statistics of Income *Corporation Income Tax Returns* (various years).

III. ECONOMIC INCENTIVES CREATED UNDER PRESENT LAW FOR BUSINESS DEBT

A. Incentives Related to Firm Capital Structure

In the absence of taxes and bankruptcy costs, the market value of any firm is independent of its capital structure.[260] Leveraged companies cannot command a premium over unleveraged companies because investors can replicate the borrowing of the firm by putting the equivalent leverage into their portfolio directly by borrowing on their own account. The combination of the unleveraged company and the individual borrowing replicates the risk and return of holding a leveraged company. Arbitrage opportunities between these two equivalent portfolios prevent a leveraged firm from being valued more highly than an unleveraged firm. Similarly, leveraged companies cannot sell at a discount to unleveraged companies because investors have the opportunity of undoing the leverage by holding the bonds of the leveraged company in their portfolio in proportion to the debt of the levered company. The combination of the leveraged company and its bonds is equivalent to an unleveraged company. Arbitrage opportunities between these two equivalent portfolios prevent an unleveraged firm from being valued more highly than a leveraged firm. Thus, under these assumptions, the value of a firm does not depend on whether or to what extent it is leveraged.

In the presence of a tax system in which interest is deductible, a firm can increase its value by taking on debt. The value of the leveraged firm is equal to the value of the unleveraged firm plus the present value of the tax savings associated with the interest deductions on the debt.[261] The deductibility of interest means that a firm can reduce its tax bill by the amount of interest it pays multiplied by the tax rate. In valuing the benefit of these reduced tax payments to the firm, the stream of tax savings is discounted at the interest rate on the debt, such that the increase in the value of the leveraged firm is equal to the tax rate multiplied by the amount of debt outstanding. This implies that the optimal capital structure of the firm might be all debt.

This analysis does not, however, consider the numerous additional factors that influence a firm's choice of capital structure. These additional factors include both economic considerations, features of Federal income tax law, and interactions with nontax laws and rules.

Economic considerations

Equity and debt capitalization of a business each involves a cost of capital, and the required rate of return to the equity of a leveraged firm may be higher than that of the unleveraged firm due to the additional risk associated with leverage. A business (the issuer of debt or equity) typically wishes to obtain capital at the lowest cost. Generally, an investor seeks a higher rate of return (and thus may impose a higher cost of capital) on an investment that is

[260] Franco Modigliani and Merton H. Miller, "The Cost of Capital, Corporation Finance, and the Theory of Investment," *American Economic Review*, vol. 48, no. 3, June 1958, pp. 261-297.

[261] Franco Modigliani and Merton Miller, "Corporate Income Taxes and the Cost of Capital: A Correction," *American Economic Review*, vol. 53, no. 3, June 1963, pp. 433-443.

riskier than on a less risky investment. Debt might commonly be thought of as more secure than equity, and thus perhaps less costly to the issuer, due to rights the debt may have in bankruptcy and various protective covenants required by a creditor in connection with a loan. However, it has been observed that a portion of the expected equity return of a stable company could be considered as secure as any debt instrument the same company might issue. Similarly, in certain highly leveraged situations, debt may be considered as risky as equity and may command a high cost of capital.

To the extent the holders of common equity capital (that is, equity capital that has full participation in the future profits of the business) also capitalize their business with other interests that have a limited participation, the rate of return on investment to the common equity holders increases if the investment is successful. At the same time, because of the need to pay the other capital returns prior to obtaining the common equity return, the risk that the common equity holder will not obtain any significant return is also higher. The desire to enhance the potential rate of return on investment may be a nontax factor in choosing to leverage a business. However, this financial result also can be obtained through the use of a preferred equity instrument that is limited in its participation in future profits, but the preferred equity would carry no tax advantage.

Given that debt typically gives creditors rights to force a debtor into bankruptcy, the relative risk of bankruptcy given a specified debt level may serve to limit the amount of debt in a firm's capital structure. Even short of bankruptcy, other costs of financial distress imposed on a business by debt covenants may influence a firm's financing. These costs include not only the direct costs of legal and accounting fees but also the indirect costs of financial distress. Suppliers or employees may demand less favorable payment terms, putting further strain on the cash flow of a highly-leveraged company. Customers may switch to competitors rather than face the risk of diminished quality or customer service. Companies without sufficient cash from current operations may need to sell assets at fire-sale prices to service their debt. In addition, even absent bankruptcy, the requirements of debt covenants may limit a firm's flexibility in its operations. These factors, among others, affect the optimal level of debt for a firm.

The extent to which business owners choose to incur debt also depends in part on the availability of limited participation equity capital on acceptable terms. None may be available or the level of participation or control required by the investor may be unattractive.

Features of Federal income tax law

Numerous features of Federal income tax law create potentially conflicting incentives for businesses to structure capital investments as debt or equity because the tax treatment of these investments may differ for both issuers and holders. In addition, if one form of investment provides an advantage to either the issuer or the holder (or to both), the tax savings can potentially be shared between the parties. Such sharing can result in an increase in an investor's after-tax return and thus lower the cost of capital to the business.

A principal difference in the Federal income tax treatment of debt and equity is that interest and dividends are treated differently for both issuers and holders. For C corporations, the deductibility of interest on debt can reduce or eliminate corporate-level income tax.

The tax treatment of holders of debt or equity depends on the status of a particular holder. For example, certain holders such as U.S. tax-exempt organizations may be indifferent as to holding debt or equity of a C corporation issuer because income in either case is exempt from tax. However, a tax-exempt organization may not be indifferent as between debt and equity in a partnership as a result of the unrelated business income tax rules. In the case of U.S. individuals, preferential income tax rates apply to dividends paid with respect to qualifying equity interests, but not on payments of interest with respect to debt. Individual taxpayers may also benefit from preferential tax rates on capital gains that may accrue to retained corporate earnings

Combinations of features of the Federal income tax can further influence the choice between debt and equity. For example, the deduction for interest on debt can be combined with other tax benefits to produce a negative tax rate greater than produced if the other benefits were equity financed.[262] This can occur if debt giving rise to deductible interest payments is used to finance an investment that produces income taxed at preferential rates, offering special tax credits, or not taxed at all. In such cases, the otherwise unused interest deduction can be deducted against other taxable income of the issuer, while the debt-financed asset produces low-tax or tax-exempt income.

Rules governing the recognition of income enable a business owner to obtain funds for use in his business, or may allow an owner to extract value from the business, in either case without the recognition of gain that would result from a sale of assets.

Federal income tax law treats different business entities differently in various circumstances that can create incentives for debt or equity financing. For example, the partnership rules that increase a partner's basis in his partnership interest by his allocable share of partnership debt may encourage partners to incur debt at the entity level because such debt can increase the amount of partnership losses a partner can deduct, and the amount of cash distributions that a partner can receive without tax. In contrast, the S corporation rules do not contain a similar incentive for entity level debt.

Interaction with nontax laws and rules

Whether a particular instrument is classified as debt or equity has significance in a number of nontax contexts, including financial accounting, the regulation of banks, insurance companies and other financial institutions, securities law and the credit determinations of rating agencies. In addition, the rules for determining what constitutes debt or equity for these different purposes are not always consistent with the Federal income tax rules.

This section describes incentives issuers and holders have to use debt, to use equity, to create hybrid instruments blending aspects of each, to substitute for debt economically similar arrangements, incentives to use leveraged ESOPs, and discusses financial accounting and related considerations.

---

[262] If the same investment were equity financed, the special credits or accelerated deductions would be available to shelter other income, but the interest deduction for debt finance magnifies the effect.

1. Tax incentives for debt

Incentive for corporate leverage

Although returns to debt investment (interest) are generally deductible by a borrowing business, returns to equity investment (e.g., dividends on equity) are not. This tax distinction is particularly important to C corporations because only such entities are taxed at the entity level. For a C corporation, which is subject to entity-level tax, the after-tax effect of debt financing is more favorable than equity financing due to the deductibility of interest.[263]

Example 1:[264] Corporation X is in the 35 percent tax bracket and wants to raise $100 million of additional capital. X can issue either debt with a 5 percent interest rate, or preferred stock with a 5 percent dividend. Assume that after raising the capital, Corporation X earns $10 million and pays $5 million to the new investors. If the $100 million raised is in the form of debt, corporation X can deduct the $5 million paid to the investors, leaving cash after tax of $3.25 million.[265] If the $100 million is in the form of preferred stock, cash available to Corporation X after tax is only $1.50 million.[266]

Figure 1, below, depicts the results of this *Example 1*. Figure 2 demonstrates the results of a $100 million investment if, instead of involving a third party bank or preferred stock holder, the current shareholders of Corporation X finance the $100 million investment themselves. Notwithstanding the fact that individual shareholders pay Federal income tax at a higher rate on interest (35 percent) than on dividends (15 percent), the total tax paid by Corporation X and the shareholders together is less if the investment is debt financed. In addition, the tax savings associated with the interest deduction result in a greater net return from the $100 million investment ($6.01 million)[267] than results from a preferred stock investment ($5.52 million).[268]

---

[263] If debt is substituted for equity, increased cash flow from the reduction in taxes may enable a corporation to cover much of its debt service over a period of years and retire the debt (although the corporation might also have to sell some of its assets to cover the debt service).

[264] The examples are simplified to assume the 35 percent rate applies to all income (rather than the corporate graduated rates) and that the equity and debt rates that can be obtained are equal.

[265] Gross income of 10, less 5 distributed to the debt holders, less corporate tax of 1.75 (.35 x (10-5)).

[266] Gross income of 10, less 5 distributed to the preferred shareholders, less corporate tax of 3.50 (.35 x 10).

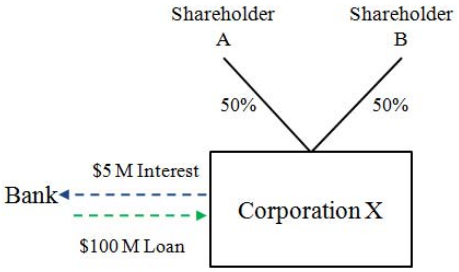
[267] Net return on the investment financed with debt is equal to the gross income from the property ($10 million) less corporate taxes paid ($1.75 million) and individual taxes paid ($1.75 million on interest and $0.49 million on dividends).

[268] Net return on the investment financed with preferred stock is equal to the gross income from the property ($10 million) less corporate taxes paid ($3.50 million) and individual taxes paid ($0.75 million on preferred stock dividends and $0.225 million on common stock dividends).

Figure 1.–Financing Additional $100 M Investment: Debt vs. Preferred Stock with Third Party Investor

A C corporation needs $100 M additional capital to expand its business.
Assume the corporation earns $10 M and pays corporate tax at 35% rate.

<u>5% Bank Loan</u>



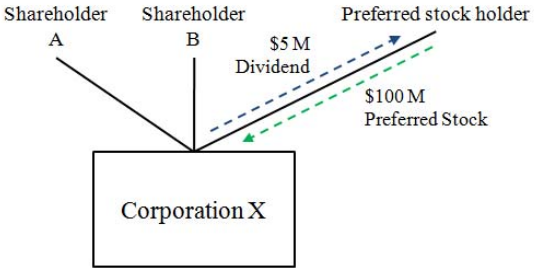
<u>Loan Results</u>:

Gross income = $10 M
Interest expense = $5 M
<u>Taxable</u> income = $5 M ($10 - $5 deductible interest)

Corporation pays **corporate tax** of **$1.75 M** ((10-5)*35%)

After-tax cash = $3.25 M

<u>5% Preferred Stock</u>



<u>Preferred Stock Results</u>:

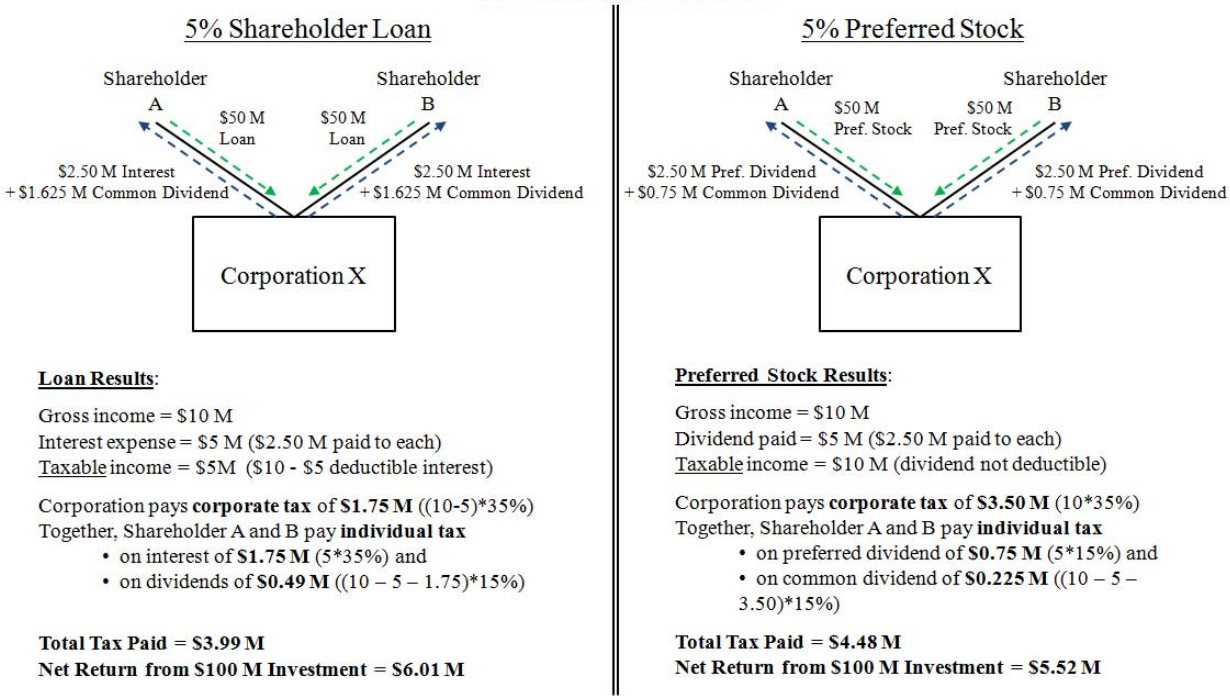
Gross income = $10 M
Dividend paid = $5 M
<u>Taxable</u> income = $10 M (dividend not deductible)

Corporation pays **corporate tax** of **$3.50 M** (10*35%)

After-tax cash = $1.50 M

Figure 2.–Financing Additional $100 M Investment: Debt vs. Preferred Stock with Current Shareholders

Same facts as Figure 1, but current shareholders provide additional capital.
Assume shareholders are in the 35% tax bracket and the corporation distributes all its after-tax cash for the year as a dividend on its common stock.



Loan Results:

Gross income = $10 M
Interest expense = $5 M ($2.50 M paid to each)
Taxable income = $5M ($10 - $5 deductible interest)

Corporation pays **corporate tax** of **$1.75 M** ((10-5)*35%)
Together, Shareholder A and B pay **individual tax**
- on interest of **$1.75 M** (5*35%) and
- on dividends of **$0.49 M** ((10 – 5 – 1.75)*15%)

Total Tax Paid = $3.99 M
Net Return from $100 M Investment = $6.01 M

Preferred Stock Results:

Gross income = $10 M
Dividend paid = $5 M ($2.50 M paid to each)
Taxable income = $10 M (dividend not deductible)

Corporation pays **corporate tax** of **$3.50 M** (10*35%)
Together, Shareholder A and B pay **individual tax**
- on preferred dividend of **$0.75 M** (5*15%) and
- on common dividend of **$0.225 M** ((10 – 5 – 3.50)*15%)

Total Tax Paid = $4.48 M
Net Return from $100 M Investment = $5.52 M

Example 2: Assume, Partnership Y has partners who are in the 35 percent tax bracket and wants to raise $100 million additional capital. Y can issue either debt with a 5 percent interest rate, or new preferred partnership interests with a 5 percent preferred distribution. Partnership Y earns $10 million and pays $5 million to the new investors. If the $100 million raised is in the form of debt, the $5 million interest is not included in the partnership income allocated to any of the partners. If the $100 million is in the form of a preferred partnership equity interest, none of the $5 million return allocated to the preferred equity interest is included in the share of partnership income of the other partnership interests. The original partners are thus indifferent to the feature of debt that interest is deductible.

Corporate transactions that substitute debt for equity can increase earnings per share

The effect of using debt rather than equity to capitalize a corporation means that a corporation can increase its after-tax earnings per share simply by substituting debt for equity capitalization. The accounting effect of allocating all after-tax earnings to a smaller pool of equity shares than before the transaction is magnified for a corporate issuer, because the interest deduction from the substitution of debt for equity itself increases after-tax earnings. A common transaction in which this occurs is a leveraged buyout ("LBO") which is an acquisition of corporate stock using debt imposed at the corporate level to provide the cash to buy out the

former shareholders. Another common transaction is a corporation's redemption of its own stock with cash from the proceeds of a corporate borrowing (without any acquisition of corporate stock by an unrelated firm or its shareholders), or other corporate distributions to shareholders financed through corporate borrowing.

Example 3:[269] Corporation X is in the 35 percent income tax bracket, and has outstanding 2.6 million shares of common stock and no debt. It has annual income of $40 million. It pays Federal income tax of $14 million ($40 million multiplied by 35 percent), resulting in net after-tax income of $26 million ($40 million less $14 million). Earnings per share are $10 ($26 million divided by 2.6 million shares). The stock has market value of $80 per share (eight times after-tax earnings).

A buyout fund offers $312 million in cash for all the outstanding Corporation X stock ($120 cash per share, 50 percent more than the current market value). The acquisition is funded with $42 million of the buyout fund's own cash, and the remaining $270 million is raised by issuing notes paying eight percent interest to be secured by the assets of Corporation X. Taxable shareholders who sell to the buyout fund recognize gain or loss on the sale of their shares.

Even if the annual pre-tax income of Corporation X after the buyout is unchanged, its taxes are significantly reduced by the deduction of the interest ($270 million x 8 percent = $21.6 million) paid to its bondholders. The reduction of Corporation X's income taxes by $7.56 million ($21.6 million multiplied by 35 percent) caused by the interest deduction produces an additional $7.56 million for the investors. The buyout fund that invested $42 million of equity obtains an after-tax return in the first year of $11.96 million, a 28.5 percent return on its equity investment.[270]

Example 4: Assume the same initial facts as in *Example 3*. Instead of being acquired in a leveraged buyout, Corporation X issues bonds to borrow $270 million at eight percent interest, and repurchases $270 million of its shares (approximately 87 percent of the outstanding shares) at a redemption price of $120 per share, 50 percent more than the price at which the stock had been trading on the market. Taxable shareholders recognize gain or loss on the redemption of their shares. The resulting reduction in Corporation X's income taxes by $7.56 million exactly pays for the increased returns to the bondholders plus the remaining shareholders ($33.56 million

[269] Examples 3, 4 and 5 are highly simplified. They assume a corporation with zero leverage that becomes highly leveraged in transactions substituting debt for equity. In considering stock price, the examples do not take into account whether the stock price before the transaction might have reflected an expectation of eventual leverage. Also, the examples do not consider what level of debt might be considered optimal from a business standpoint for a particular business or industry, or how this might affect stock price.

[270] The transaction redistributed the operating income of Corporation X, including the benefit of the $7.56 million reduction in corporate income taxes. Before the transaction, Corporation X had total annual operating income of $40 million, bearing corporate income tax of $14 million and producing after-tax corporate earnings of $26 million ($10 per share, for a market value at eight times earnings of $80 per share). After the transaction, Corporation X continues to have total annual operating income of $40 million. $21.6 million is distributed as interest to the new bondholders; $6.44 million is corporate income tax paid, and $11.96 million remains as after-tax corporate earnings of the corporation in the hands of the new shareholder that invested $42 million.

in interest and earnings = $26 million of earnings before the transaction plus $7.56 million in reduced income taxes). Depending on whether the increased returns are paid to taxable bondholders and shareholders, there may or may not be an increase in investor-level income taxes paid.

As a result of the leveraged redemption, the after-tax earnings per share of Corporation X increase from $10 per share ($26 million divided by 2.6 million shares outstanding) to over $34.17 per share ($11.96 million divided by 350,000 shares outstanding). If the stock will still sell for eight times its after-tax earnings after the transaction, the stock price would rise from $80 to $273.37 ($34.17 x 8).

Example 5: Assume the same initial facts as in *Example 3*. Instead of engaging in a leveraged buyout or a stock redemption, Corporation X borrows $270 million at eight percent interest and distributes the proceeds pro rata to its shareholders. Each share receives approximately $104, or almost 30 percent more than the price at which the stock had been trading on the market. The distribution is, in general, a taxable distribution to shareholders that are subject to tax. After the distribution, the earnings per share of Corporation X are $4.60 ($11.96 million divided by 2.6 million shares outstanding). If the stock will sell for eight times after-tax earnings, the stock price would be $36.80.[271]

Passthrough entities - debt minimizes U.S. income taxation of tax-exempt or foreign investors

A tax-exempt investor generally may prefer to hold debt rather than equity of a partnership or S corporation. A foreign investor must own debt to invest in an S corporation, because foreign persons are not permitted to own S corporation stock.[272]

Tax-exempt or foreign equity investors in a partnership that are not otherwise engaged in the conduct of a trade or business would nevertheless be deemed to be so engaged to the extent the partnership is so engaged. As a result, the investors would be taxed on their share of partnership income if they make an equity investment in a partnership that conducts active business in the U.S.[273] For U.S. tax-exempt equity investors, if an investment partnership is debt-financed at the partnership level, the rules relating to debt-financed income can cause tax-exempt partnership investors to be taxed on their shares of dividends, interest, or other

[271] Thus, although it may have appeared that most if not all the value of the stock would be depleted as a result of the borrowing, a significant portion of the value remains because of the tax benefits from the leveraged transaction.

[272] Sec. 1361(b)(1)(C). There is no limitation on a foreign investor's ownership of partnership equity, but the investor is taxed on the partnership's income from the conduct of a trade or business in the U.S. Secs. 871(b) and 882.

[273] In the case of a tax exempt entity that is a partner, income from the partnership's conduct of an active business is "unrelated business taxable income." Secs. 512 and 513. In the case of a foreign partner, the active business income is subject to U.S. tax only if the business is conducted in the U.S and the income is "effectively connected" with the conduct of the U.S. trade or business. Secs 871(b) and 882.

investment income. Foreign equity investors in investment real estate partnerships would also be taxed on gain from the sale of U.S. real property interests under rulers treating such gain as income from the conduct of a business effectively connected with the U.S.[274] In the case of an S corporation investment, tax-exempt investors may own equity investments but are generally subject to unrelated business income tax on their share of S corporation income, and on any gain on sale of the S corporation stock.[275]

However, if a tax-exempt or foreign investor makes its investment in a partnership or S corporation in the form of debt rather than equity, the return to the investment is generally not subject to U.S. tax unless, in the case of a foreign investor, interest payments on the debt are subject to withholding tax. These factors encourage use of debt when capital is raised from tax-exempt or foreign investors.

Within limits, debt instruments can be constructed that allow such holders to have some participation in equity appreciation. For example the interest rate could include an "equity kicker" that increases the amount payable as interest to reflect up to a specified amount of equity appreciation of the entity.

Interest deductions can create a negative income tax rate for when combined with depreciation deductions, credits, preferential rates, or tax exemption of the earnings financed with debt

Interest deductions for borrowing, combined with tax benefits associated with specific assets, can produce excess interest deductions that can be used to offset other income of the taxpayer. Thus, a taxpayer may have an incentive to incur debt so that deductible interest expense, in combination with other deductions such as depreciation or amortization, can shelter or offset the taxpayer's income. For example, if the purchase of depreciable assets is debt-financed, the taxpayer may be able to acquire more assets than without incurring debt. The tax impact of leveraging the acquisition of depreciable or amortizable assets can be that the taxpayer has a greater amount of deductible depreciation or amortization, as well as deductible interest expense.

For example, assume Corporation X is a domestic taxpayer in the 35-percent income tax bracket. Corporation X borrows $1,000,000 in Year One at a six percent interest rate to purchase a new piece of equipment for $1,000,000. The equipment is classified as three-year property under the modified accelerated cost recovery system ("MACRS") such that it is subject to the 200 percent declining balance method of depreciation under the midyear convention.[276]

---

[274] Secs. 897, 1445 (enacted in the Foreign Investment in Real Property Tax Act of 1980 ("FIRPTA"), Pub. L. No. 96-499, sec.1122).

[275] Sec. 512(e). There is an exception for an ESOP that owns stock of an S corporation. Unlike other tax exempt investors, the ESOP is not subject to unrelated business income tax on its share of S corporation income or its sale of S corporation stock. Sec. 512(e)(3).

[276] For this example, assume that the property is acquired in a year in which bonus depreciation does not apply.

Therefore, the first year depreciation deduction is $583,000; the second year depreciation deduction is $277,800; the third year depreciation deduction is $123,500; and the fourth year depreciation deduction is $15,400. Corporation X has earnings before interest, taxes, depreciation, and amortization ("EBITDA") attributable to the new equipment of $300,000 annually in each of Years One, Two, Three, and Four.[277]

Table 8.–Depreciable Investment with Leverage

	Year 1	Year 2	Year 3	Year 4
EBITDA	300,000	300,000	300,000	300,000
Interest Expense	(60,000)	(60,000)	(60,000)	(60,000)
MACRS Depreciation	(583,300)	(277,800)	(123,500)	(15,400)
Taxable Income/(Loss)	(343,300)	(37,800)	116,500	224,600
Tax/(Refund)	(120,155)	(13,230)	40,775	78,610

The year by year taxable income or operating loss resulting from the acquisition of this equipment is detailed in Table 8, above. Corporation X may deduct interest expense of $60,000 annually on the debt incurred to acquire the equipment. As a result of the deductions for depreciation and interest expense, in Year One, Corporation X reports a loss for income tax purposes of $343,300. At a 35-percent tax rate this creates a tax benefit of $120,155 that Corporation X may use to offset a tax liability from other income (shelter that other income from current tax) or to carry forward (or backward) against future (or past) tax liability of the corporation. Likewise in Year Two, Corporation X records an income tax benefit of $13,230. In Years Three and Four, Corporation X has positive tax liabilities of $40,775 and $78,160.[278]

If one computes the net present value[279] of the tax liabilities (positive and negative) over the four-year life of the equipment, the result is a negative $28,626 for the investment. For this reason, some analysts observe that the combination of interest deductions and depreciation deductions can create negative tax rates on the income from investment.[280]

---

[277] After the fourth year, the equipment is no longer productive. Assuming a six percent cost of capital, the net present value of this $300,000 annual income stream over the four-year period is $1,039,532 which is greater than the $1,000,000 purchase price of the equipment. Therefore, Corporation X might consider acquiring the equipment independent of the associated tax benefits.

[278] This example assumes that tax losses generated in Year One and Year Two are not carried forward to reduce Year Three and Year Four taxable income.

[279] Discounted at six percent.

[280] Congressional Budget Office, *Taxing Capital Income: Effective Rates and Approaches to Reform*, October 2005, and Congressional Budget Office, *Computing Effective Tax Rates on Capital Income*, December 2006.

Alternatively, Corporation X could have financed the acquisition of the equipment without borrowing, for example, through the use of retained earnings. The year by year taxable income or operating loss resulting from an equity financed acquisition is detailed in Table 9, below. Because the purchase is equity financed, Corporation X has no deductible interest expense with respect to the income generated by the equipment. In Year One, Corporation X reports a loss for income tax purposes of $283,300. In Years Two, Three, and Four, Corporation X reports income of $22,200, $176,500, and $284,600. If one computes the net present value of the tax liabilities (positive and negative) over the four-year life of the equipment, the result is a positive, $44,141. The difference in the present values of net tax liabilities in each example is the present value of four years of $60,000 in interest expense deductions valued at the 35-percent corporate tax rate ($72,767).

Table 9.−Depreciable Investment Without Leverage

	Year 1	Year 2	Year 3	Year 4
EBITDA	300,000	300,000	300,000	300,000
MACRS Depreciation	(583,300)	(277,800)	(123,500)	(15,400)
Taxable Income/(Loss)	(283,300)	22,200	176,500	284,600
Tax/(Refund)	(99,155)	7,770	61,775	99,610

Negative effective rates may also result from the use of debt by a domestic corporation to finance a foreign acquisition. A domestic corporation may incur interest expense that is related to income eligible for deferral. Present law provides detailed rules for the allocation of expenses between U.S. source and foreign source income.[281] These rules do not, however, affect the timing of the expense deduction; rather, for a domestic corporation they apply principally for purposes of determining the foreign tax credit limitation. Thus, a domestic corporation may claim a current deduction, even for expenses that it incurs to produce tax-deferred income through a foreign subsidiary. By reducing the amount of tax imposed on currently taxable income, these interest expense deductions enhance the benefits of the existing deferral regime by yielding low and, in some cases, negative effective tax rates on that income.

Present law imposes limitations on interest deductions in particular circumstances in which the underlying debt funds assets that produced untaxed income. For example, present law imposes a pro rata interest deduction limitation on interest expense of financial institutions that is allocable to tax-exempt interest, and imposes a somewhat similar pro rata interest deduction limitation on interest expense allocable to the unborrowed cash values of life insurance policies and annuity and endowment contracts held by entities other than natural persons.[282] These rules

[281] Sec. 864.

[282] Secs. 265(b) and 264(f), respectively, described in more detail above. A similar concept applies limiting the dividends received deduction for debt-financed portfolio stock (sec. 246A).

are addressed to particular situations, however, and do not address other situations in which untaxed income of other types could be funded by leverage, the interest on which is deductible.

Borrowing as a monetization of asset value

In general

If a taxpayer borrows money, the amount borrowed is not considered income. This is true even if the borrowing is secured by the taxpayer's appreciated assets, and even if the borrowing is non-recourse, so that only the assets are subject to the debt and neither the taxpayer nor his business is otherwise liable. The borrowing is not considered either income or a sale of the assets unless and until the borrower experiences difficulties that require the debt to be restructured, or defaults, so that debt is in effect cancelled without repayment of the borrowing in full or the assets are taken by the borrower in a foreclosure.[283] If none of these events occurs, the amounts borrowed are not income and do not cause any gain recognition, because the taxpayer is considered still potentially liable for the debt and not to have received an unencumbered economic benefit.

Notwithstanding the fact that the borrowed amounts are not income, the borrower can use the proceeds of borrowing to buy assets whose debt-financed purchase price basis is depreciable (thus offsetting taxable income) and is used to determine whether a sale or other taxable disposition of the asset produces a taxable gain or a deductible loss.

Partnership debt affects partners' loss deductions and the tax treatment of cash distributions

The partnership tax rules may give rise to an incentive to take on debt at the partnership level. When a partnership borrows money, the same general principle applies that the proceeds of the borrowing are not income. A partnership is a passthrough entity for Federal income tax purposes, so partnership items of income, loss, deduction, and credit are taken into account by the partners. Debt of the partnership generally can have the effect of increasing the amount of losses and deductions of the partnership that can be deducted by partners, as well as the amount of cash that can be distributed to the partners without current taxation.

More specifically, under the partnership tax rules, a partner's basis in its partnership interest limits the partner's deduction for its share of partnership losses and deductions, as well as the amount of cash that may be distributed to the partner without current taxation.[284] A partner's basis in his partnership interest includes his allocable share of amounts borrowed by the partnership.[285]

---

[283] These situations are discussed below.

[284] Secs. 704(d), 731.

[285] A partner's basis in a partnership interest is increased by the adjusted basis of the partner's contributions of money or other property to the partnership, and by the amount of partnership income allocated to the partner, and is decreased by the amount of cash and the adjusted basis of other property distributions to the

Because a partner can deduct its share of items of partnership loss and receive distributions of cash or other property from a partnership without tax (so long as the deduction or distribution does not exceed the partner's basis in his partnership interest), there is a tax incentive (if the partners do not wish to contribute additional funds to the partnership that would increase their basis) to ensure that partnership level borrowing does not fall below the level necessary to support the partners' full deduction of losses and full exclusion from income of any partnership distributions. Guarantees of partnership debt may also be used. [286]

The determination, under regulations, of what portion of partnership debt is allocable to a partner depends on an analysis of who bears the economic risk of loss, and is based on presumptions that may be simplifying but that do not always fully reflect the particular economic situation. In the case of recourse debt of the partnership, a partner who is personally liable for such debt is considered to bear as his share the amount for which he would be liable if all the partnership's assets (including cash) had no value and the partnership liquidated.[287] If a partner guarantees a portion of debt incurred by the partnership, it is generally irrelevant whether the debt is small in comparison to the partnership's assets and the likelihood may be minimal that these "last dollars" of partnership assets would have to be reached to pay the debt. Nevertheless, the partner's basis generally can be increased by the amount guaranteed. In the case of nonrecourse debt, all partners are considered to bear a proportionate share of the debt, generally in accordance with the partners' shares of partnership profits.[288] Unlike situations in which a single owner borrows and acquires property, the partnership rules attempt to deal with situations in which a number of owners who are partners agree on the allocation of income and the allocation of deductions of an enterprise, as well as the distribution of partnership cash flow and of other partnership property, all in possibly different ratios over time or in any taxable year. In these circumstances, a partner's proportionate share of debt would be important if, for example,

---

partner and by partnership deductions allocated to the partner. For these purposes, an increase in the partner's share of partnership indebtedness is treated as a contribution of money, and a decrease in such share is considered a distribution of money. Further, a partner's basis in his partnership interest is decreased by the amount of partnership loss allocated to the partner and by distributions made to the partner, and increased by the amount of partnership income allocated to the partner and by capital contributions made by the partner. Secs. 705, 721, 733 and 752.

[286] See Blake D. Rubin, Andrea Macintosh Whiteway, and Jon G. Finkelstein, "Working With the Partnership Liability Allocations Rules: Guarantees, DROs and More," 68 *N.Y.U. Federal Tax Institute*, chapter 10, 2010; Eric B. Sloan, Steven E. King, and Judd A. Sher, "Through the Looking Glass: Seeing Corporate Problems as Partnership Opportunities,"Practising Law Institute Course Handbook, Tax Planning for Domestic and Foreign Partnerships, LLCs, Joint Ventures & Other Strategic Alliances (2008)(813 PLI/Tax 567); Deloitte Development LLC (2007).

[287] Sec. 752 and Treas. Reg. secs. 1.752-2(b) and -2(c)(2). It is difficult to see how a partnership's cash would have no value, but, perhaps in order to accommodate potential fluctuating cash balances as the partnership invests in other assets while giving certainty to the partners, the regulations so provide. See William S. McKee, William F. Nelson, and Robert L. Whitmire, *Federal Taxation of Partnerships and Partners*, Fourth Edition, Volume 1, paragraph 8.02[3], describing the circumstances assumed under the regulations as a "hypothetical cataclysm."

[288] Treas. Reg. sec. 1.752-3.

the partner were entitled to losses or distributions in a greater proportion than other partners during the taxable period.

The IRS, in litigation, has challenged as sales certain types of transactions involving guarantees by partners of partnership debt (or other methods of retaining a high basis in a partnership interest) that are designed to minimize gain recognition on the withdrawal of cash from a partnership.[289]

S corporation rules

An S corporation, like a partnership, generally is treated as a passthrough entity for Federal income tax purposes, in that items of S corporation income, loss, deduction, and credit are taken into account by the S corporation shareholders for tax purposes.[290] A shareholder can deduct its share of S corporation losses to the extent of the sum of the shareholder's basis in the S corporation stock and the shareholder's basis of any debt of the S corporation to the shareholder.[291] Unlike a partnership interest, the basis of an S corporation shareholder does not include debt incurred at the entity level by the S corporation, other than the S corporation's debt to the shareholder.

The S corporation tax rules may not create the same incentive to incur debt at the S corporation level that the partnership rules provide to incur debt at the partnership level to increase partners' bases in their partnership interests.[292] Since shareholders obtain basis for either stock or loans to the S corporation, they may be indifferent to what form their own investment takes except to the extent they might obtain priority over other creditors through the loan form.

Timing of debt deductions and inclusions

In general

Interest on a debt instrument is generally deductible by the issuer (and includible by the holder) when the interest is paid or accrued. However, in certain cases the deduction (and inclusion) occurs prior to the time of any payment. Tax-exempt or foreign holders that do not

[289] See, e.g., *Canal Corporation v. Commissioner*, 135 T.C. 199 (2010). This case involved a leveraged partnership which made a cash distribution to one of the partners that was funded by partnership borrowing. The Tax Court held that the transaction should be recharacterized as a sale of assets to the other partner by the partner that received the cash distribution. The partner that received the cash also indemnified the partnership-level borrowing. The court disregarded this indemnity in analyzing whether that partner had the economic risk of loss with respect to the debt, applying an anti-abuse rule in Treas. Reg. sec. 1.752-2(j).

[290] Sec. 1363(a). If the S corporation was previously a C corporation or acquired assets from a C corporation with a carryover basis, any built-in gain on those assets is subject to corporate level tax if recognized within a specified period following the conversion or acquisition. Sec. 1374.

[291] Sec. 1366(d).

[292] Table 6, above, illustrates that for the most recent year for the period 1999 - 2008, partnership interest expense exceeds S corporation interest expense.

pay tax on interest income in any event are indifferent to the consequence of including interest income for tax purposes earlier than the receipt of cash. As in the case of any other interest payments to tax indifferent parties, the issuer deducts the interest expense and no tax is imposed on the holder. The value of the deduction is increased to the extent it is allowed before payment.

Original issue discount

When the amount to be paid at the maturity of a debt instrument exceeds the issue price by more than a minimal amount, a portion of the amount to be paid at maturity is treated as interest accruing on a constant yield basis over the life of the instrument as OID. This results in deemed interest amounts being deductible by the issuer and included by the holder prior to any payment of cash. Even in the case of significant OID subject to the AHYDO rules, there is no limit on the deduction if the instrument ceases to have significant OID by the end of the fifth year after it is issued.[293]

Issuer treatment if an instrument is troubled and is modified, or cancelled

In the event an investment loses value or becomes worthless, the tax consequences to the issuer vary significantly depending on whether the instrument is debt or equity. In general, a taxable issuer experiences either cancellation of indebtedness income or gain on a taking of property in foreclosure, if debt is forgiven or restructured. By contrast, failure to pay dividends or to return equity capital to investors does not result in income to the issuer.

In some situations, retaining significant debt may have permitted a taxpayer to receive cash without tax when the business prospered, thereby benefitting from deferral. However, a subsequent default can require the taxpayer to recognize income and incur a tax obligation at that later (perhaps economically less opportune) time. A number of rules permit nonrecognition of income, however, including rules relating to discharge of indebtedness in bankruptcy or to the extent of insolvency. Such rules possibly mitigate a potential disincentive to use debt financing.

2. Tax incentives related to equity

Equity of a C corporation can bear more than one level of tax if the C corporation pays corporate tax on its non-deductible dividends or other stock distributions, and a taxable investor also pays tax on the dividend or other equity distribution. However, in some cases this "double tax" effect is mitigated by deferral (if the shareholder does not receive a dividend or sell the stock until years after the corporate earnings arise). The double tax effect may disappear entirely for stock held until the death of a shareholder, to the extent the stock does not pay dividends and the appreciation in value of the stock (due to retained earnings or otherwise) obtains a stepped up basis at death. This may create an incentive to retain earnings. The effect is also mitigated if

[293] An instrument is treated as having "significant original issue discount" if the aggregate amount of interest that would be includible in the gross income of the holder with respect to such instrument for periods before the close of any accrual period (as defined in section 1272(a)(5)) ending after the date five years after the date of issue, exceeds the sum of (1) the aggregate amount of interest to be paid under the instrument before the close of such accrual period, and (2) the product of the issue price of such instrument (as defined in sections 1273(b) and 1274(a)) and its yield to maturity. Sec. 163(i)(2).

shareholder level income from enhanced corporate value is taxed to the shareholder at a lower tax rate than is available on other forms of income.

Equity can permit a corporate holder to obtain dividends received deduction or an individual holder to obtain a favorable tax rate

A corporation that owns stock in another corporation is generally allowed a dividends received deduction[294] that in effect excludes between 70 percent and 100 percent of the dividend from the recipient's income. The percentage of the deduction increases depending upon the recipient corporation's percentage ownership of dividend paying corporation.[295] At the lowest percentage deduction, applicable to stock ownership of less than 20 percent, the maximum tax rate on dividends received is currently 10.5 percent.[296]

Individual holders of corporate equity are currently eligible for a maximum 15 percent tax rate on qualified dividend income (compared to the maximum 35 percent rate on interest income), as well as a maximum rate of 15 percent on long term capital gain from the sale of stock.[297]

A corporate issuer that has significant losses or tax-exempt income and that does not expect to be able to use an interest deduction may nevertheless have "earnings and profits" that cause distributions to be treated as dividends.[298] Such a corporation may have an incentive to issue equity to provide a corporate holder with a dividends received deduction (or a taxable individual shareholder with a beneficial rate on dividends), even though the earnings did not bear corporate level tax prior to distribution.

---

[294] A number of special rules apply to limit use of the corporate dividends received deduction. The deduction is not allowed unless the holder has held the stock, at risk, for a specified time, or if the payor is a foreign corporation whose earnings were not subject to U.S. tax. The deduction is reduced to the extent the stock was debt-financed by the holder. And the basis of the stock with respect to which the dividend was paid must be reduced for certain dividends, to prevent the allowance of a loss on disposition of stock from which earnings have been extracted without tax.

[295] The deduction is equal to 100 percent for dividends received by a corporation that owns at least 80 percent of the vote and value of the payor stock; 80 percent for dividends received by a corporation that owns 20 percent or more of the stock but less than 80 percent, and 70 percent for ownership below that threshold. Sec. 243.

[296] The 35 percent maximum corporate tax rate multiplied by the 30 percent of the dividend that is taxable.

[297] The 15 percent rate is scheduled to expire at the end of 2012. After that time, dividends of individuals are taxed at the maximum ordinary income rate of 39.6 percent, and long term capital gain of individuals with respect to corporate stock is generally taxed at a maximum 20 percent rate.

[298] "Earnings and profits" is a concept directed at identifying economic income of a corporation, generally for purposes of determining whether distributions to shareholders should be treated as dividends of as a return of capital. Earnings and profits includes tax exempt income and certain other income on which no tax has been paid due to accelerated depreciation. Sec. 312. In addition, the Code requires a dividend paid out of current year earnings and profits to be treated as a dividend, even if the corporation has loss carryforwards that will cause it to have no taxable income (and no net accumulated earnings and profits) as of the end of the year in which the dividend is paid.

In addition, even a corporation that expects to have entirely taxable income may be able to obtain a lower cost of capital on at least part of its capital structure by issuing stock to those investors that are eligible for the lower rates on dividend income but would not receive the lower rates on interest income (e.g., U.S. taxable individuals or corporations).

3. Incentives to create hybrid instruments

In general

Taxpayers have significant flexibility to create economically similar instruments and categorize them either as debt or equity. In general, instruments are not bifurcated into part debt and part equity, and the categorization as one type of instrument or the other applies across the board for all tax purposes. Taxpayers may have incentives to create instruments with hybrid features, that is, having features of both debt and equity,[299] either solely for Federal income tax purposes, or because of additional benefits that may occur if the instrument is classified in a different manner for other purposes such as financial reporting, regulatory capital, or foreign tax purposes.

For example, issuers may seek to structure an instrument offering many of the attributes of equity while still providing an interest deduction. Some investors may seek debt-like protections while allowing for the possibility of sharing in the earnings or appreciation of a business. Instruments characterized as debt for tax purposes contain significant equity like features, the economic risks of high leverage might be mitigated. For example, a debt instrument having a long term that permits deferral of cash interest or principal payments, or an instrument that allows final payment of interest or principal (or both) in an amount of issuer stock rather than cash, may provide some cushion against an issuer's default and bankruptcy. Similarly, debt instruments held by a shareholder of the issuer could be perceived by third parties as equity-like to the extent the debt-holding stockholders are less likely to exercise their rights as creditors and drive a troubled issuer into bankruptcy. Such shareholders might instead voluntarily cancel or restructure their debt to avoid bankruptcy and preserve the potential for the corporation to improve its performance and ultimately increase their overall return through their return to equity.

To the extent debt provides interest deductions but also some flexibility against causing bankruptcy and lacks covenants that inhibit operations, it might be viewed in the marketplace as creating a less risky capital structure than other, more restrictive debt.

---

[299] See, e.g., *Commissioner v. H.P. Hood & Sons*, 141 F.2d 467, 469 (1st Cir. 1944) ("It is clear that a common stock is a proprietary interest on which dividends are paid and a bond is a debt on which interest is paid. Between the two extremes, however, there have grown divers types of securities with many overlapping characteristics. Some of these myriad variations have, no doubt, been developed to meet fundamental business needs. Others have been mere window dressing to catch the eye of the purchasing public.").

C corporation shareholder debt

Although identity of ownership of a corporation's debt and equity is one common law factor against classification as debt, there is no prohibition against such significant ownership. In the case of a C corporation, since interest payments eliminate the corporate level tax on the share of earnings that is interest rather than dividends, if the shareholders are also lenders to the corporation, they are able to extract corporate returns with only a single level of tax. Also, as noted previously, it is possible that outside lenders may perceive shareholder debt as less likely to drive a company into bankruptcy than debt to an unrelated party, because shareholders may have an incentive to cancel or restructure such debt in order to preserve their future equity interest, should the company become troubled.

In the case of a corporation controlled by shareholders where a tax treaty reduces the rate of gross-basis withholding tax on interest paid by that corporation, the earnings stripping limitations of section 163(j) permit such controlling shareholders to maintain a 1.5 to 1 debt to equity ratio and themselves receive up to half of the corporate earnings as interest payments (assuming the debt is respected). The amount of the one-half of earnings that may deducted as interest to shareholders that are also creditors is computed before depreciation and other deductions that, after interest deductions, will further reduce corporate tax. Even if shareholders are not tax-exempt, there is still a motivation to have shareholders also own corporate debt to eliminate the corporate level of tax, in cases where the shareholders are not themselves corporate entities (for example, in the case of a corporation that is owned by private equity fund that in turn is a partnership of individuals, or in the case of any other closely held corporation). This is because the corporate level interest deduction results in only one level of tax. Thus, it might be that domestically and foreign owned companies have equal incentives to reduce their corporate-level tax with interest deductions to controlling shareholders. Any U.S. tax saving for a foreign owned company as compared to a domestically owned company might appear at the shareholder level to the extent no tax would be paid on the interest income under applicable treaties or otherwise.

Corporate interest deductions on certain hybrid instruments

A corporation may issue debt that is convertible to corporate equity. Such an instrument could be viewed as part debt and part equity, with the amount paid to the corporation being attributable in part to the fixed interest debt instrument, and in part to the conversion feature. Treasury regulations and rulings provide inconsistent results for similar types of instruments, depending upon how the conversion feature is structured. If an instrument is simply convertible into stock of the issuer or a related party, the amount of interest deduction that is considered the economic equivalent of a payment on the amount attributable to conversion feature is denied.

Under an IRS ruling,[300] if the instrument is not automatically convertible at a specific price, but rather is convertible only if one or more contingencies is satisfied (e.g., only if corporate earnings or share prices change by a specified threshold amount), then the rules for

[300] Rev. Rul. 2002-3.

determining the market comparable for interest deduction purposes allow the instrument to be treated as if it did not have a conversion feature, thus allowing more interest to be deducted in advance of actual payment. Depending on the point at which the fixed conversion price is set compared to the conditions of the contingency, the two instruments could be economically very similar. The IRS has solicited comments on whether the approach allowing deductible interest to be determined as if there were no contingency should be extended beyond contingent convertible bonds. Commentators have expressed different views and have noted other inconsistencies in the treatment of potentially similar instruments that offer a debt holder the opportunity to participate in corporate growth or appreciation.[301] The inconsistencies in treatment may allow taxpayers to select the treatment most favorable by proper structuring of the instrument.

A corporation also may issue debt that is under certain circumstances payable in corporate equity. Section 163(l) denies interest deductions for such instruments. The IRS has ruled that certain hybrid instruments are not within the scope of this denial.[302]

Advantages when debt instrument for tax is treated as equity or part equity for financial accounting, rating agency or regulatory purposes

Federal income tax is not the only context in which classification of an instrument as debt or equity has significance. And because classification rules applicable in different contexts vary, taxpayers have designed hybrid instruments to achieve different, advantageous results under the different rules. Examples of other contexts include rules under U.S. GAAP determining the treatment of instruments for financial accounting purposes, bank regulatory rules determining whether an instrument qualifies as equity capital for purposes of bank capital requirements and the rules of various rating agencies considering how an instrument is treated for purposes of financial tests in assigning credit ratings to issuers. Although the treatment of an instrument for purposes non-tax purposes is a factor in the Federal income tax classification analysis, it is not determinative.

Trust preferred securities[303] are an example of a hybrid instrument developed, and adapted over time, to be classified differently for tax, financial accounting, regulatory or rating

---

[301] See, e.g. David P. Hariton, "Conventional and Contingent Convertibles: Double or Nothing," *Tax Notes* vol. 96 no. 1 (July 1, 2002), p. 123; Jeffrey Strnad, "Taxing Convertible Debt," 56 *Southern Methodist University Law Review* 399 (2003); Jeffrey Strnad, "Laboring in the Pin Factory: More on Taxing Convertible Debt," 56 *Southern Methodist University Law Review* 471 (2003); Dana L. Trier and Lucy V. Farr, "Rev. Rul. 2002-31 and the Taxation of Contingent Convertibles, Parts 1 and 2," *Tax Notes* vol. 95 no. 13 (June 24, 2002), p. 1963 and Tax Notes vol. 96 no.1(July 1, 2002), p. 105; Edward D. Kleinbard, Erika W. Nijenhuis and William L. McRae, "Contingent Interest Convertible Bonds and the Economic Accrual Regime," Tax Notes vol. 95 no. 13 (June 24, 2002), p.1949; Edward D. Kleinbard, "Taxing Convertible Debt: A Layman's Perspective," 56 *Southern Methodist University Law Review* 453 (2003).

[302] See, e.g., Rev. Rul.2003-97, 2003-34 IRB 380.

[303] The term "trust preferred securities" as used in this pamphlet is a generic term for various, but similar, financial products including monthly income preference shares (MIPS), trust originated preferred securities (TOPrS), quarterly income preference shares (QUIPS), trust preferred securities (TruPS) and more recent variants such as enhanced capital advantaged preferred securities (ECAPS) and Enhanced TruPS (ETruPS).

agency purposes. Trust preferred securities are an instrument used to raise capital involving the creation of an additional entity to stand between the corporation raising the funds and the investors in the instrument.[304] For example, a corporation interested in raising capital could issue debt or preferred stock directly to investors. As an alternative, in the case of trust preferred securities, a corporate issuer forms a passthrough entity by contributing capital in exchange for a common equity interest. The passthrough entity then sells preferred equity interests to investors. The passthrough entity then lends the money it received from the corporation (as a capital contribution) and the investors (in exchange for the preferred equity interests) back to the corporation. As a result, the corporation has funds raised from investors, and has an obligation to make payments on indebtedness to the newly created passthrough entity. Payments on the corporation-passthrough entity indebtedness are typically designed to match the payments required on the passthrough entity-investor preferred securities. In other words, the passthrough entity operates as a conduit to receive payments of interest from the corporation, which it pays on to its preferred interest holders.

Prior to changes in the financial accounting rules in 2003,[305] the simplified structure described above allowed the corporation interest deductions on amounts paid through to the investors for Federal tax purposes without treating the arrangement as a liability for financial accounting purposes. For Federal income tax purposes, the debt between the corporate issuer and the passthrough entity was designed to qualify as debt. Similarly, the terms of the preferred interests issued to investors was designed to qualify as debt for Federal income tax purposes even if treated as issued by the corporate issuer directly.[306] Under U.S. GAAP rules, the passthrough entity was consolidated with the corporate issuer, with the effect that the loan between the corporate issuer and the passthrough entity (which would be treated as a liability for GAAP) was ignored for financial accounting purposes, and the preferred securities were treated as issued directly by the corporation. These preferred securities were designed to qualify as equity for GAAP purposes.

In 2003, U.S. GAAP rules were revised to require that trust preferred securities be reflected as a liability for financial accounting purposes. However, the trust preferred security structure has also involved benefits for credit rating purposes. Very generally, rating agencies such as Moody's Investor Services and Standard and Poor's may assign a credit rating to certain company instruments. These agencies are concerned primarily with a company's ability to make payments on an instrument as required, without default. An important component of such an analysis is the composition of the issuer's capital structure, and the degree of flexibility a

---

[304] The additional entity can be a foreign limited liability company, a domestic partnership or state law trust. Different structures have used different entities for a variety of non-tax reasons over time including compliance with securities laws, transaction costs and investor convenience.

[305] Accounting Standards Codification ("ASC") 480 (formerly FASB Statement No. 150).

[306] In TAM 199910046, the IRS concluded, *inter alia*, that in a trust preferred securities structure using a foreign limited liability company that (1) loans to the foreign LLC were debt for Federal tax purposes and (2) that preferred securities issued by the foreign LLC would constitute debt for tax purposes if issued directly to the public by the corporate owner of the foreign LLC. In CCA 200932049, IRS Chief Counsel reached a similar conclusion for a trust preferred securities structure employing a State law trust.

company has in periods of impaired cash flow. For example, Moody's Investor Services' rules have granted partial "equity credit" to hybrid instruments that allow, like trust preferred securities, for the deferral of periodic payments.[307] In effect, giving "equity credit" for hybrid instruments could make such instruments more attractive to issuers than other financing alternatives, especially if such credit improved the company's credit rating.[308]

In addition to credit rating benefits, for an issuer of trust preferred securities that is a bank holding company, such securities were designed to count as Tier 1 regulatory capital. Very generally, under U.S. bank regulatory capital requirements, banks are required to hold some minimum level of capital (e.g., three percent of total assets) and satisfy a minimum risk-based capital ratio (e.g., a ratio of total capital to total risk-weighted assets of eight percent). These requirements are generally designed to insure banks hold capital sufficient to absorb potential losses. Debt issued directly by a bank could give rise to tax deductible interest payments, but would not qualify as capital for regulatory purposes. Preferred stock issued directly by the bank could count as equity capital, but generally would not give rise to interest deductions. For certain banks, specifically, bank holding companies regulated by the Federal Reserve Board, trust preferred securities meeting certain requirements counted as Tier 1 capital. For banks other than bank holding companies, trust preferred securities did not count as Tier 1 capital. Section 171(b) of the Dodd-Frank Wall Street Reform and Protection Act[309] generally phases out the treatment of trust preferred securities as Tier 1 capital for most large bank and thrift holding companies.[310]

Hybrid instrument advantages in cross-border investment

Instruments may be treated as debt for foreign income tax purposes but as equity or U.S. tax purposes. Other instruments exist that may be treated as debt for U.S. tax purposes and as equity for foreign tax purposes. These instruments are often used within a multinational group to achieve cross-border tax arbitrage, to accomplish foreign or U.S. tax base erosion, or to engage

[307] See, e.g., TAM 199910046; Richard A. Kahn, "The Evolution of Hybrid Securities" 1866 PLI/Corp 463, February 2011 (describing rating agency treatment of hybrid securities).

[308] See, e.g., "The Law of Unintended Consequences: New Generation of Trust Preferred Squeezes Market for DRD Preferreds," 2006 TNT 69-18 (April 11, 2006) (describing issuances of trust preferred securities by Lehman Brothers, Inc., Burlington Northern Santa Fe Corp., and US Bancorp following a 2005 change in the equity credit rules by Moody's Investor Services).

[309] Pub. L. No. 111-203.

[310] Specifically, section 171(b) Dodd-Frank prohibits bank holding companies with assets in excess of $15 billion on December 31, 2009 to count trust preferred securities issued after May 19, 2010 as Tier 1 capital and phases previously issued trust preferred securities out of Tier 1 capital by January 2016. Bank holding companies with $15 billion or less in assets are not allowed to include trust preferred securities issued on or after May 19, 2010 in Tier 1 capital, but are not required to phase out trust preferred securities outstanding before that date. Federal home loan banks and certain small bank holding companies (i.e., bank holding companies with less than $500 million in assets) are exempted from the limitation provision (i.e., these entities may continue to count trust preferred securities as Tier 1 capital), as are trust preferred securities issued to the United States or any agency or instrumentality thereof pursuant to the Emergency Economic Stabilization Act of 2008.

in foreign tax credit planning.[311] Such instruments may also be used by investors (e.g., investment funds) making cross border investments. One such example is a Convertible Preferred Equity Certificate ("CPEC"). A CPEC is a hybrid financing instrument designed to be regarded as debt of a Luxembourg issuer from a Luxembourg tax perspective,[312] but equity from a U.S. tax perspective.[313] Typical features of the CPEC include a 49-year term; a fixed annual interest rate computed based on the "arm's-length" principle, taking into consideration their conversion feature; convertibility into shares of the issuer at a fixed ratio established upon the issuance of the CPECs; an ability to be redeemed at fair market value under certain conditions; transferability by the holder only with the simultaneous transfer of an equivalent portion of the holder's shares of the issuer; subordination to other debt; and no voting power.

Because CPECs are treated as debt for Luxembourg tax purposes, interest expense may be imputed on CPECs resulting in Luxembourg tax deductions. In addition, interest paid on CPECs is generally exempt from Luxembourg withholding tax. From a U.S. perspective, assuming the holder is treated as owning equity, interest imputed on a CPEC does not result in corresponding imputed interest income in the United States. Holders typically owe U.S. tax on dividend income only when declared and paid. In addition, CPECs are convertible into common shares and under certain circumstances are redeemable. Because conversion or redemption is typically carried out at the fair market value of the shares at the time of the conversion or redemption, holders are able to extract appreciation in the issuer in a tax efficient manner. From a Luxembourg perspective, a conversion is not a dividend subject to withholding, and from a United States holder's perspective, the exchange may qualify for a preferential rate of tax as qualified dividend income or the sale or exchange of a capital asset.[314]

4. Incentives to substitute other arrangements for debt

Shareholders may extract other deductible payments not subject to interest limitations

Corporate equity owners can extract a stream of earnings from the corporation in a form that is deductible to the corporation (and thus does not bear corporate level tax) through transactions other than owning debt. For example, property to be used in the corporate business might be held outside the corporation and leased to the corporation. The corporation could deduct the lease payments, the owners who are leasing the property pay one level of tax on the

[311] The ability to use hybrid instruments to engage in foreign tax credit planning was significantly curtailed with the enactment of Code section 909. Pub. L. No. 111-226, sec. 211. Prior to enactment of section 909, certain hybrid instruments treated as debt for foreign tax purposes and as equity for U.S. tax purposes were used to help facilitate certain "foreign tax credit splitter" transactions where creditable foreign taxes were separated from the underlying foreign earnings and profits.

[312] Although the IRS will typically not issue a private letter ruling, it is not uncommon for issuers of CPECs to obtain a ruling from Luxembourg tax authorities confirming the treatment of CPECs as debt.

[313] Profit participating loans are another example of a hybrid instrument that may be treated as debt in Luxembourg and certain other foreign jurisdictions while being treated as equity from a U.S. tax perspective.

[314] Since CPECs are also treated as equity in certain foreign jurisdictions, CPECs may also be used to facilitate cross-border arbitrage between Luxembourg and other foreign jurisdictions.

rent received, and appreciation in the assets remains outside of the corporation and not subject to corporate tax.

Similarly, the equity owners of a corporation might extract other streams of earnings in a form that is deductible to the corporation by performing services to the corporation and extracting fees. Private equity owners of a corporation, for example, may require the corporation itself to pay them fees for management services, which are deducted by the entity.

In situations where interest deductions might be limited, such arrangements could substitute for debt.

Tax-exempt organizations are subject to UBIT on the receipt of deductible payments from entities the organization controls. However, deductible payments might be shared between taxable and tax-exempt organizations in other ways. For example, taxable entities controlled by tax-exempt organizations might bear deductible costs that might otherwise be allocated to the controlling tax-exempt organization.

5. Incentives to use leveraged ESOPs

C Corporation ESOP leveraged transactions

Examples of leveraged transactions

In general

In a leveraged ESOP transaction, the trust of a retirement plan borrows funds, which are used to purchase employer stock either from the employer (e.g., to raise capital for the corporation), or from a third party with the employer's guarantee (e.g., to buy out an existing shareholder). Generally the sources of funds lent to a leveraged ESOP are banks and existing equity owners (seller financing). The purchased shares are collateral for the loan and are held by the ESOP in a suspense account. At the retirement plan trust level, the debt is nonrecourse debt with only the shares of employer stock acquired with the loan as security, but the debt is generally guaranteed by the employer corporation. The loan is repaid by the trust using contributions by the employer to the qualified retirement plan. As the loan is repaid with these employer contributions to the plan, the shares of stock are released from the suspense account and allocated to the accounts of plan participants. Leveraged ESOP financing may be used as a substitute for debt issued by the corporation. A corporation might use a leveraged ESOP to (1) provide new capital for expansion or improvements, (2) to buy out stock of a retiring owner (or owners), or (3) to divest a division of the corporation.

Mergers and divestitures

A leveraged ESOP may be used to acquire a company. For example, a leveraged ESOP maintained by the acquiring corporation or its subsidiary could borrow funds in an amount equal to the amount needed to acquire the target company. The proceeds of the loan would be used to purchase employer securities from the employer. The employer corporation (or a newly formed subsidiary) would then use the proceeds of the sale to purchase the stock or assets of the target

company. Finally, the employer corporation would make annual qualifed retirement plan contributions to the leveraged ESOP until the loan is repaid.

One variation of this leveraged-ESOP financing technique is for the employer to purchase target stock, either directly or through a subsidiary, using funds borrowed from a financial institution or other lender. Once the acquisition has been completed, the newly acquired subsidiary could establish a leveraged ESOP. The ESOP borrows money and purchases either newly issued stock of the subsidiary or stock of the subsidiary from the acquiring corporation; the acquiring corporation could then use the proceeds of this sale to pay off the original acquisition loan. The subsidiary would make annual qualified retirement plan contributions sufficient to amortize the ESOP loan and pay interest.

A leveraged ESOP could be similarly used in a divestiture. First, the employer corporation could create a subsidiary which sets up an ESOP. Next, the ESOP would borrow from a lender, with the parent corporation acting as a guarantor. The leveraged ESOP then acquires the stock of the newly formed corporation and that corporation would then make annual qualified retirement plan contributions to the leveraged ESOP to amortize the loans.

Purchase of shareholder interest

A leveraged ESOP transaction may be used to purchase the interest of an existing shareholder rather than having the shareholder sell to an unrelated third party. First, the ESOP would borrow the funds to purchase the stock, second the shareholder would sell the stock to the leveraged ESOP, and finally the employer corporation would make a contribution to the leveraged ESOP to amortize the loan. Perhaps one of the most significant tax incentives for using a leveraged ESOP transaction is that a shareholder of a closely held C corporation may defer the gain on the sale of qualifying employer securities to an ESOP through the purchase of qualifying replacement property if certain requirements are satisfied. For at least 10 years after the sale, no assets attributable to qualified employer securities may be allocated to the account of the seller under the ESOP. Immediately after the sale, the ESOP generally must own at least 30 percent of the employer corporation.

Advantages and disadvantages to a C corporation of using a leveraged ESOP for corporate financing

There are two primary tax advantages for a C corporation to using leveraged ESOPs for corporate financing.[315] First, because ESOP contributions are tax deductible as contributions to a qualified retirement plan, a corporation that repays an ESOP loan with employer contributions

[315] Those who favor the special tax benefits available to ESOPs generally argue that ESOPs serve to expand capital ownership to workers. Some would also argue that worker ownership, in turn, increases worker productivity and profitability of the company. Proponents of the tax benefit of ESOPs argue that leveraging is an integral part of the transfer of ownership process because borrowing is often the only way that an ESOP can obtain funds to acquire a significant block of employer securities. Those opposing these tax benefits argue that, for an employer in financial difficulties, ESOPs double the risk to employees by putting both their job and retirement plan benefits at risk.

to the ESOP is effectively able to deduct principal[316] as well as interest.[317] The deduction of payments for principal reduces the after-tax cost of the loan for the corporation. Second, dividends paid on ESOP stock passed through to employees or used to repay the ESOP loan are deductible by C corporations as plan contributions. This may further reduce the after-tax cost of the loan for the corporation.

The tax benefit of a deduction for principal and interest may also be achieved by the corporation borrowing directly from a third party lender and directly repaying the lender, and then contributing shares of employer stock to a qualified retirement[318] with a fair market value equal to the principal portion of the loan payment. This approach may allow the corporation to avoid certain costs and risks of using a leveraged ESOP. For example, the loan need not satisfy the requirements for the prohibited transaction exemption. However, this approach does not allow other tax benefits of a leveraged ESOP, such as deferral of gain by a selling shareholder for stock sold to the ESOP. Such deferral of gain may cause the shareholder to be willing to sell at a lower price. Similarly, there is no opportunity to repay the loan with dividends paid with respect to the employer stock held by the plan and obtain a deduction for those dividends.

S corporation ESOP leveraged transaction

General rules

The same types of transactions for which a C corporation uses a leveraged ESOP may also be used by an S corporation. However, given the inherent structure of an S corporation (which only permits one class of stock and up to 100 shareholders who generally must be U.S. individuals), an S corporation may be less likely to use a leveraged ESOP transaction for a merger or divestiture. An S corporation most commonly uses a leveraged ESOP transaction to buy out the interests of existing shareholders.

An S corporation with an ESOP may also need to borrow funds in order to cash out or reacquire shares from terminated employees or employees who decide to diversify their accounts. If reacquisitions are predictable or manageable, the S corporation may have sufficient

[316] The payment of principal is used to allow the shares of stock to be released from the suspense account and be allocated to the accounts of plan participants. In that respect, the contributions are not different from other contributions to qualified defined contribution plans that are used to purchase plan assets which are then allocated to participant accounts. In the context of a qualified retirement plan, it is the additional deduction of interest without regard to the general limitation on the deduction for plan contributions that is a departure from the normal rule.

[317] This tax benefit of a deduction for principal and interest may also be achieved by debt at the corporate level with direct repayment to the lender and contributions of the shares of employer stock to the plan equal to the principle payment on the loan rather than using a leveraged ESOP. However, this approach does not allow other tax benefits of a leveraged ESOP, such as deferral of gain by a selling shareholder for stock sold to the ESOP.

[318] Plan must be an eligible individual account plan under section 407 of ERISA which generally requires that the plan be a profit-sharing plan, stock bonus plan, or an ESOP.

tax-free[319] build up of assets to allow it to make these repurchases without incurring debt. However, unpredictable events may require a large unexpected reacquisition. Further the S corporation may decide that debt is a better mechanism for repurchases than depleting working capital.

A C corporation may structure a leveraged transaction using an ESOP and then make an S election after the ESOP and acquisition loan are in place.[320] In this case, a leveraged ESOP transaction might be used for a divestiture or even a transaction where a publicly held corporation becomes a privately owned corporation.[321]

A transaction that begins with the corporation being a C corporation may also allow a selling shareholder of a nonpublic C corporation to take advantage of the nonrecognition provisions for sales to an ESOP. To qualify for nonrecognition treatment by the seller, the stock when purchased by the ESOP must be stock of a nonpublic C corporation and the ESOP must retain the stock for at least three years after the sale but there is no requirement that it remain C corporation stock.

Tax benefits available to S corporations that maintain ESOPs

The special rules for allowing a deduction of the amount of loan payments of interest and the amount of dividends on employer stock held by the ESOP without regard to the 25 percent of compensation limit on qualified plan contributions are not available to an S corporation. However, the tax benefits of being exempt from both income tax and UBIT with respect to income on the shares of the S corporation stock held by an ESOP generally exceed these tax benefits available to C corporations. The potential for tax-free build up of income within the S corporation to provide working capital makes the company more viable and thus likely to be more attractive to lenders.

Further, to the extent that shares of the S corporation are held by the ESOP, the allowance or disallowance of deductions for contributions to the ESOP would not affect any shareholder's income tax liability. However, the amount in excess of the 25 percent limit may still be a nondeductible contribution and thus subject to the 10 percent excise tax at the S corporation level. The S corporation can avoid such a consequence by using cash distributions to the ESOP with respect to the stock the ESOP owns to repay the loan. However, in this case, if the stock is not 100-percent owned by the ESOP, cash distributions will also need to be made in the same proportion with respect to any shares of stock not owned by the ESOP.

---

[319] The S corporation would pay no tax on its earnings to the extent it is owned by an ESOP, whether or not it makes current distributions to the ESOP. In many cases, the S corporation ESOP owns all the stock of the corporation.

[320] See, e.g., Robert Willens, "ESOPs and S Corporations," *Tax Notes*, vol. 126, no 11 (March 15, 2010) 1407.

[321] Michael S. Knoll, "Samuel Zell, the Chicago Tribune, and the Emergence of the S ESOP: Understanding the Tax Advantages and Disadvantages of S ESOPs," 70 *Ohio State Law Journal* 519 (2009).

Role of warrants or similar interests in leveraged S corporation ESOP transaction

A leveraged ESOP transaction by an S corporation may include mezzanine debt with warrants (which in certain circumstances can provide options for shares that, when combined with the outstanding shares of the S corporation, are options for up to 49 percent of the stock).[322] Thus, for example, if the shareholders of an S corporation want to retire and sell their S corporation shares, they might decide to establish an ESOP and sell their shares to the ESOP in a leveraged transaction. The transaction might be structured as a combination of senior debt in the form of a bank loan and junior debt in the form of a loan by the seller. The senior debt is at the market rate for commercial lenders. The junior debt held by the seller may include warrants[323] in combination with an interest rate that is lower than the rate that actually reflects the level of risk associated with the junior debt. In fact the senior debt holder might condition its approval of the loan on the combination of debt and warrants at the junior debt level to reduce the cash drain on the S corporation during the initial years of the loan.

The seller may be willing to accept the warrant as consideration for the debt rather than interest because the seller can expect to recognize little ordinary interest income from the sale. Instead, when the warrant is put to the S corporation for cash, the warrant holder can recognize any return as long term capital gain, taxed at a lower rate than ordinary income.[324] To the extent that the S corporation is owned by the ESOP, its income is not taxed currently, and if not distributed to shareholders can accumulate tax-free. The seller may view this as increasing the potential for S corporation stock to appreciate in value during the period that the warrant is outstanding reducing the risk of accepting a warrant.

6. Financial accounting and other considerations

In general

Treatment of an instrument under rules other than tax rules can also affect the issuer. For example, the treatment as debt or equity under U.S. Generally Accepted Accounting Principles (hereinafter "GAAP" or "financial reporting") purposes can affect the issuer of financial statements in multiple ways. Similarly, the treatment for regulatory capital purposes is important

[322] The transaction must be structured so that is does not cause a nonallocation year. If no ESOP plan participants are disqualified persons, as defined in section 409(p)(4),and there is no other synthetic equity within the meaning of section 409(p)(6)(C) (and Treasury regulations)with respect to the S corporation, the transaction generally can provide for warrants for any portion up to (but still less than) 50 percent of the outstanding share of the S Corporation, after synthetic equity is taken into account, as part of the corporate finance transaction without causing a nonallocation year.

[323] Such warrants are frequently structured not to allow the seller to regain ownership of the S Corporation but rather to allow the seller to share in the profits during a specified period.

[324] The cash payment to the warrant holder dilutes the value of the S corporation and thus of the remaining ESOP stock and stock of any other shareholders. Furthermore, to the extent the payment reflects the tax-free increase in corporate value from S corporation income that was not taxed during the period that the lender held the warrant (because it was allocated to the tax-exempt ESOP), such income might not ever be paid to the ESOP or its employee beneficiaries.

to a financial institution subject to such requirements. The treatment by a ratings agency that rates the issuer's stock or bonds is also a consideration. This section describes general considerations under GAAP.

Consequences of debt classification

The classification of an instrument as debt for financial reporting purposes will generally have an impact on the computation of the company's net income. In general, any instrument treated as debt for financial reporting purposes will have an actual or imputed interest expense component. This interest expense must be taken into account in deriving net income and, therefore, earnings per share (generally determined by dividing net income by the number of shares issued and outstanding). Furthermore, some companies are required to meet interest coverage ratios[325] pursuant to covenants agreed to in existing loan documents.[326] The more interest expense a company is deemed to have, the more pressure may be put upon that company to generate sufficient earnings to meet these leverage coverage ratios to avoid being in violation of these debt covenants.

The classification of an instrument as a debt instrument will also increase that entity's leverage ratio.[327] This ratio is an important metric often used by lenders to determine whether an enterprise can obtain additional future financing, how expensive that financing will be (for example, incremental debt can reduce the issuer's credit rating), as well as whether that enterprise is in compliance with debt covenants under existing obligations.

From a balance sheet perspective, an instrument classified as debt will generally be recorded at historic cost with any accrued but unpaid interest also accounted for as a liability. The company, however, will be required to disclose the fair market value of the debt in the notes to its financial statements.

Consequences of equity classification

To the extent an instrument is, instead, classified as equity for financial reporting purposes, such a classification will generally not have the same impact on net income, interest coverage and leverage ratios. Rather than being treated as interest expense, a payment on equity is generally treated as a dividend which is taken into account as a reduction to the company's

---

[325] The interest coverage ratio is a measure of the number of times a company could make the interest payments on its debt with its earnings before interest and taxes ("EBIT"). In general, the lower the interest coverage ratio, the higher the company's debt burden and the greater the possibility of bankruptcy or default. The formula for the interest coverage rate is: EBIT (earnings before interest and taxes) / Interest Expense.

[326] Debt covenants are generally agreements between a company and its creditors requiring or forbidding certain actions of the company. For example, a company may be required under a covenant to limit other borrowing or to maintain a certain level of leverage.

[327] In general, the leverage ratio is a measure of the amount of equity in comparison to debt or the amount of earnings in comparison to debt. Although there are variations on the formula used, one leverage ratio, the debt-to-equity ratio, is as follows: (Short Term Debt + Long Term Debt) / Equity.

retained earnings rather than as a reduction to net income. Although payments on equity do not reduce net income, the issuance of an equity instrument generally will still have a dilutive impact on earnings per share (since the denominator, number of shares issued and outstanding, increases, while the numerator, net income, is not impacted by the additional equity issuance). Unlike debt, the issuance of equity will have no impact on the interest coverage ratio and will decrease the leverage ratio. Like debt, equity also is recorded on the balance sheet at its historical cost; however, there is no requirement that it be reflected at fair market value in the company's notes to the financial statements.

Financial accounting classification as either debt or equity

As with the Federal income tax rules, the classification of an instrument as debt (i.e., a liability) or equity for financial reporting purposes can be a challenging area for the issuers of financial statements. Financial reporting rules generally define a liability, including debt instruments, as a probable future sacrifice of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events. In general, a liability has three essential characteristics:

1. it embodies a present duty or responsibility to one or more other entities (including a business enterprise, an educational or charitable organization, a natural person and the like) that entails settlement by probable future transfer or use of assets at a specified or determinable date, on occurrence of a specified event, or on demand;

2. the duty or responsibility obligates a particular person, leaving it little or no discretion to avoid the future sacrifice; and

3. the transaction or other event obligating the entity has already happened.[328]

Solely with respect to financial instruments (and not contracts to provide services or other types of contracts), GAAP defines an obligation as a conditional or unconditional duty or responsibility to transfer assets or to issue equity shares.[329]

In contrast, in the case of a business enterprise, financial reporting rules generally define equity as the ownership interest in the enterprise stemming from ownership rights (or the equivalent) and involves a relation between the enterprise and its owners as owners rather than as employees, suppliers, customers, lenders, or in some other nonowner role. Since equity ranks

[328] FASB Concepts Statement No. 6 ("Con. 6"), par. 60. Although the FASB Concepts Statements do not establish generally accepted accounting standards, they are intended to serve the public interest by setting the objectives, qualitative characteristics, and other concepts that guide selection of economic phenomena to be recognized and measured for financial reporting and their display in financial statements or related means of communicating information to those who are interested. Furthermore, Concepts Statements guide the FASB in developing sound accounting principles and provide the FASB and its constituents with an understanding of the appropriate content and inherent limitations of financial reporting. Financial Accounting Standards Board, "FASB Home: Standards: Concepts Statements," http://www.fasb.org/jsp/FASB/Page/SectionPage&cid=1176156317989.

[329] ASC 480-10-20 - Distinguishing Liabilities from Equity: Overall: Glossary.

after liabilities as a claim to or interest in the assets of the enterprise, it is a residual interest: (a) equity is the same as net assets, the difference between the enterprise's assets and its liabilities, and (b) equity is enhanced or burdened by increases and decreases in net assets from nonowner sources as well as investments by owners and distributions to owners.[330] An enterprise may have several classes of equity (for example, one or more classes of common or preferred stock) with different degrees of risk stemming from different rights to participate in distributions of enterprise assets or different claims on enterprise assets in the event of liquidation.[331] Even so, all classes of equity depend at least to some extent on the enterprise's profitability for distributions of enterprise assets, and no class of equity carries an unconditional right to receive future transfers of assets from the enterprise except in liquidations, and then only after liabilities have been satisfied.[332]

Although the distinction between debt and equity is clear in concept, it can be obscured in practice as securities issued by business enterprises may have characteristics of both debt and equity in varying degrees. Additionally, the names given to these securities may not be reflective of their essential nature. By way of example, a bond may be viewed as a classic illustration of a debt instrument. Nonetheless, the traditional distinction between stocks and bonds has become blurred through the increased use of instruments with characteristics of both debt and equity. For example, convertible bonds have both liability and residual interest characteristics. Additionally, preferred stock, may have characteristics more reflective of debt such as maturity amounts and dates at which it must be redeemed.[333]

The mixed characteristics of these securities have historically made accounting for them under GAAP a challenge. Convertible bonds typically give their holder the right to exchange the bond for common stock under certain stipulated terms. In circumstances in which these instruments can be settled wholly or partly in cash, GAAP requires the issuer of the instrument to split the instrument into its debt and equity components. The issuer accomplishes this by first valuing the debt component and then subtracting this value from the total proceeds received to derive the equity component. As discussed above, although Congress gave Treasury regulatory authority under section 385 to treat an interest in a corporation as part debt and part equity in 1989, no regulations have been promulgated. The U.S. tax rules generally treat an instrument as all debt or all equity.

---

[330] Con. 6, par. 60.

[331] An equity security is defined as any security representing an ownership interest in an entity (for example, common, preferred or other capital stock) or the right to acquire (for example, warrants, rights and call options) or dispose of (for example, put options) an ownership interest in an entity at a fixed or determinable price. The term equity security does not include any of the following: a.) written equity options; b.) cash-settled options on equity securities or options on equity-based indexes; and c.) convertible debt or preferred stock that by its terms either must be redeemed by the issuing entity or is redeemable at the option of the investor. ASC 320-10-20 - Debt and Equity Securities: Overall: Glossary.

[332] Con. 6, par. 62.

[333] Con. 6, par. 55.

In other cases, GAAP requires financial instruments with some characteristics of debt and equity to be classified as a liability. An example is a mandatorily redeemable financial instrument such as mandatorily redeemable preferred stock. These instruments are structured such that they embody an unconditional obligation requiring the issuer of the instrument to redeem it by transferring its assets at a specified or determinable date (or dates) or upon an event that is certain to occur.

The FASB and International Accounting Standards Board ("IASB") are undertaking a joint project to develop a comprehensive standard on financial instruments with characteristics of equity, liabilities or both. Among other goals, this guidance is expected to revisit the definition of liabilities mentioned above.[334]

[334] Prior to the project becoming a joint effort between the FASB and IASB, the FASB issued a report with its preliminary views in November 2007 soliciting comments. This report recommended an approach that would classify an instrument as equity if it (1) is the most subordinated interest in an entity and (2) entitles the holder to a share of the entity's net assets after all higher priority claims have been satisfied. All other instruments including forward contracts, options and convertible debt would be classified as liabilities or assets. Financial Accounting Standards Board, *Preliminary Views: Financial Instruments with Characteristics of Equity* (No. 1550-11), November 2007. Although several comment letters were received that critiqued various aspects of the FASB report, an update to these preliminary views have not been released.

IV. TAX TREATMENT OF CORPORATE DEBT IN SELECTED COUNTRIES

A. Summary

There are similarities and differences in the tax treatment of corporate debt across countries. A strict country-to-country comparison of these provisions is difficult because each country has distinct market institutions as well as a distinct set of policies (both tax and nontax) that may be similar in certain ways but dissimilar in others. A comprehensive analysis of foreign taxation of corporate debt is therefore beyond the scope of this publication. However, following is a brief overview of the similarities and differences in key tax provisions of corporate debt across seven countries: Australia, Canada, France, Germany, Japan, Mexico, and the United Kingdom.

Thin capitalization rules[335]

Thin capitalization rules, which are intended to limit interest deductions for highly leveraged companies, vary across the seven countries.

In Australia, corporate debt deductions are denied when an entity's worldwide debt-to-equity ratio of 3:1 is exceeded. Canada also has thin capitalization rules that require interest payments withdrawn by non-residents from resident corporations to be treated as dividends that must be paid out of earnings accumulated after Canadian tax. In France, a borrowing corporation is deemed thinly-capitalized if the overall indebtedness granted by related parties exceeds 1.5 times the net equity of the borrower, the amount of interest exceeds 25 percent of the adjusted operating profits realized by the borrower, and the amount of interest paid to related parties exceeds the amount of interest received from affiliated parties. Under rules enacted in Germany in 2008, a company's excess of interest expense over interest income is deductible only up to 30 percent of the company's taxable income before interest, taxes, and depreciation and amortization unless one of three possible exceptions applies. The rules apply irrespective of where the ultimate shareholders of the company are residents of Germany. Japan's thin capitalization rules provide that when liabilities exceed three times the capital held by the foreign controlling shareholder, the amount of interest payable on the excess amount is not deductible. Also, when a company maintains less than a 3:1 debt-to-equity ratio, it is not treated as thinly capitalized. In Mexico, a corporate taxpayer may not deduct interest derived from the amount of its debt contracted with nonresident related parties that exceeds three times its equity. Interest deductions in the United Kingdom may be limited if the amount of a borrowing, either domestic or cross-border, exceeds what is considered an arm's-length amount.

[335] For a more detailed description of the treatment of expenses, including interest, in Australia, Canada, France, Germany, Japan, and the United Kingdom, see Joint Committee on Taxation, *Background and Selected Issues Related to the U.S. International Tax System and Systems that Exempt Foreign Business Income* (JCX-33-11), May 20, 2011.

General anti-avoidance rules

As just described, the seven surveyed countries have specific rules that limit interest deductions in particular situations in which taxpayers are thinly capitalized. Four of the seven countries, Australia, Canada, France, and Germany, also have what are commonly referred to as general anti-avoidance rules (often termed GAARs) intended to prevent inappropriate tax reduction through transactions that may satisfy the literal requirements of the tax rules but that violate the intent of those rules. Application of these GAARs may limit interest deductions in circumstances that are determined to be abusive or non-arm's-length.

Limitations on double taxation of corporate earnings

Countries may limit double taxation of corporate earnings by various means. The United States, for example, imposes a reduced rate of taxation (generally 15 percent) on dividends received by individual shareholders from domestic corporations and some foreign corporations. Other countries, including Australia, Canada, and Mexico, have what are referred to as imputation systems under which resident shareholders who receive dividend distributions are credited with their shares of the corporate tax imposed on the earnings out of which the dividends have been paid.

In part to comply with European Union rules forbidding countries from discriminating against residents of other European Union countries, some European countries such as Germany have abandoned their imputation systems because, for instance, the systems had been available only to resident shareholders.

Treatment of cancelled debt

In Australia, if a debt is "commercial,"[336] then the creditor may be able to claim a deduction in relation to waiving the debt, while the amount of the forgiven debt may be applied to reduce certain deductions of the debtor. However, these debt forgiveness rules do not apply if the debtor is a shareholder or employee of the company. Similarly, in Canada the forgiven amount of a debt is used to reduce non-capital losses and capital loss carryforwards. In France, the creditor of cancelled debt may deduct the amount if the cancellation is considered of "normal nature."

In Germany, Japan, Mexico and the United Kingdom, cancelled debt is considered taxable income for the corporate taxpayer.

[336] A debt is "commercial" if "part or all of the interest payable on the debt is, or would be, an allowable deduction."

B. Law Library of Congress: Tax Treatment of Corporate Debt

Following is the Report for Congress, June 2011, Tax Treatment of Corporate Debt, prepared by the Law Library of Congress.

The Law Library of Congress

REPORT FOR CONGRESS

June 2011

Global Legal Research Center
LL File No. 2011-005756

TAX TREATMENT OF CORPORATE DEBT

This report deals with the deductibility of corporate interest expenses in Australia, Canada, France, Germany, Japan, Mexico, and the United Kingdom. It focuses on equity-stripping and thin capitalization rules and also discusses other tax-related limitations on debt financing, the deductibility of corporate distributions, and the treatment of debt forgiveness.

The Library of Congress
James Madison Memorial Building, 101 Independence Avenue, S.E., Room LM-240
Washington, DC 20540-3200
(202) 707-6462 (phone), (866) 550-0442 (fax), law@loc.gov (email)
http://www.loc.gov/law

2011–005756

LAW LIBRARY OF CONGRESS

AUSTRALIA

TAX TREATMENT OF CORPORATE DEBT

Executive Summary

Under Australian tax law, the interest paid on a debt by a company is deductible if it meets the criteria of the general deduction provision. Specific rules apply to determine whether an interest in a company is classed as debt or equity, and therefore whether a resulting payment is deductible interest or a nondeductible dividend. Interest deductions are limited by thin capitalization rules and by other anti-avoidance provisions that allow the Commissioner of Taxation to cancel tax benefits that arise from tax avoidance arrangements. Rules also apply that may result in a distribution being deemed to be a dividend, particularly in situations involving related parties.

I. Introduction

The Australian Income Tax Assessment Act 1997 (Cth) contains a general deduction provision and also sets out specific deductions that may be claimed by businesses.[1] The general deduction provision, section 8-1, allows businesses to claim a deduction for interest on loans, provided it is an expense that is incurred in gaining or producing taxable income[2] or is necessarily incurred in carrying on a business for the purpose of gaining or producing taxable income.[3] The ability to deduct interest expenses is, however, limited by the second part of section 8-1, which state that an expense cannot be deducted to the extent that it is of a capital, private, or domestic nature, if it is incurred in relation to gaining or producing exempt income, or if another provision prevents it from being deductible.[4] Expenditure that is deductible under section 8-1 is generally deductible in full in the year it is incurred.[5]

---

[1] *Income Tax Assessment Act 1997* (Cth) (ITAA 1997), *available at* http://www.comlaw.gov.au/Details/C2011C00374. Additional rules relevant to this report are contained in the *Income Tax Assessment Act 1936* (Cth) (ITAA 1936), *available at* http://www.comlaw.gov.au/Details/C2011C00427.

[2] Gross taxable income is called "assessable income" in Australia. The net taxable income that remains after deductions have been taken out is then called "taxable income." *See* ITAA 1997 s 4-15(1). However, for the purposes of clarity, this report uses "taxable income" throughout to refer to gross taxable income.

[3] ITAA 1997 s 8-1.

[4] ITAA 1997 s 8-1(2).

[5] R.L. DEUTSCH ET AL., AUSTRALIAN TAX HANDBOOK 867 (2009).

Debt/equity rules were introduced in 2001. These rules define what can be classed as equity in a company and what constitutes debt for tax purposes.[6] The tests therefore determine whether a distribution by a company is treated as a dividend or as deductible interest on a debt. The rules are also important in determining what deductions may be disallowed under the thin capitalization rules, which were also expanded in 2001.

II. Limitations on the Deductibility of Interest

A. Thin Capitalization or Equity-Stripping Rules

Thin capitalization rules "operate when the amount of debt used to finance the Australian operations exceeds specified limits."[7] The aim of the rules is to "limit the amount of debt that can be allocated to Australian entities that are foreign-controlled and to non-residents with Australian investments, as well as Australian companies with overseas investments."[8] In addition to applying to both inbound and outbound investors, the current thin capitalization regime "limits the deductions relating to the total debt of the Australian operations of those investors, rather than the foreign debt only."[9]

Under the rules, when the entity's overall debt-to-equity ratio of 3:1 (20:1 for financial entities) is exceeded, debt deductions (including interest deductions) in relation to the excess "will be permanently denied."[10] However, debt deductions will not be denied if the entity shows that the debt amount is at arm's length.[11] The provisions may also be avoided if Australian entities with overseas investments show that the average value of their Australian assets constitutes at least 90 percent of their worldwide assets.[12] Furthermore, the rules do not apply to taxpayers whose annual debt deductions do not exceed AU$250,000 (about US$266,000).

Whether an interest in a company is characterized as debt or equity is relevant to determining the application of the thin capitalization rules, as well as the imputation system (described below). Debt/equity rules introduced in 2001 "operate to determine what constitutes equity in a company and what constitutes debt for tax purposes."[13] The rules classify an interest

---

[6] These rules were introduced through the *New Business Tax System (Debt and Equity) Bill 2001*. For a detailed explanation of the rules, *see* Parliament of the Commonwealth of Australia, New Business Tax System (Debt and Equity) Bill 2001 – Explanatory Memorandum, *available at* http://www.austlii.edu.au/au/legis/cth/bill_em/nbtsaeb2001441/memo1.html.

[7] AUSTRALIAN MASTER TAX GUIDE 1303 (CCH Australia, 47th ed. 2010). The thin capitalization rules are contained in ITAA 1997 Div 820.

[8] Tom Toryanik, *Australia – Corporate Taxation* ¶ 10.3., INTERNATIONAL BUREAU OF FISCAL DOCUMENTATION [IBFD]: COUNTRY ANALYSES (AUSTRALIA), http://ip-online.ibfd.org/kbase/ (by subscription) (last visited June 17, 2011).

[9] AUSTRALIAN MASTER TAX GUIDE, *supra* note 7, at 1,304.

[10] Toryanik, *supra* note 8, ¶ 10.3.

[11] *Id.*

[12] *Id.*

[13] *Id.*, ¶ 10.6.

in a company "according to the economic substance of the rights and obligations of an arrangement," rather than just looking at its legal form.[14] They apply only to financing arrangements.[15] Broadly, "a financing arrangement is a scheme entered into or undertaken to raise finance for the company or a connected entity, or to fund another financing arrangement."[16]

Essentially, if the interest in a company is considered to be an equity interest, the distributions arising from it may be dividends, whereas if it constitutes debt the interest payments made by the company may be deductible under the deduction provisions.

An interest in a company will be considered a debt interest where:

- the scheme is a financing arrangement (defined above) or is one that constitutes a share;
- the entity or associate receives or will receive a financial benefit under the scheme;
- the entity or a connected entity has an effectively non-contingent obligation under the scheme to provide a financial benefit in the future; and
- it is substantially more likely than not that the value of the financial benefit to be provided will equal or exceed the value of the financial benefit received.[17]

If the return paid on the debt interest meets the general deduction criteria in section 8-1 it will be deductible.[18] Even if it does not meet the criteria it may still be deductible but "the deduction is capped by reference to the rate of return on an equivalent straight debt interest, increased by a margin to recognize the premium paid for the increased risk of non-payment because of the contingency."[19] Under the legislation, the limit is the benchmark rate of return plus 150 basis points (i.e., 1.5 percent).[20]

Special rules apply to "at-call" loans from related parties. These loans do not have a fixed term and are repayable on demand. Such loans "are treated as debt interests if the borrowing company has an annual turnover of not less than AU$20 million [about US$21.17 million]."[21]

---

[14] *Id.*

[15] *See* ITAA 1997 Div 974.

[16] Toryanik, *supra* note 8, ¶ 10.6. *See also* AUSTRALIAN MASTER TAX GUIDE, *supra* note 7, at 1,267; ITAA 1997 s 974-130.

[17] Toryanik, *supra* note 8, ¶ 10.6 (referring to ITAA 1997 s 974-20). Note that "if the term of the interest is 10 years or less, the amount to be paid to the holder must equal or exceed the issue price in nominal value terms. If the term of the interest is greater than ten years, the amount to be paid to the holder must equal or exceed the issue price in present value terms." *Id.* (referring to ITAA 1997 s 974-35).

[18] AUSTRALIAN MASTER TAX GUIDE, *supra* note 7, at 1,269.

[19] Toryanik, *supra* note 8, ¶ 10.6.

[20] *Id. See also* AUSTRALIAN MASTER TAX GUIDE, *supra* note 7, at 1,269 (referring to ITAA 1997 s 25-85). This rule is mirrored in the rules relating to the Taxation of Financial Arrangements, which are referred to below.

[21] Toryanik, *supra* note 8, ¶ 10.6 (referring to ITAA 1997 s 974-75).

Where an interest is not a debt interest, it will be an equity interest if it arises under the following financial arrangements:

- shares;
- interests providing variable or fixed returns from the company that are contingent on economic performance, or at the discretion of the company; and
- interests that may or will convert into such equity interests.[22]

Where an equity interest is not a share in a legal form it is called a "non-share equity interest" and is generally treated in the same way as a share for tax purposes. Shares that are debt interests are known as "non-equity shares." They are not equity interests but are still treated as shares for tax purposes, although the dividends paid are not able to be franked under the imputation system, and thus, the recipient may not claim a tax credit for them.[23]

B. Limits on Borrowing for Tax-Exempt Income

As noted in the introduction to this report, expenses incurred in gaining exempt income are not deductible under the general deduction provision (section 8-1). Exempt income can be divided into three main classes: income of particular entities that are exempt from income tax, regardless of what kind of income they have (e.g., charities, trade unions); income of a particular type that is exempt from income tax, no matter who earns it; and income of a particular type that is exempt only if it is derived by certain entities.[24] An entity will not be exempt merely because it is controlled by an entity; the company must itself be covered by the relevant provisions.[25]

Anti-avoidance provisions apply to ensure that "entities that would otherwise be tax exempt are specifically made liable to pay tax on income that is diverted to them as part of a tax avoidance agreement, e.g., where a person with a right to receive an amount on which he/she would be liable to pay tax assigns that right to an exempt entity for a lesser or non-taxable amount."[26] No deductions are allowed for expenses incurred under or in connection with a tax avoidance agreement.[27] In addition, "a tax-exempt entity that distributes funds offshore may be penalized" as a result of anti-avoidance rules.[28] These rules have the effect of disqualifying charitable trusts from exempt status if they directly distribute funds overseas, or if overseas

---

[22] *Id.* (referring to ITAA 1997 s 974-130).

[23] *Id.* Franked dividends are dividends paid by an Australian resident company from profits that have had Australian tax paid on them. Under Australia's imputation system, a shareholder can receive a tax offset for franking credits that are attached to a dividend. If dividends are not franked, no franking credits are available to the recipient. *See infra*, notes 53 and 54, and accompanying text.

[24] AUSTRALIAN MASTER TAX GUIDE, *supra* note 7, at 432 (referring to ITAA 1997 ss 11-1, 11-5, 11-10, and 11-15).

[25] *Id.* at 433 (referring to ITAA 1936 Pt III Div 9C).

[26] *Id.* at 438.

[27] *Id.*

[28] ROBIN WOELLNER ET AL., AUSTRALIAN TAXATION LAW SELECT 1,015 (2011) (referring to ITAA 1997 ss 50-60 to 50-70).

organizations with a physical presence in Australia do not incur expenditure or pursue their objectives principally in Australia.[29]

III. Tax-Related or Other Limitations on Debt Financing

A. Tax-Related Limitations

The legislation includes a general anti-avoidance rule that allows the Australian Commissioner of Taxation to cancel the effects of any tax benefits that a taxpayer derives from an agreement or arrangement entered into for the purpose of obtaining a tax benefit, such as a deduction being allowed.[30] This includes where a benefit is obtained by the stripping of company profits as a result of a "dividend stripping" or a similar scheme, including one that involves the disposal of property by way of the payment of a dividend or the making of a loan by the company.[31]

In addition, other anti-avoidance provisions mean that payments to related entities "are deductible only to the extent to which, in the Commissioner's opinion, they are reasonable in amount."[32] An amount that is in excess of what is reasonable is not deductible. The Australian Taxation Office considers that if the amount paid is equivalent to an arm's length payment, the whole payment will be a reasonable amount.[33] Similarly, where a taxpayer prepays interest with the aim of reducing the nondeductible capital amount payable for a property, deductions may be denied unless the amount was no more than what would be expected to be paid under an arm's length transaction.[34]

Provisions targeted at hidden profit distributions mean that amounts that are paid, loaned, or forgiven by a private company to certain associates, including individual shareholders, may be deemed to be dividends and therefore nondeductible.[35] Such dividends are included in the taxable income of the recipient and are generally unfrankable (see the explanation of the imputation system, below).[36] However, there is an exclusion from this rule for all payments and loans to another company.[37]

---

[29] *Id.*

[30] Toryanik, *supra* note 8, ¶ 10.1. The general anti-avoidance rules are set out in ITAA 1936 Pt IVA.

[31] ITAA 1936 s 177E.

[32] R.L. DEUTSCH ET AL., *supra* note 5, at 762 (referring to ITAA 1997 s 26-35). *See also* ROBIN WOELLNER ET AL., *supra* note 28, at 1,131. In the case of a partnership this includes, for example, relatives of a partner and "an individual, company or other entity that is or has been a shareholder in a company that is a partner in the partnership and which is a private company for the income year." *Id.*

[33] *Id.*

[34] AUSTRALIAN MASTER TAX GUIDE, *supra* note 7, at 880 (referring to ITAA 1936 s 82KJ).

[35] *Id.* at 123. These anti-avoidance provisions are contained in ITAA 1936 Pt III Div 7A.

[36] *Id.* at 124.

[37] Toryanik, *supra* note 8, ¶ 1.2.1.1. *See also* AUSTRALIAN MASTER TAX GUIDE, *supra* note 7, at 125–27; ROBIN WOELLNER ET AL., *supra* note 28, at 1,448 (referring to ITAA 1936 s 109K).

Payments made to shareholders or directors of a company, or their relatives, or to persons associated with a partner of a partnership, may also be treated as dividends where they are considered unreasonably high.[38] Deductions will be denied for the amount that is deemed to be a dividend.

B. Other Limitations

In 2009, the Tax Laws Amendment (Taxation of Financial Arrangements) Act 2009 was enacted.[39] This legislation implemented the final stages of the reforms that saw the introduction of new rules, known as the Taxation of Financial Arrangements (TOFA) rules, regarding the tax treatment of gains and losses from financial arrangements. These rules are aimed at emphasizing the economic effects of an arrangement instead of its legal form.[40] Aspects of the debt/equity rules and thin capitalization rules referred to above were part of the first stages of the implementation of the TOFA rules.[41] The TOFA rules are compulsory for entities with an annual turnover or aggregate financial assets of AU$100 million (about US$106 million) or more. Taxpayers that are not subject to the rules may also elect to use them. The TOFA rules apply to arrangements that involve "cash-settleable" rights or obligations to receive or provide a financial benefit.[42] Under the rules, there are specific limitations and conditions on deductions arising from such arrangements. This includes "a deduction limit of 150 basis points over the benchmark rate of return for returns on debt instruments that are contingent on economic performance."[43]

IV. Deductions for Corporate Profit Distributions

A. Basic Principles of Taxing Corporate Income

Companies pay a flat rate of tax, which is currently 30 percent.[44] Australian resident companies are taxed on their income from all sources, whether within or outside of Australia.[45] Nonresident companies are taxed only on their Australian-sourced income.[46] Generally, an

---

[38] Toryanik, *supra* note 8, ¶ 1.2.1.1. (referring to ITAA 1936 ss 65 and 109). *See also* ROBIN WOELLNER ET AL., *supra* note 28, at 1,449.

[39] *Tax Laws Amendment (Taxation of Financial Arrangements)* 2009 (Cth), *available at* http://www.comlaw.gov.au/Details/C2011C00030.

[40] *See Guide to the Taxation of Financial Arrangements (TOFA) Rules*, AUSTRALIAN TAXATION OFFICE (ATO), http://www.ato.gov.au/businesses/content.aspx?doc=/content/00194622.htm&pc=001/003/109/001/002&mnu=0&mfp=&st=&cy= (last visited June 17, 2011).

[41] *Id.*

[42] Toryanik, *supra* note 8, ¶ 1.2.1.2.1.

[43] *Id.* (referring to ITAA 1997 s 820-15). This mirrors ITAA 1997 s 25-85, referred to above.

[44] *Income Tax Rates Act 1986* (Cth) s 23(2); 24; 25, *available at* http://www.comlaw.gov.au/Details/C2011C00187. This is the "general corporate tax rate." Special rates apply to certain companies, such as life insurance companies and non-profit companies.

[45] AUSTRALIAN MASTER TAX GUIDE, *supra* note 7, at 17 & 56. *See also* ITAA 1997 ss 6-5 and 6-10.

[46] *Id.*

Australian branch of a foreign resident company is not a separate entity from the company itself and has the same residence status.[47]

Special rules apply in relation to income derived by Australian resident companies from foreign resident companies or from other foreign sources.[48] Generally, amounts paid by certain foreign companies and trusts may be "attributed" to an Australian resident,[49] while there are also rules that exempt "non-portfolio dividends,[50] income of foreign branches conducting an active business and disposal of non-portfolio interests in foreign companies conducting an active business."[51] Where foreign tax has been paid on foreign source income, Australia "uses the credit method to grant relief from the effects of international double taxation."[52]

In terms of profit distributions, Australia operates an imputation system that allows Australian resident companies to pass on credits to shareholders for the tax that has already been paid on the profits.[53] To do so, an entity must "frank" a distribution to a shareholder. Only those distributions that are attributable to a company's realized taxed profits are able to be franked.[54] A resident individual or corporate entity that receives a franked distribution then includes the amount of the franking credit on the distribution in their gross taxable income and is entitled to a tax offset equal to the amount of the franking credit.[55]

Distributions of franked dividends to nonresident shareholders are not subject to a withholding tax.[56] Nonresidents do not need to include the franking credit in their gross taxable income and are not entitled to a tax offset for the credit.[57]

---

[47] *Id.* at 56. However, a special tax regime provides limited separate entity treatment to Australian branches of foreign banks and foreign financial entities. *See* ITAA 1936 Pt IIIB.

[48] *Id.* at 58.

[49] R.L. DEUTSCH ET AL., *supra* note 5, at 11. There are three broad provisions that subject the income of a foreign company or trust to Australian taxation: the controlled foreign company (CFC), transferor trust, and foreign investment fund (FIF) rules.

[50] A dividend is a "non-portfolio dividend" if the company receiving it has "an interest of 10% or more in the voting power of the distributing company at the time the dividend is paid." Toryanik, *supra* note 8, ¶ 7.2.1.3. Note that while this income is not taxable and therefore interest incurred in relation to deriving it would be denied under ITAA 1997 s 8-1, a deduction is allowed for such interest under s 23AJ. *See id.* ¶ 1.4.5.

[51] Toryanik, *supra* note 8, ¶¶ 7.2.1.1, 7.2.6. *See also* ITAA 1936 ss 23AI, 23AJ.

[52] Toryanik, *supra* note 8, ¶ 7.2.6.

[53] *Id.* ¶ 6.1.1.

[54] *Id.*

[55] *Id.* ¶ 6.1.1. *See also* ITAA 1997 s 207-20; Toryanik, *supra* note 8, ¶ 1.4.4 (stating that "from 1 July 2002, the rebate for intercorporate dividends was replaced by the simplified imputation system. As such, intercorporate dividends are generally included in the assessable income of the recipient."); *id.* ¶ 1.2.1.1. (stating that "A resident shareholder of a company is liable to income tax on all dividends paid to him by the company out of profits derived by it from any source (Sec. 44(1)(a) ITAA 36), except those which are exempt from tax in certain circumstances.").

[56] *Id.* ¶ 6.1.2. and 6.1.1. *See also id.* ¶ 1.2.1.1. (stating that "A non-resident is liable to income tax on all dividends paid out of profits derived from sources in Australia. It is irrelevant whether the dividends are paid by resident or non-resident companies (Sec. 44(1)(b) ITAA 36). Nevertheless, if dividends are subject to withholding

B. Deductibility of Distributions

In general, dividends are not deductible for the distributing company.[58] However, dividends paid under instruments that are classified as "debt" under the debt/equity rules discussed above are deductible, subject to limitations.[59] In addition, "a deduction may be allowed for on-payments of unfranked non-portfolio dividends (including non-share dividends) by an Australian resident company to its foreign resident parent."[60]

V. Deductions for Distributing Dividends Under an Employee Stock Ownership Plan

New laws relating to the taxation of Employee Share Schemes (ESS) came into effect from July 1, 2009.[61] An ESS is "a scheme under which ESS interests in a company are provided to employees (including past or prospective employees and their associates) in relation to the employee's employment."[62] Such schemes are now specifically excluded from being taxed under the standard fringe benefit provisions[63] and will qualify for concessional treatment depending on the type[64] of scheme offered and if certain conditions[65] are met. In some cases, up to an AU$1,000 (about US$1,060) concession is available to an employee participating in a "taxed up-front" scheme where the employee's net taxable income is AU$180,000 (about US$190,480) or less.[66]

---

tax or would be subject to withholding tax if they were not franked, they are exempt from ordinary income tax (Sec. 128D ITAA 36).").

[57] *Id.* ¶ 6.1.1.

[58] *Id.* ¶ 1.4.5.

[59] *Id.*

[60] AUSTRALIAN MASTER TAX GUIDE, *supra* note 7, at 106 (referring to ITAA 1936 s 46FA). A "non-portfolio dividend" is, broadly speaking, a dividend paid to a company with at least a 10 percent voting interest in the company paying the dividend.

[61] *ESS – Guide for Employers*, ATO, http://www.ato.gov.au/businesses/content.aspx?doc=/content/00224626.htm (last visited June 20, 2011). *See generally Employee Share Schemes*, ATO, http://www.ato.gov.au/businesses/pathway.aspx?pc=001/003/120&mfp=001/003&mnu=49312#001_003_120 (last visited June 20, 2011).

[62] *ESS – Guide for Employers: Taxation Arrangements for Employee Share Schemes*, ATO, http://www.ato.gov.au/businesses/content.aspx?menuid=0&doc=/content/00224626.htm&page=3&H3 (last visited June 20, 2011).

[63] *See* Toryanik, *supra* note 8, ¶ 4.3. The rules relating to the taxation of fringe benefits are contained in the *Fringe Benefits Tax Assessment 1986* (Cth).

[64] *ESS – Guide for Employers: Types of Employee Share Schemes*, ATO, http://www.ato.gov.au/businesses/content.aspx?menuid=0&doc=/content/00224626.htm&page=4&H4 (last visited June 20, 2011).

[65] *ESS – Guide for Employers: General Conditions for Concessional Tax Treatment*, ATO, http://www.ato.gov.au/businesses/content.aspx?menuid=0&doc=/content/00224626.htm&page=5&H5 (last visited June 20, 2011).

[66] *ESS – Guide for Employers: Taxed-upfront Schemes*, ATO, http://www.ato.gov.au/businesses/content.aspx?menuid=0&doc=/content/00224626.htm&page=6&H6 (last visited June 20, 2011).

Generally, there is no deduction available for employers who issue interests to employees under an ESS. However, the new rules provide for a limited deduction in situations where the above $1,000 concession is available. Where an employer provides interest in such a scheme, "a deduction equal to the amount of the upfront concession is available to employers up to a maximum of $1,000."[67] A general deduction may also be available if an employer provides "money or other property to an employee share trust to enable it to acquire securities to provide" to employees who then have "an interest in a specific number of shares in the trust (rather than specific shares)."[68]

VI. Treatment of Debt Cancellation

Debt forgiveness rules apply to the "commercial debts" of both businesses and individuals.[69] A debt is "commercial" if "part or all of the interest payable on the debt is, or would be, an allowable deduction."[70] Under these rules, the creditor may be able to claim a deduction in relation to waiving the debt, while (in order to avoid double deductions) the amount of debt that is forgiven may need to be applied to reduce certain deductions of the debtor.[71] Specifically, a forgiven amount may reduce, in the following order, a taxpayer's prior income year revenue losses, net capital losses from earlier years, deductible expenditure, and cost base and reduced cost base of assets.[72]

In line with the above reference to payments to related entities, the debt forgiveness rules will not apply where the debtor is a shareholder of the company. They will also not apply where the debtor is an employee and the forgiveness constitutes a form of benefit or payment arising from the employment relationship.[73] In those situations the forgiven amount will be deemed to be a dividend or considered a fringe benefit and treated as such for tax purposes. The commercial debt forgiveness rules also do not apply if the debt is forgiven as a result of an action under bankruptcy law, in a deceased person's will, or for reasons of "natural love and affection."[74]

---

[67] *ESS – Guide for Employers: Deduction by Employers*, ATO, http://www.ato.gov.au/businesses/content.aspx?menuid=0&doc=/content/00224626.htm&page=30&H30 (last visited June 20, 2011).

[68] *ESS – Guide for Employers: Share Trusts*, ATO, http://www.ato.gov.au/businesses/content.aspx?menuid=0&doc=/content/00224626.htm&page=32#P553_50390 (last visited June 20, 2011).

[69] *See* ITAA 1997 Div 245. A debt is defined for these purposes as "an enforceable obligation imposed by law on a person to pay an amount to another person, and includes accrued interest." DEUTSCH ET AL., *supra* note 5, at 779.

[70] *CGT and Debt Forgiveness*, ATO, http://www.ato.gov.au/content/36559.htm (last modified May 18, 2011). *See also* DEUTSCH ET AL., *supra* note 5, at 779.

[71] DEUTSCH ET AL., *supra* note 5, at 779.

[72] *CGT and Debt Forgiveness*, *supra* note 70.

[73] AUSTRALIAN MASTER TAX GUIDE, *supra* note 7, at 980.

[74] *CGT and Debt Forgiveness*, *supra* note 70.

Prepared by Kelly Buchanan
Foreign Law Specialist
June 2011

2011–005756

LAW LIBRARY OF CONGRESS

CANADA

TAX TREATMENT OF CORPORATE DEBT

Executive Summary

A reasonable amount of interest paid by a business on money borrowed to earn income is generally deductible in calculating taxable income. Interest paid on money borrowed to produce tax-exempt income is not deductible. Thin capitalization rules exist to prevent nonresidents from withdrawing corporate profits in the form of interest payments. Canadian law does not establish equity thresholds. Dividends received by individual taxpayers are taxable. Such dividends are multiplied by 125 or 144 percent, but a tax credit can then be claimed to reduce the amount otherwise owing. Canada's tax laws do not directly address employee stock ownership plans, but do contain debt forgiveness rules. Under these rules, half of the amount forgiven is generally taxable after non-capital and capital losses are taken into account.

I. Introduction

The general rule under Canada's Income Tax Act (I.T.A.) is that a reasonable amount of interest paid on money borrowed for the purpose of earning income from a business or property is deductible in the year in which it is paid, provided that there was a legal obligation to pay the interest and the money was not borrowed to earn tax-exempt income or acquire a life insurance policy.[1] The provision of the Income Tax Act that creates this general rule was added after the courts had ruled that interest paid on acquired properties should generally be capitalized.[2] The addition of this rule has not, however, ended litigation over the deductibility of interest paid by a business. Such questions as what is a reasonable amount, what is a legal obligation, what is interest, and what must be shown to demonstrate an intention to earn income have all been extensively reviewed by the judiciary and tax authorities. The Canada Revenue Agency has issued an Interpretation Bulletin on Interest Deductibility and Related Issues.[3] The Bulletin is not binding on the courts, but summarizes the Agency's interpretation of the current state of the law.

---

[1] Income Tax Act, R.S.C. ch. 1, § 20(1)(c) (5th Supp. 1989), *as amended*, http://laws-lois.justice.gc.ca/eng/acts/I-3.3/index.html.

[2] 2 Canadian Tax Rep. (CCH Canada) ¶ 5061a.

[3] Canada Revenue Agency, Interest Deductibility and Related Issues, No. IT-533 (Oct. 31, 2003), http://www.cra-arc.gc.ca/E/pub/tp/it533/it533-e.html.

One other notable restriction on the deductibility of interest by a business is that interest paid on money borrowed to acquire property in the hope of earning only a capital gain and not income is not currently deductible, but may be capitalized.

II. Limitations on the Deductibility of Interest

A. Thin Capitalization or Equity-Stripping Rules

Canada does have thin capitalization rules that are designed to prevent "non-residents of Canada who own significant shareholding (generally over 25%) in Canadian resident corporations from withdrawing the profits of that Canadian resident corporation from Canada in the form of interest payments."[4] If this was allowed these payments would be deductible in computing income. The thin-capitalization rules require the payments to be treated as dividends that must be paid out of earnings accumulated after Canadian tax.[5]

This limitation is only imposed on debtors who are corporations. The general rule is that, if the amount of outstanding debts to specified nonresidents exceeds two times the equity of the Canadian corporation, a prorated portion of any interest paid is not allowed in computing the income of the Canadian corporation. This is a fairly technical rule and the formulas for prorating disallowed interest expenses are complex.

The amount of "equity" of a borrower corporation is the aggregate of retained earnings, contributed surplus, and paid-up capital. Contributed surplus and paid-up capital are calculated on a monthly basis and then divided to give monthly averages. This method is intended to limit the ability of nonresidents of Canada who have significant shareholding in Canadian resident corporations from being able to inject capital into a corporation at the end of a year in order to avoid a thin-capitalization problem.[6]

B. Limits on Borrowing for Tax-Exempt Income

The I.T.A. does not allow the deduction of interest paid on money borrowed to produce tax-exempt income.[7]

III. Tax-Related or Other Limitations on Debt Financing

A. Tax-Related Limitations

Canada has a general anti-avoidance rule (GAAR), which can apply to "any transaction … that, but for [the GAAR], would result, directly or indirectly, in a tax benefit, unless the transaction may reasonably be considered to have been undertaken or arranged primarily for

---

[4] 3 Canadian Tax Rep. (CCH Canada) ¶ 4867.

[5] *Id.*

[6] *Id.* ¶ 4869.

[7] Income Tax Act, R.S.C. ch. 1, § 20(1)(c).

bona fide purposes other than to obtain the tax benefit."[8] However, it is limited to cases of misuse of Canada's laws or tax treaties. The cases summarized in the *Canada Tax Reporter* do not indicate that the GAAR has been used to limit the amount of debt a corporation can carry.[9]

B. Other Limitations

Canadian law does not appear to protect the paid-in share capital by requiring a threshold amount of equity, or by preventing corporations from buying their own stock. No investment laws that are intended to protect investors from highly leveraged investments have been found.

IV. Deductions for Corporate Profit Distributions

A. Basic Principles of Taxing Corporate Income

In Canada, the basic federal corporate income tax rate is 16.5 percent. This rate is reduced to 11 percent for Canadian-controlled private corporations that can claim the small business deduction.

The provinces have two tax rates. The appropriate rate for a corporation is usually determined by the size of its profits. The lower rates extend from 0 to 5 percent, but are mostly 4 to 4.5 percent. The higher rates extend from 10 to 16 percent, but average approximately 13 percent. Provincial income taxes are added to federal taxes.[10]

The taxation of dividends in Canada is an extremely complex subject as it is dependent on many factors and subject to many exceptions. However, the basic rule is that dividends are not tax deductible in computing taxable income and are therefore usually paid out of after-tax profits. Intercorporate dividends are generally not taxed in the hands of the recipient, unless the recipient is a closely-held corporation being used to avoid tax, but they are taxed in the hands of individual shareholders.[11]

There is a system for partially mitigating double taxation in these cases, which is basically designed to try to ensure that the amount of tax being paid by Canadian residents on Canadian dividends is roughly equal to what the individual would have paid on a direct investment. This system requires the taxpayer to first "gross up" his or her dividends and then allows him or her to claim a dividend tax credit. There are two types of dividends. "Eligible dividends" are usually from small Canadian corporations that are taxed at a lower rate. These dividends must be grossed up by 144 percent. Other dividends must be grossed up by 125

[8] *Id.* § 245(1).

[9] *See* 5A Canadian Tax Rep. (CCH Canada) ¶ 27,886e.

[10] Canada Revenue Agency, Corporation Tax Rates, http://www.cra-arc.gc.ca/tx/bsnss/tpcs/crprtns/rts-eng.html (last modified June 21, 2011).

[11] Income Tax Act , R.S.C. ch. 1, § 112.

percent.[12] The grossed up dividends are added to income and the taxpayer must calculate the amount of tax he or she would have to pay on that total amount at their marginal tax rate. Once this calculation is made, the taxpayer can claim a tax credit of approximately 18 percent on eligible dividends and 13.3 percent on other dividends.[13]

B. Deductibility of Dividends

Dividends are not a deductible expense for distributing corporations as they are paid out of after-tax profits.[14]

V. Deductions for Distributing Dividends Under an Employee Stock Ownership Plan

The I.T.A. does not appear to have provisions specifically addressing employee stock ownership plans. The Canada Revenue Agency reports that payments to such a plan would be deductible as a business expense and, if paid to the employee, would be considered income.[15]

VI. Treatment of Debt Cancellation

The I.T.A. contains complex debt forgiveness rules that apply when a commercial obligation of a debtor is settled without payment, or with a payment of an amount that is less than the principle amount or the amount for which it was issued.[16] Basically, the forgiven amount is used to reduce non-capital losses and capital loss carryforwards as well as tax costs of properties and resource expenditures. One half of any remainder must be added to a corporation's income for a tax year. In the case of a partnership, the full amount must be added to the partnership's income. The debt forgiveness rules apply to trade debts as well as other forms of commercial obligations.[17]

Prepared by Stephen F. Clarke
Senior Foreign Law Specialist
June 2011

---

[12] Canada Revenue Agency, Line 120–Taxable Amount of Dividends (Eligible and Other Than Eligible) from Taxable Canadian Corporations, http://www.cra-arc.gc.ca/tx/ndvdls/tpcs/ncm-tx/rtrn/cmpltng/rprtng-ncm/lns101-170/120/menu-eng.html (last modified Jan. 5, 2011).

[13] Canada Revenue Agency, Line 425–Federal Dividend Tax Credit, http://www.cra-arc.gc.ca/tx/ndvdls/tpcs/ncm-tx/rtrn/cmpltng/ddctns/lns409-485/425-eng.html (last modified Jan. 5, 2011).

[14] Income Tax Act, R.S.C. ch. 1, § 112.

[15] Telephone Interview with Canada Revenue Agency Official (June 26, 2011).

[16] Income Tax Act, R.S.C. ch. 1, §§ 80–80.04.

[17] Canada Revenue Agency, IT-293R, Debtor's Gain on Settlement of Debt, http://www.cra-arc.gc.ca/E/pub/tp/it293r/it293r-e.html (last modified Aug. 5, 2002).

2011–005756

LAW LIBRARY OF CONGRESS

FRANCE

TAX TREATMENT OF CORPORATE DEBT

Executive Summary

As a general rule interest paid on corporate debt is deductible from a corporation's gross income under French law. The deductibility of interest, however, may be restricted by thin capitalization rules. Corporations are subject to corporate tax on their earnings and profits whether or not distributed to the shareholders. Once distributed, the profits are again taxed either under the personal income tax or the corporate tax depending on the status of the beneficiary of the distribution. This "double taxation" is mitigated either by the parent-subsidiary tax exemption regime or by the 40 percent income allowance for individual taxpayers. Dividends distributed under an employee stock ownership plan are not deductible. The tax treatment of debt cancellation depends on whether or not such cancellation is of a "normal nature" and on whether the debt cancellation is of a financial or commercial nature.

I. Introduction

As a general rule, financial expenses (essentially interest paid on money borrowed or advanced) are deductible from a corporation's gross income under French law. There are, however, two situations in which the deductibility of interest is cut back by special rules. The first concerns the case where the lender is an associate of, controlled by, or in control of the borrowing corporation. The second deals with interest incurred by a corporation on loans to another corporation that is directly or indirectly related (earnings stripping/thin capitalization).[1]

New thin-capitalization rules were introduced by the 2006 Finance Law applicable on or after January 1, 2007.[2] In addition, the 2011 Finance Law introduced a provision extending the scope of the rules to certain loans granted by third-party lenders and guaranteed by a related party.[3] Previous thin capitalization provisions had been challenged on two grounds: inconsistency with bilateral tax treaties and inconsistency with the freedom of establishment principle as set forth in the Treaty of Rome, which founded the European Union (EU).[4]

---

[1] FRENCH TAX & BUSINESS LAW GUIDE (Sweet and Maxwell) ¶ 21760.

[2] *Id*. ¶¶ 21772–21774.

[3] *Id*. ¶ 21774; CODE GENERAL DES IMPÔTS [C.G.I.] art. 212, *available at* LEGIFRANCE, http://legifrance.gouv.fr/ (*Les codes en vigueur*).

[4] FRENCH TAX & BUSINESS LAW GUIDE, *supra* note 1, ¶¶ 21772–21774.

A limitation on interest deductions previously applied to loans by foreign parent corporations to their French subsidiaries. The same limitation was not imposed on French parent corporations. This discriminatory treatment violated nondiscrimination provisions of bilateral treaties that followed the Organisation for Economic Co-operation (OEDC) model and the EU freedom of establishment clause. The new regime applies to French parent corporations as well as foreign parent corporations.[5]

II. Limitations on the Deductibility of Interest

A. Thin Capitalization or Equity-Stripping Rules

Thin-capitalization rules apply to the following:

1. *Entities subject to corporate income tax*.

2. *Loans granted to the borrowing corporation by any related party or secured directly or indirectly by a related party*. Two corporations are considered related where (i) one of the corporations, directly or indirectly, holds the majority of the share capital of the other or de facto exercises the power to make decisions; or (ii) the two corporations are under the control of a third corporation, directly or indirectly, under the conditions stated in (i), above.[6]

3. *Loans granted by unrelated lenders when the reimbursement of such loans is guaranteed by a related party*.[7] This provision is set forth by the 2011 Finance Law aimed at excluding back-to-back loans that might be used to avoid the thin capitalization rules. There are two exceptions so that normal corporate financial transactions are not affected: obligations issued in the context of a public offering and certain categories of loans incurred for leveraged buyouts.[8]

Interest incurred by a borrowing corporation on loans granted by related parties is only deductable within the limit of a maximum interest rate, which is either the rate referred to in article 39-1-3-1 of the General Tax Code (average effective floating rate on bank loans with a minimum maturity of two years) or, if higher, the rate that the borrowing corporation could have obtained from independent financial institutions in similar circumstances.[9]

If the interest rate on the related-party loan complies with the rate explained above, interest on such a loan will be fully deductable subject to thin capitalization limitations described

---

[5] *Id.*

[6] C.G.I. art. 39(12).

[7] *Id.* art. 212.

[8] FRENCH TAX & BUSINESS LAW GUIDE, *supra* note 1, ¶ 21-774.

[9] C.G.I. art. 39-1-3-1.

below. If the interest rate exceeds the maximum interest rate, the excess portion will be included in the borrowing corporation's taxable income and treated as a constructive dividend.[10]

A borrowing corporation will be deemed thinly-capitalized if the total amount of interest incurred on related party loans, which is deductable under the interest rate test, simultaneously exceeds the three following limits within the relevant fiscal year:

- The overall indebtedness in respect of loans granted by the related parties (i.e. all receivables, except trade receivables) exceeds 1.5 times the net equity of the borrower (including share premiums [and] retained earnings), i.e. a debt/equity ratio of 1.5:1;

- The amount of the interest paid to the related companies exceeds 25% of the adjusted operating profits (grossed-up by the tax, the interests paid to related parties, depreciation and amortization, [and] certain lease payments) realized by the borrower, i.e. interest/profit ratio of 1:4; and

- The amount of interest paid to related parties exceeds the amount of interest received from affiliated companies, i.e. interest paid/interest received ratio of 1:1.[11]

The part of the interest paid by the borrowing corporation that exceeds the three limits described above is not deductible unless it does not exceed €150,000.[12] Interest exceeding this threshold may be carried forward in subsequent years under certain conditions.[13]

The General Tax Code also includes a safe-harbor provision. The borrowing corporation may avoid the limitation if it brings evidence that the overall debt/equity ratio of the group to which it belongs is, with respect to the relevant fiscal year, equal to or higher than its own overall debt/equity ratio.[14]

As mentioned in the introduction, the deductibility of interest may also be restricted where the lender is an associate of, controlled by, or in control of the borrowing corporation. Deductibility is subject to three conditions: (1) the corporation capital must be entirely paid; (2) the interest rate must not exceed a set maximum, which is set by the Bank of France each quarter and published in the *Journal Officiel*, France's official gazette (however, the maximum rate may be exceeded for shareholders loans that are regular commercial credit transactions in which shareholders are acting as regular clients or suppliers of the corporation paying the interest); and (3) the total loans must not exceed a debt-equity ratio of 1:5. This third restriction applies to

---

[10] *Id*. art. 212.

[11] Eric Robert, *France – Corporate Taxation* ¶ 10.3, *in* INTERNATIONAL BUREAU OF FISCAL DOCUMENTATION [IBFD]: EUROPEAN TAX SURVEYS, *available at* http://ip-online.ibfd.org/eth/ (by subscription) (last visited June 15, 2011); C.G.I. art. 212.

[12] At the current exchange rate €1 is equal to approximately US$1.43.

[13] C.G.I. art. 212 III.

[14] *Id*.

loans made to a corporation by managing associates or associates holding more than 50 percent of the voting or capital stock of such corporation.[15]

B. Limits on Borrowing for Tax-Exempt Income

N/A

III. Tax-Related or Other Limitations on Debt Financing

A. Tax-Related Limitations

France has a general anti-avoidance rule. The French tax authorities are empowered to disregard or recast any legal arrangements, transactions, or legal acts that are either "artificial" and/or have been executed or entered into for the sole purpose of avoiding French tax by relying on a literal application of the law to achieve a result that contradicts the real objective of lawmakers.[16]

No information on whether this rule is used to limit debt versus equity could be located.

B. Other Limitations

It does not appear that there is any other significant limitation. Prior to 1998, the Commercial Code prohibited corporations from subscribing to or repurchasing its own shares. The Code now only prohibits a corporation from subscribing to its own shares. Repurchasing of its own shares by a corporation is authorized: (1) to achieve a reduction in capital not motivated by losses; (2) to redistribute the shares to the corporation's employee pursuant to a tax-qualified profit-sharing plan or to offer the employees tax-qualified stock options; and (3) within the framework of a redemption plan. This procedure permits French corporations that are quoted on a regular stock exchange to repurchase their shares without a public offering.[17]

IV. Deductions for Corporate Profit Distributions

A. Basic Principles of Taxing Corporate Income

A corporation established in France is subject to corporate tax at 33.33 percent on its earning and profits whether or not distributed to its shareholders. Once distributed, the profits are again taxed either under the personal income tax or the corporate tax depending on the status of the beneficiary of the distribution. This "double taxation" is mitigated either by the parent-subsidiary tax exemption regime or by the 40 percent income allowance for individual taxpayers.[18]

---

[15] FRENCH TAX & BUSINESS LAW GUIDE, *supra* note 1, ¶ 21-770.

[16] Robert, *supra* note 11, ¶ 10.1.1.

[17] FRENCH TAX & BUSINESS LAW GUIDE, *supra* note 1, ¶ 14-030.

[18] *Id* .¶ 27-500.

Under the parent-subsidiary tax exemption regime, 95 percent of the gross dividends the parent corporation receives from its subsidiaries are tax exempt. A lump sum of 5 percent of the gross dividends, deemed to represent nondeductible expenses, must be added back to the taxable income of the parent corporation and taxed at the standard rate. If, however, the parent corporation can establish that its expenses incurred during the year of receipt of the dividends were less than 5 percent, the difference between the 5 percent and the paid expenses may also be excluded from taxable income.[19]

As a general rule, 40 percent of dividends received by an individual from a corporation subject to corporate income tax or equivalent tax whose registered office is located in France or in an other EU member state, or in a country that entered into a double taxation treaty with France containing an administrative assistance clause, is exempt from tax. An additional €1,525 for a single taxpayer or €3,050 for a married couple is also exempt from tax. The remaining dividends are subject to income tax at the ordinary tax rate.[20]

B. Deductibility of Distributions

Generally, a corporation cannot claim any deductions for dividend distributions. There is, however, one minor exception to this rule: compensation of the administrative board members for attending board meetings is considered a dividend in the hands of the administrators and taxed as such even though it is still deductible for corporation purposes as a personnel expense.[21]

V. Deductions for Distributing Dividends under an Employee Stock Ownership Plan

France has adopted several statutory schemes to encourage the ownership by employees of stocks in their employer corporations or other French corporations. They include employee stock option plans (*options de souscription ou d'achat d'actions*), employee free share plans, and savings investment plans. Below is a brief discussion of the key features of employee stock option plans and of the tax consequences for the granting corporation.[22]

A corporation may grant to some or all of its employees either an option to subscribe to shares of stock to be issued by the corporation pursuant to an increase in registered capital or an option to purchase shares repurchased by the corporation for the purpose of the stock option plan. The implementation of a stock option plan by a French corporation requires shareholder approval. The shareholders must adopt a resolution at an Extraordinary General Meeting (EGM) authorizing the Board of Directors to grant such options. The EGM determines the period during which said authorization may by used by the Board of Director, the conditions under which the

---

[19] C.G.I. art. 216(I); Robert, *supra* note 11, ¶ 6.1.3.1.

[20] Marc Henderson, *France–Individual Taxation* ¶ 1.5.1, *in* IBFD: EUROPEAN TAX ANALYSIS, http://online.ibfd.org/kbase/ (by subscription) (last visited June 15, 2011).

[21] FRENCH TAX & BUSINESS LAW GUIDE, *supra* note 1, ¶ ¶ 10-140; 27-530.

[22] DOING BUSINESS IN FRANCE (Matthew Bender) ¶ 12.05[3][b].

options may be granted, and the period, if any, during which the shares issued upon the exercise of the option will remain inalienable. This period cannot exceed thee years.[23]

The granting corporation is entitled to claim a deduction for the following expenses: (1) expenses incurred in connection with the purchase of shares that are intended for the employees; (2) capital increase expenses in the case of a subscription option; (3) expenses related to the management of the shares purchased or issued until the date the option is exercised; and (4) various expenses paid in relation to the exercise by the employees of subscription or purchase options (e.g. agent's commission, taxes related to stock exchange activities, stamp duties, etc.).[24]

In addition, any capital losses incurred upon the repurchase of stock that is subsequently sold to an employee pursuant to the stock option plan may be deductible. Where the stock option plan provides for a capital increase, the corporation is entitled to deduct the difference between the purchase price it paid and the exercise price paid by the employee if (1) the stock option plan benefits all the employees; and (2) the distribution of the stock options is uniform, proportionate to salary or seniority, or a combination of these factors.[25]

No provision authorizing deductions for the distribution of dividends under an employee stock ownership plan could be found.

VI. Treatment of Debt Cancellation

A. General Statement

Debt cancellation and the grant of a subsidy receive the same tax treatment under French tax law. The tax treatment of debt cancellation depends on whether or not such cancellation is of a "normal nature."[26] In order to be considered of a normal nature, the debt cancellation granted by a parent/creditor to its subsidiary/debtor must rest on valid business reasons. The fact that the debt cancellation was granted in the interest of the corporation and that there exists real and sufficient consideration must be established. Debt cancellation is generally not considered abnormal where a creditor waives its receivables from an affiliated corporation in financial distress, specifically if there is a risk that recovering the debt could result in the insolvency or bankruptcy of the affiliated corporation and thus have an impact on the creditor's commercial or financial status.[27]

The tax treatment will further depend on whether the debt cancellation was of a financial or commercial nature. The debt cancellation is of a financial nature where the ties between the

---

[23] *Id.*

[24] I LAMY FISCAL, IMPÔTS SUR LE REVENU § 794 (Lamy 2011).

[25] *Id.*

[26] I LAMY FISCAL, IMPOTS SUR LE REVENU, *supra* note 24, § 797; Les abandons de créances et subventions entre entreprises [Debt cancellation and subsidies between companies], *in* DROIT FISCAL, *available at* http://www.lexbase.fr/ (by subscription) (last visited June 23, 2011).

[27] *Id.*

creditor and debtor and the reasons behind the cancellation are of a strict financial nature. The tax administration, for example, ruled that the following debt cancellations have a financial nature: debt cancellation or subsidy granted by a corporation to another corporation in order to terminate their commercial relations; debt cancellation or subsidy granted by the parent corporation to its subsidiary in the absence of any significant commercial relations; and debt cancellation or subsidy granted by a corporation participating in the financial reorganization of another corporation, group, or a determined economic sector.[28]

Debt cancellation is of a commercial nature if it has its source in a business relationship between the debtor and the creditor, i.e., for the creditor to maintain its customer base or to preserve its source of supply.[29]

B. Tax Treatment of the Creditor

The creditor may not deduct the amount of the debt cancellation if such debt cancellation is considered abnormal.[30]

A debt cancellation of a financial nature is deductible only up to a certain amount. As waiving a debt owed to a parent corporation increases the net asset value of the subsidiary, the deduction of the debt waived is only permissible up to the amount of the negative net asset value of the subsidiary, if any, and the positive net asset value after debt waiver allocable to the other shareholders.[31] The following example illustrates this rule:

> A parent corporation owns 90 percent of the capital of its subsidiary. This subsidiary has a negative net asset of €50,000. The parent corporation grants its subsidiary a debt forgiveness of €70,000. The parent corporation will be able to deduct €50,000 (amount of negative net asset of the subsidiary) plus €2000 ([70,000-50,000] x 10%), which is the positive net asset value after debt waiver allocable to the other shareholders.[32]

When the debt cancellation is of a commercial nature, the entire amount is fully deductible by the creditor. This charge has to be deducted from the result of the financial year during which the cancellation takes place.[33]

---

[28] I LAMY FISCAL, IMPOTS SUR LE REVENU, *supra* note 24, § 798; Les abandons de créances et subventions entre entreprises [Debt cancellation and subsidies between companies], *in* DROIT FISCAL, *available at* http://www.lexbase.fr/ (by subscription) (last visited June 23, 2011).

[29] I LAMY FISCAL, IMPOTS SUR LE REVENU, *supra* note 24, § 798; Les abandons de créances et subventions entre entreprises, *in* DROIT FISCAL.

[30] I LAMY FISCAL, IMPOTS SUR LE REVENU, *supra* note 24, §§ 799, 800; Les abandons de créances et subventions entre entreprises [Debt cancellation and subsidies between companies], *in* DROIT FISCAL, *available at* http://www.lexbase.fr/ (by subscription) (last visited June 23, 2011).

[31] *Id.*

[32] *Id.*

[33] *Id.*

If the debt cancellation contains a recapture clause on return to better fortune, the eventual reimbursement of the reinstated debt leads to taxation in the hands of the creditor but only for any sums that were initially deducted for tax purposes.[34]

C. Tax Treatment of the Debtor

The debtor is taxable on the amount of the debt cancelled if such debt cancellation is considered to be abnormal. The tax treatment will again depend on whether the debt cancellation is of a financial or commercial nature if the debt cancellation is considered normal.[35]

If a debt cancellation is of a financial nature, the part that is deductible by the creditor constitutes taxable profit in the hands of the debtor subject to a corporate income tax rate of 33.1/3 percent. The part that is not deductible by the creditor is not taxable in the hands of the debtor provided that (1) the creditor is the parent corporation of the debtor for tax purposes, and (2) the debtor undertakes to increase its capital by an amount equal to the debt waiver within the following two years. If these conditions are not fulfilled, the entire amount of the debt waived is taxable in the hands of the debtor.[36]

If a debt cancellation is of a commercial nature, it is fully taxable in the hands of the debtor.[37]

Prepared by Nicole Atwill
Senior Foreign Law Specialist
June 2011

[34] *Id.*

[35] *Id.*

[36] *Id.*

[37] *Id.*

2011–005756

LAW LIBRARY OF CONGRESS

GERMANY

TAX TREATMENT OF CORPORATE DEBT

Executive Summary

In 2008, Germany replaced its equity-stripping rules with a more stringent restriction on the deductibility of interest that applies to domestic and foreign creditors irrespective of their relationship to the debtor company. In addition, Germany disallows deductions for interest that is attributable to tax-exempt income, and treats inappropriate interest payments to shareholders as constructive dividends.

Germany lowered its tax rate in recent years and grants relief from economic double taxation of corporate incomes through the tax exemption of 95 percent of all domestic and foreign intercorporate dividends.

Germany treats the forgiveness of a corporate debt as taxable income while granting relief from this principle in bankruptcy situations.

I. Introduction

German tax law underwent numerous changes in the past decade that were aimed at making Germany a more competitive business location. The most striking of these was a drop in the corporate tax rate from 40 percent to 25 percent in 2001,[1] followed by a drop from 25 percent to 15 percent in 2008.[2] The treatment of debt, however, did not participate in this "race to the bottom." To the contrary, Germany intended to recoup some of the revenue losses when it flanked the enactment of the lower tax rate for 2008 with the enactment of a novel and stringent limitation on debt financing (interest barrier).[3]

In Germany, corporations and limited liability companies are taxed in accordance with the Corporate Income Tax Act.[4] Their taxable income, however, is computed in accordance with the net worth comparison method as provided in the Income Tax Act for the business of

---

[1] Lorenz Jarass & Gustav Obermair, *Earnings before Interest (EBIT) instead of Profits as a Tax Base?* EUROPEAN TAXATION 38, 41 n.13 (2007).

[2] Unternehmenssteuerreformgesetz 2008 [UntStRefG 2008], Aug. 14, 2007, BUNDESGESETZBLATT [BGBL.] I at 1912.

[3] Bernd Jonas, *Zinsschranke–Neuorientierung der Konzernfinanzierung*, *in* Harald Schaumburg & Detlev Piltz, Grensüberschreitende Gesellschaftsstrukturen im Internationalen Steuerrecht 33 (2010).

[4] Körperschaftsteuergesetz [KStG], repromulgated Oct. 15, 2002, BGBL. I at 4210, *as amended*.

individual taxpayers.[5] Under this method, the taxable annual income is the difference between the net worth of the taxable year and that of the preceding year.[6] The net worth at the end of each year is established through the annual financial statement in which profits show up as increases in assets or decreases in liabilities. Deductible expenses, on the other hand, show up as decreases in assets or increases in liabilities.[7] Under German tax law, interest expenses are generally deductible if they are occasioned by the business;[8] the major exception from this principle is the recently enacted interest barrier that limits the amount of deductible interest.

II. Limitations on the Deductibility of Interest

A. Thin Capitalization or Equity-Stripping Rules

1. The Development of the Interest Barrier

Until 2008 Germany had equity-stripping rules that were aimed at limiting debt financing by foreign shareholders in order to protect against revenue losses.[9] These rules applied a 1.5-to-1 debt-to-equity ratio to the corporate debtor and converted interest paid on certain shareholder loans to constructive dividends. From 2002 on, these rules applied to interest paid to domestic as well as foreign shareholders[10] in order to comply with the *Lankhorst-Hohorst* decision of the European Court of Justice,[11] which held that earlier German equity-stripping rules violated the freedom of capital movements of the European Treaty[12] by discriminating against loans from other EU member states.

The new deductibility limitation on interest was enacted in 2007 and became effective in 2008.[13] It is aptly referred to as an interest barrier, and it departs from former concepts by limiting the deductibility of interest from all types of loans, including bank loans. The harshness of the measure has led to numerous complaints and to two modest reforms that raised the interest threshold and enhanced the carry-forward of undeducted interest, and thereby may have helped smaller German companies avoid the measure.[14] Nevertheless, German business is complaining about the timing of the restriction, which hit business during a recession.[15]

---

[5] Einkommensteuergesetz [EStG], repromulgated Oct. 19, 2002, BGBL. I at 4210, § 5.

[6] Id.

[7] Henry J. Gumpel et al., 1 Taxation in the Federal Republic of Germany ¶ 2/2.3 (CCH, 1991).

[8] *Id*. ¶ 7/2.5.

[9] KStG § 8a, as effective until Dec. 31, 2008.

[10] First by case law, *see* BERND ERLE & THOMAS SAUTER, KÖRPERSCHAFTSSTEUERGESETZ 610 (3rd ed., 2010), and then by virtue of KStG § 8a as enacted by Gesetz, Dec. 22, 2003, BGBL. I at 2840.

[11] Case C-324/00, Lankhorst-Hohorst GmbH v. Finanzamt Steinfurt, Sept. 26, 2002, E.C.R. I-11779.

[12] EC Treaty art. 43 (as in effect in 2002) (now Consolidated Version of the Treaty on the Functioning of the European Union art. 49).

[13] KStG § 8a in conjunction with EStG § 4h.

[14] In July 2009, relief was granted by increasing the exempted amount of net interest from €1 million (about US$1.41 million) to €3 million (about US$4.23 million) on a temporary basis. Bürgerentlastungsgesetz Krankenversicherung July 16, 2009, BGBL. I at 1959. A stimulus law of December 2009 made that change

Both the former and present thin capitalization rules were influenced by section 163(j) of the U.S. Internal Revenue Code.[16] It appears, however, that the current German interest barrier disallows more interest deductions than the equity-stripping system of the United States.[17] Moreover, German critics have asserted that the German system is more restrictive than that of other European countries.[18]

The interest barrier rules of 2008 had the legislative purpose of preserving domestic revenue by disallowing excessive interest payments to foreign shareholders.[19] Nevertheless, the rules do not distinguish on their face between domestic and foreign creditors, in order to comply with European Union law. Domestic shareholders, however, may mitigate the effects of the rules by forming a consolidated group, thereby shifting the applicability of the rules from the affiliated companies to the overall group while permitting them to borrow from each other within the group.[20] Commentators have already raised the possibility that this preferred treatment of German creditors may once again lead to a European court decision invalidating the German rules.[21]

2. The Current Interest Barrier Rules

a) Subjected Entities

The interest barrier rules apply to an enterprise (*Betrieb*; hereinafter subjected entity),[22] and this concept does not necessarily coincide with an individual or corporate taxpayer. Individual taxpayers, in particular, may have several subjected entities.[23] Corporations usually are one entity,[24] yet they are only subjected to the regime if they are part of a group.[25] "Stand

---

permanent and made it easier to carry undeducted interest forward. Wachstumsbeschleunigungsgesetz, Dec. 22, 2009, BGBL. I at 3950.

[15] Jonas, *supra* note 3, at 33.

[16] Markus Ernst, Gesellschafter-Fremdfinanzierung im Deutschen und U.S. –Amerikanischen Steuerrecht 19, 315 (Berlin, 2010).

[17] BDI/KPMG-Studie 2009, Die Behandlung von Finanzierungsaufwendungen: Ein Vergleich der Zinsschranke in Deutschland mit den Regelungen in den USA, Italien, Frankreich, den Niederlanden und Schweden 19, http://www.bdi.eu/download_content/Marketing/91707_BDI_Zinsschranke_final.pdf.

[18] *Id.* at 19.

[19] Antwort der Bundesregierung, Aug. 3, 2010, BUNDESTAG DRUCKSACHE 17/2696.

[20] KStG § 15(3).

[21] Sören Goebel & Karolina Eilinghoff, *(nicht-) Konformität der Zinsschranke mit dem Grundgesetz und Europarecht?*, DEUTSCHE STEUER ZEITSCHRIFT 550 (2010).

[22] EStG § 4h(1).

[23] Bundesministerium der Finanzen, Zinsschranke (§ 4h EStG; § 8a KStG), IV C 7- S 2742-a/o7/10001, July 4, 2008.

[24] Id.

[25] EStG § 4h(2)(b).

alone" corporations are subjected entities only if they pay interest to a related shareholder and that interest exceeds the net interest of the corporation (excess of interest expenses over interest earnings) by more than 10 percent.[26]

Members of a group, however, are also exempted if they belong to a consolidated group that submits one consolidated tax return for the entire group.[27] In such a situation, the affiliated companies may borrow from each other without penalty, and the interest barrier regime is applied to the overall group in its relations with third parties.[28]

In addition, an "escape clause" is provided that exempts a corporation from the interest barrier regime if its equity-to-profit ratio is not significantly less favorable than that of the overall group to which it belongs.[29]

b) The Interest Threshold and its Consequences

The regime restricts the deductibility of net interest (annual interest expenses exceeding annual interest earnings) if it is higher than 3 million Euros (approximately US$4.23 million) during the tax year.[30] Interest that falls below this threshold is fully deductible. Interest in excess of this threshold, however, can only be deducted up to 30 percent of the tax year's earnings before interest, taxes, depreciation, and amortization (EBITDA).[31] Nondeductible interest may be carried forward indefinitely, and it can be deducted against any "unused" 30 percent EBITDA allowance of future years. "Unused" EBITDA allowances also are carried forward, but only for five years, to be used according to the first-in, first-out method.[32]

B. Limits on Borrowing for Tax-Exempt Income

Section 3c of the Income Tax Code provides that expenses are not deductible if they are incurred in relation to tax-exempt income.[33] This provision applies to individual as well as corporate taxpayers.

The principle of denying deductions for tax-exempt income also seems to be realized in the taxation of intercorporate dividends. These are exempt from taxation, except for 5 percent of such income, which is taxed as a proxy for the disallowance of deductions.[34]

---

[26] KStG § 8a(2).

[27] KStG § 14.

[28] KStG § 15.

[29] EStG § 4h(2)(c).

[30] EStG § 4h(2)(a).

[31] EStG § 4h(1).

[32] *Id*.

[33] EStG § 3c.

[34] *Infra* note 69 and accompanying text.

III. Tax-Related or Other Limitations on Debt Financing

A. Tax-Related Limitations

1. Overview

A significant disallowance of deductions for interest expenses is applied in the trade tax. Within the realm of corporate taxation, however, restrictions on the deductibility of interest are limited to the nondeductibility of interest payments without a business purpose,[35] the interest barrier, and the disallowance of deductions for interest attributable to tax-exempt income.[36] For businesses owned by individuals or partnership, the law also denies the deductibility of interest for debts contracted after the owners stripped the business of its assets.[37] This rule is closely related to the denial of non-business-related interest.[38] For corporations, however, the withdrawal of capital is to some extent prevented by rules of corporation law, as explained immediately below (Part III(B), "Other Limitations").

In addition, corporate interest expenses cannot be deducted for inappropriate corporate interest payments that are to be reclassified as constructive dividends, thus leading to the addition of the interest expense to the annual taxable income of the corporate entity.[39] The law provides two vehicles for accomplishing this goal—the constructive dividend rule of Corporation Tax Act § 8 and the general anti-avoidance rule of Fiscal Code § 42[40]—yet in the scant case law that has developed on this issue, the courts have not always been in agreement on how to draw the distinction between these two remedies.[41] Transfer pricing rules,[42] on the other hand, have until now not played a role in reevaluating inappropriate dividends.[43]

2. Trade Tax

The trade tax is a supplemental income tax that is imposed on plants and other business installations that are located in Germany. It is imposed on the basis of a federal law,[44] yet the local communities determine the applicable tax rate by applying a multiplier to the statutory

---

[35] EStG § 4(4).

[36] Rolf Schwedhelm, *Die neue Zinsschranke für Kapitalgesellschaften*, DIE AKTIENGESELLSCHAFT 540 (2007).

[37] EStG § 4(4a).

[38] LUDWIG SCHMIDT, EINKOMMENSTEUERGESETZ § 4 nn.522–524 (27th ed. 2008).

[39] DIETMER GOSCH, KÖRPERSCHAFTSSTEUERGESETZ § 8 nn.192–194 (2nd ed. 2009).

[40] Abgabenordnung [AO], Mar. 16, 1976, BGBL. I at 613, *as amended*.

[41] *Id*.

[42] Aussensteuergesetz, Sept. 8, 1972, BGBL. I at 1713, *as amended*, § 1.

[43] GOSCH, *supra* note 39.

[44] Gewerbesteuergesetz [GewStG], repromulgated Dec. 15, 2002, BGBl. I at 4167, *as amended*.

rate.[45] The trade tax rate is applied to taxable income as determined for the individual or corporate income tax, and as adjusted by provisions of the Trade Tax Act.

One of these adjustments is an addition of deductions claimed for interest expenses. Currently, 25 percent of interest expenses that were deducted on a corporate or individual income tax return and that are attributable to the plant that is subject to the trade tax must be added to the adjusted taxable income to which the trade tax rate is applied.[46] The effect of this rule is the denial of the deductibility of 25 percent of interest expenses for the trade tax.

3. Constructive Dividends

According to Corporation Tax Act § 8(3), hidden distributions of profits to shareholders are reclassified as constructive dividends and added to the taxable income of the distributing corporation.[47] The courts have interpreted this provision as applying to benefits bestowed on a shareholder if these transfers lacked an appropriate business connection and diminished the profit of the distributing corporation.[48] This principle is also applied to interest payments that are excessive or not based on a valid legal or business reason,[49] yet it is immaterial for this reclassification whether the improper contribution was made with the intent of avoiding tax or for other reasons.[50] If interest is thus reclassified to a dividend, it will no longer be counted as an interest expense in the application of the interest barrier rules.[51]

4. General Anti-Avoidance Rule

Inappropriate interest payments can also be converted into a constructive dividend under application of Fiscal Code § 42. This general anti-avoidance rule can be applied when the taxpayer chooses a legal form or transaction that serves no purpose other than that of obtaining a tax advantage. Currently, it appears that this provision is not much used for interest payments,[52] due to the existence of the more specific provisions of the constructive dividend rule and the tax barrier rules.

In the past, however, the general anti-avoidance rule was the major vehicle for developing equity-stripping rules. Until the first enactment of the equity-stripping rules of section 8a of the Corporate Tax Code in 1993, the courts used the anti-avoidance provision to convert excessive interest into constructive dividends.[53] This practice, however, led to a lack of

---

[45] GewStG § 11.

[46] GewStG § 8 no. 1(a).

[47] KStG § 32a.

[48] GOSCH, *supra* note 39, § 8 nn.166–170.

[49] *Id.* § 8 n.192.

[50] *Id.* § 8 nn.192–194.

[51] *Id.* at § 8 n.196.

[52] *Id.* § 8 nn.192–196.

[53] ERNST, s*upra* note 16, at 19.

legal certainty because the courts oscillated between striking down abusive transactions between related taxpayers on the one hand and upholding a corporation's right to choose its form of financing on the other. To make the law more predictable, the 1993 version of section 8a of the Corporate Tax Code was enacted.[54]

B. Other Limitations

Company law imposes some restrictions on debt financing that aim at preserving the capital of the company. These include minimum capital requirements, limitations on a company's right to purchase its own stock, and limits on distributions to shareholders. Such rules exist for the limited liability company and the corporation.[55]

Limited liability companies must have a paid-in capital of at least €25,000 (approximately US$35,000).[56] The share capital, moreover, must be paid in[57] and may not be distributed to the shareholders.[58] The repurchase of a company's own shares is also restricted; in particular, the shares must be purchased from sufficient reserves.[59]

Corporations must have a paid-in share capital of €50, 000 (approximately US$70,000).[60] Corporations may acquire their own shares only for certain restricted purposes and to a limited extent. Most repurchase situations are limited to a repurchase of 10 percent of the stock and the purchase must be financed from reserves, not debt.[61] In addition, contributions may be repaid to shareholders only in very limited situations, and distributions to shareholders must be limited to distributable profits.[62]

IV. Deductions for Corporate Profit Distributions

A. Basic Principles of Taxing Corporate Income

The German corporate tax rate is 15 percent.[63] This rate is augmented by a 5.5 percent surcharge on taxable income, which is imposed to finance German unification.[64] This increases

---

[54] *Id.*

[55] *Id.* at 21.

[56] Gesetz betreffend die Gesellschaft mit beschränkter Haftung [GmbHG], Apr. 20, 1892, BGBL. III no. 41231, *as amended*, § 5.

[57] GmbHG § 14.

[58] GmbHG § 30.

[59] GmbHG § 33.

[60] Aktiengesetz [AktG], Sept. 6, 1965, BGBL. I at 1089, *as amended*, § 7.

[61] AktG § 71.

[62] AktG § 7.

[63] KStG § 23.

[64] Solidaritätszuschlagsgesetz, repromulgated Oct. 15, 2002, BGBL. I at 4130, *as amended*.

the tax rate to 15.83 percent. In addition, domestic corporations are subject to trade tax at the plant level,[65] which, on average, amounts to 17 percent of taxable income.[66]

When Germany began lowering its corporate tax rate in 2000,[67] it abolished a complex imputation system for the taxation of corporate distributions that had been in effect since 1977. That system gave the shareholder a credit for the tax the corporation had paid on the distributed profits and also granted the corporation a lower tax rate for distributed profits.[68]

Since 2000, the current system of corporate taxation has governed. It taxes corporate profits with the same rate, irrespective of the distribution of the profits, and it exempts 95 percent of intercorporate dividend income from taxation. The remaining 5 percent is taxed as compensation for deductible business expenses that may have been attributable to this tax-exempt income.[69]

B. Deductibility of Distributions

The Corporation Tax Act states categorically in section 8(3) that the income of a corporation is not affected by its profit distributions. This denial of deductibility of distributions applies to dividends on shares. For hybrid instruments that straddle the distinction between participatory rights and debt instruments, deductibility is denied if the security grants the owner a right to participate in the profits of the company and in any return on its liquidation.[70] In Germany, the most common of these hybrid instruments is the jouissance share,[71] which has much in common with preferred stock in American corporate practice.

V. Deductions for Distributing Dividends Under an Employee Stock Ownership Plan

Germany does not have Employee Stock Ownership Plans that involve Employee Share Ownership Trusts.[72] German experts have been studying the American model, yet doubt whether it would be transferrable to Germany.[73] Germany encourages employee stock ownership through tax measures, primarily through partial income tax exemptions for the employee.[74] Companies that compensate employees with shares can deduct this compensation

---

[65] *See supra* note 44 and accompanying text.

[66] Jarass & Obermair, *supra* note 1, at 41 n.13.

[67] *Id*. and accompanying text.

[68] ERLE & SAUTER, *supra* note 10, at 29.

[69] KStG, § 8b

[70] GOSCH, *supra* note 39, § 8 nn.148–151.

[71] Id.

[72] Jens Lowitzsch, Mitarbeiterbeteiligung und Unternehmensnachfolge in KMU – Der Employee Stock Ownership Plan, BETRIEBS-BERATER [BB] Beilage no. 001, 12 (2009).

[73] *Id.*

[74] Gregor Thüsing, Zum Entwurf eines Gesetzes zur steuerlichen Förderung der Mitarbeiterkapitalbeteiligung, BB Beilage no. 001, 6 (2009).

as an expense.[75] There is no rule that would allow the corporate employer to deduct dividend distributions on shares held by employees or groups of employees.[76]

VI. Treatment of Debt Cancellation

The forgiveness of a debt is taxable income for the corporate taxpayer. There is no statutory provision to this effect, yet this is an undisputed principle in German tax law that also applies to the forgiveness of a business debt of an individual taxpayer.[77] Cancelled debts are income because they decrease the liabilities of a company or business and thereby increase the taxable profit.[78]

Special rules, however, apply to debt cancellations in the course of a bankruptcy-related reorganization or an informal effort of creditors to salvage a failing company.[79] To the extent that such cancelled debts are not absorbed by losses and show a profit, their taxation is deemed to be a hardship that may lead to a forgiveness of the tax or to a postponement until the enterprise has recovered.[80]

Prepared by Edith Palmer
Senior Foreign Law Specialist
June 2011

[75] SCHMIDT, *supra* note 38, § 4 n.520 – Arbeitslohn.

[76] There is no statutory exception to KStG § 8(3), which disallows the deductibility of corporate profit distributions.

[77] SCHMIDT, s*upra* note 38, §5 n.671.

[78] Id.

[79] Gerhard Bruschke, *Der steuerfreie Sanierungsgewinn*, DEUTSCHE STEUER-ZEITUNG 166 (2009).

[80] *Id.*; AO §§ 163, 222 & 227; Bundesministerium der Finanzen, Erlass IV A 6 – S 2140 – 8/03, Mar. 27, 2003, BUNDESTEUERBLATT I at 240.

2011–005756

LAW LIBRARY OF CONGRESS

JAPAN

TAX TREATMENT OF BUSINESS DEBT

Executive Summary

Interest paid on debt is regarded as a "non-operating expense" in Japan and reduces income. The thin capitalization rule provides an exception to this.

Dividends paid are not deducted from taxable income. There are Employee Stock Ownership Plans in Japan, but they are different from such plans in the United States.

When a debt is reduced or cancelled, the borrower has taxable income from the reduction or cancellation.

I. Introduction

Net taxable income for corporation tax purposes is calculated based on the results reflected in the company's financial statements, prepared in accordance with Japan's generally accepted accounting principles.[1] Interest paid on debt is regarded as a "non-operating expense"[2] and reduces income.

II. Limitations on the Deductibility of Interest

Japan has thin capitalization rules. Where the average balance of liabilities due to either a foreign controlling shareholder or capital supplier[3] exceeds three times the capital in the company held by the foreign controlling shareholder, the amount of interest payable on the excess amount is not deductible. Where a company maintains a less than three-to-one debt-to-equity ratio, it is not treated as thinly capitalized even if the amount borrowed from a foreign controlling shareholder or capital supplier exceeded three times the foreign controlling shareholder or capital supplier's equity interest. In cases where the total average liabilities for

---

[1] Hōjin zei hō [Corporation Tax Law], Law No. 34 of 1965, *last amended by* Law No. 65 of 2010, arts. 21, 22.

[2] Eigyōgai hiyō [non-operating expenses], KOTOBANK (Japanese online dictionary), http://kotobank.jp/word/%E5%96%B6%E6%A5%AD%E5%A4%96%E8%B2%BB%E7%94%A8 (last visited June 14, 2011).

[3] According to Eric Rose & Takeo Mizutani, *Japan – Corporate Taxation* ¶ 10.3, INTERNATIONAL BUREAU OF FISCAL DOCUMENTATION [IBFD]: COUNTRY ANALYSES (JAPAN), http://ip-online.ibfd.org/kbase/ (by subscription) (last visited June 23, 2011), the thin capitalization rules also apply to a loan guaranteed by a foreign controlling shareholder and to interest paid on such a loan, and also to a loan mortgaged with bonds borrowed from a foreign controlling shareholder and to interest paid on such a loan.

the year of a company that may be subject to this rule do not exceed three times its own capital, the disallowance of the interest deduction does not apply.[4]

In this context a foreign controlling shareholder means a nonresident or foreign company that can control the domestic company because

1. it owns more than 50 percent of its capital directly or indirectly;[5]
2. the same person or entity owns more than 50 percent of the domestic and foreign company's capital directly or indirectly;[6] or
3. it holds a special relationship, such as one in which the domestic company's business mainly relies on transactions with the foreign shareholder.[7]

Interest payable on certain repurchase agreement (repo) transactions with a foreign controlling shareholder or capital supplier is exempted from thin capitalization rules and can be deducted from the total amount of interest due to a foreign controlling shareholder or capital supplier. However, in this case, a more restrictive 2-to-1, rather than 3-to-1, debt-to-equity ratio is applied to the calculation of thin capitalization.[8]

III. Tax-Related or Other Limitations on Debt Financing

N/A

IV. Deductions for Corporate Profit Distributions

A. Basic Principles of Taxing Corporate Income

Japan's effective corporate tax rate as of January 2011 is 40.69 percent.[9] The corporate tax rate under the Corporation Tax Law is 30 percent.[10] A lower tax rate applies to small companies.[11] Local taxes are added to this amount.

Dividends paid are not deducted from the corporation's taxable income. Individuals who have received dividends must pay taxes on them. In some cases a tax deduction is allowed.[12]

---

[4] Sozei tokubetsu sochi hō [Tax Special Measures Law], Law No. 26 of 1957, *last amended by* Law No. 12 of 2011, art. 66-5, para. 1.

[5] *Id*. art. 66-5, para. 4, item 1.

[6] Sozei tokubetsu sochi hō shikō rei [Tax Special Measures Law Enforcement Order], Order No. 43 of 1957, *last amended by* Order No. 206 of 2010, art. 39-13, para. 11.

[7] *Id*.

[8] Tax Special Measures Law art 66-5, para. 2.

[9] Hojin shotoku kazei no jikkō zeiritsu no kokusai hikaku [International comparison of effective corporate tax rate] (as of Jan. 2011), MINISTRY OF FINANCE JAPAN, http://www.mof.go.jp/tax_policy/summary/corporation/084.htm.

[10] Corporation Tax Law, Law No. 34 of 1965, *last amended by* Law No. 65 of 2010, art. 66, para. 1.

[11] *Id*. para. 2.

Among domestic corporations, 50 percent of dividends received from other domestic corporations less that portion of interest incurred on borrowed funds attributable to the principal amount on which such dividends have been received is not included in the calculation of profit. In cases where a domestic corporation receives a dividend from a subsidiary in which the corporation directly or indirectly owns 100 percent of the shares, the entire dividend from the subsidiary is excluded from profit for the purpose of corporation tax.[13] Certain exemptions also apply to dividends received from foreign corporations.

B. Deductibility of Distributions

Dividends paid are not deducted from taxable income.

V. Deductions for Distributing Dividends Under an Employee Stock Ownership Plan

There are Employee Stock Ownership Plans (ESOPs) in Japan. However, they are different from ESOPs in the United States. While a U.S. ESOP is a retirement benefit plan, a Japanese ESOP is not. There is not a specific law to define and regulate Japanese ESOPs. Most Japanese ESOPs are partnerships.[14] In recent years, some companies have begun using trusts for ESOPs.[15] In such cases, corporations are regarded as deemed beneficiaries of trusts and may be allowed to claim a deduction for interest paid on debts incurred to buy stock.[16] In either case, companies are not allowed to claim a deduction for dividends paid out to ESOPs.

VI. Treatment of Debt Cancellation

When a debt is reduced or cancelled, the borrower has taxable income from the reduction or cancellation.[17] When a corporation files bankruptcy, it is important to plan how to deal with the profit from exempted debt. There are special provisions in the Corporation Tax Law that allow corporations that have filed bankruptcy to minimize this profit.[18]

---

[12] Japan's taxation scheme for dividends paid to individuals is complicated. *See* Japanese Dividend Taxation for Individuals, THE JAPAN TAX SITE (Sept. 14, 2010), http://japantax.org/?p=3103; Shiro Sakakibara, Outline of Japanese Individual Income Taxes on Dividend Income (Sakakibara & Co., Nov. 2010), *available at* http://minatokobe-kaikei.com/wp/wp-content/uploads/2010/11/Japanese-taxation-on-dividend_Nov2010.pdf.

[13] Corporation Tax Law, Law No. 34 of 1965, *last amended by* Law No. 65 of 2010, art. 23.

[14] Masahiro Michino, Jūgyōin mochikabu kai no mondai ten [Questions Regarding Employee Stock Ownership Plans], RITSUMEIKAN HŌGAKU 6 (256), 340 (1552) (1996), http://www.ritsumei.ac.jp/acd/cg/law/lex/97-6/michino.htm (last visited June 14, 2011).

[15] Aratana jisha kabushiki hoyū sukīmu kentō kai [Committee on New Scheme on Company Holding Its Own Stocks], Aratana jisha kabushiki hoyū sukīmu ni kansuru hokokusho [Report on New Scheme on Company Holding Its Own Stocks] 1 (Nov. 17, 2010), http://www.meti.go.jp/press/20081117002/20081117002-2.pdf.

[16] *Id*. at 30–32.

[17] Saimu menjo eki [Profit of exempted debt], KOTOBANK, http://kotobank.jp/word/%E5%82%B5%E5%8B%99%E5%85%8D%E9%99%A4%E7%9B%8A (last visited June 16, 2011).

[18] Saimu menjo eki kazei taisaku [Countermeasures Against Profit of Exempted Debt], CITY-YUWA PARTNERS, http://www.city-yuwa.com/explain/ex_glossary/detail/saimumenjo.html (last visited June 16, 2011).

Prepared by Sayuri Umeda
Senior Foreign Law Specialist
June 2011

2011–005756

LAW LIBRARY OF CONGRESS

MEXICO

TAX TREATMENT OF CORPORATE DEBT

Executive Summary

Interest is deductible so long as the borrowed capital has been invested in activities that support the business's purpose. Interest on capital that is borrowed for the acquisition of nondeductible or partially deductible investments or expenses may be deducted only in the same proportion as such investments or expenses. A corporate taxpayer may not deduct interest derived from the amount of its debts that exceeds three times its equity incurred from debts contracted with nonresident related parties. Dividends are not deductible for the distributing corporation. The recipient of the dividend, however, generally obtains a credit for the tax paid by the distributing corporation under the Mexican imputation system, which operates under the principle that corporate profits should be taxed only once.

I. Introduction

Mexico's Income Tax Law (MITL) provides that corporate taxpayers may deduct interest due in the tax year, so long as the borrowed capital has been invested in activities that support the business's purpose.[1] To be deductible, interest must correspond to the interest rates available in the market.[2] If paid interest exceeds the market price the excess may not be deducted.[3]

If a corporate taxpayer borrows money and lends it to third parties, its employees, partners, or shareholders, the interest payments for the borrowed funds used by such taxpayer to make the loan may be deductible only up to the amount of the lowest stipulated interest rate on loans to third parties, its employees, partners, or shareholders.[4] This rule is not applicable to financial institutions.[5]

---

[1] Ley del Impuesto sobre la Renta [Income Tax Law] arts. 29(IX), 31(VIII), *as amended*, Diario Oficial de la Federación [DO], Jan. 1, 2002, available on the website of Mexico's House of Representatives *at* http://www.diputados.gob.mx/LeyesBiblio/pdf/82.pdf.

[2] Income Tax Law art. 31 (XIV).

[3] *Id.*

[4] *Id.* art. 31(VIII).

[5] *Id.*

Interest on funds that are borrowed for the acquisition of nondeductible or partially deductible investments or expenses may be deducted only to the extent that such investments or expenses are deductible.[6]

II. Limitations on the Deductibility of Interest

A. Thin Capitalization or Equity-Stripping Rules

The MITL provides that a corporate taxpayer may not deduct interest derived from the amount of its debt contracted with nonresident related parties that exceeds three times its equity.[7]

The amount of debt that exceeds this limit is determined by subtracting, from the annual average balance of all the taxpayer's debts, the amount that results from multiplying by three the quotient that is obtained by dividing by two the sum of equity at the beginning and at the end of the tax year.[8] If the domestic party has an excess of debt under this formula, the interest paid to the foreign related party is not deductible, either in whole or in part.[9]

The MITL considers that two or more parties are related when one of them participates directly or indirectly in the administration, control, or capital of the other, or when an individual, a company, or a group of individuals or companies participate(s) directly or indirectly in the administration, control, or capital of such parties.[10]

B. Limits on Borrowing for Tax-Exempt Income

No information could be located concerning specific limits on borrowing to acquire tax-exempt income. However, as stated above, the MITL provides that interest on a debt that is borrowed for the acquisition of nondeductible or partially deductible investments or expenses may be deducted only in the same proportion as such investments or expenses.[11]

III. Tax-Related or Other Limitations on Debt Financing

A. Tax-Related Limitations

The MITL does not appear to include an anti-avoidance rule.[12] However, the MITL provides that there are a number of situations where corporate taxpayers must treat as dividends

---

[6] *Id.*

[7] *Id*. art. 32(XXVI). *See also* Jaime González-Bendiksen et al., Mexican Tax Guide (CCH) ¶ 831, http://intelliconnect.cch.com (by subscription) (last visited June 20, 2011).

[8] Income Tax Law art. 32(XXVI). *See also* González-Bendiksen et al., *supra* note 7, ¶ 831.

[9] Income Tax Law art. 32(XXVI).

[10] *Id*. art. 215.

[11] *Id*. art. 31(VIII).

[12] Ricardo León & Mariana Eguiarte, *Mexico – Corporate Taxation* ¶ 7.1, INTERNATIONAL BUREAU OF FISCAL DOCUMENTATION [IBFD]: COUNTRY SURVEYS (MEXICO), http://online.ibfd.org/kbase/ (by subscription) (last visited June 22, 2011).

(which are not deductible) the interest derived from loans granted to resident companies, or to the permanent establishments in Mexico of nonresidents, by entities that reside in Mexico or abroad who are related to the payor, including:

- When the borrower agrees in writing to an unconditional promise to pay all or part of the credit received on a date determinable at any time by the lender,
- When the interest agreed exceeds the interest rate available in the market,
- When the lender has the right to intervene in the direction or administration of the borrowing company in cases where the borrowing company is noncompliant, and
- When the interest to be paid by the borrower is conditional upon it obtaining profits or when the amount of interest to be paid is determined based on such profits.[13]

B. Other Limitations

Corporate Law

Article 134 of the General Law of Business Entities provides that *Sociedades Anónimas* (i.e., privately held corporations) may not acquire their own stock.[14] However, article 56 of the Securities Market Law provides that publicly held companies may acquire their own stock provided that applicable requirements are met.[15]

Investment Law

Mexico's Banking and Securities Commission has the authority to determine the minimum capital of financial companies.[16]

IV. Deductions for Corporate Profit Distributions

A. Basic Principles of Taxing Corporate Income

The corporate tax rate is 30 percent.[17] Corporate taxpayers that distribute dividends are responsible for paying income tax at this rate.[18] However, if a corporate entity distributes dividends using profits for which it paid income tax, then these dividends are not taxable at the

---

[13] González-Bendiksen et al., *supra* note 7, ¶ 305. *See also* Income Tax Law arts. 31(XIV), 92.

[14] Ley General de Sociedades Mercantiles [General Law of Business Entities], *as amended*, art. 134, DO, Aug. 4, 1934, *available at* http://www.diputados.gob.mx/LeyesBiblio/pdf/144.pdf.

[15] Ley del Mercado de Valores [Securities Market Law], *as amended*, art. 56, DO, Dec. 30, 2005, *available at* http://www.diputados.gob.mx/LeyesBiblio/pdf/LMV.pdf.

[16] Ley de la Comisión Nacional Bancaria y de Valores [Banking and Securities Commission Law], *as amended*, art. 4(XI), DO, Apr. 28, 1995, *available at* http://www.diputados.gob.mx/LeyesBiblio/pdf/46.pdf.

[17] Arturo Pérez Robles, *Mexico – Corporate Taxation* ¶ 6.1.1.5., IBFD: COUNTRY ANALYSES (MEXICO), http://online.ibfd.org/kbase/ (by subscription) (last visited June 23, 2011).

[18] *Id.*

level of the individual or intercorporate shareholder.[19] The principle of this imputation system is that corporate profits should be taxed only once, to the corporation that realized the profit.[20] Dividends paid are not subject to withholding income tax applicable to shareholders.[21] Individuals must add paid dividends to their annual taxable base, but they may get a tax credit for the income tax paid by the distributing company.[22]

B. Deductibility of Distributions

Corporate taxpayers may not claim a deduction for the distribution of dividends.[23]

V. Deductions for Distributing Dividends Under an Employee Stock Ownership Plan

No information could be located concerning Employee Stock Ownership Plans in Mexico.

VI. Treatment of Debt Cancellation

The MITL provides that corporate taxpayers obtain taxable income from unpaid debts during the month in which the limitations period applicable to debt collection actions expires, or before then if it is evident that collection is not possible, e.g., when it is proved that the debtor has been judicially declared bankrupt.[24]

Prepared by Gustavo Guerra
Senior Foreign Law Specialist
June 2011

[19] *Id.* *See also* León & Eguiarte, *supra* note 12, ¶ 1.1.

[20] *Id.*

[21] Pérez Robles, *supra* note 17, ¶ 6.1.1.5.

[22] Ricardo León & Mariana Eguiarte, *Mexico – Individual Taxation* ¶ 1.5.1., IBFD: COUNTRY SURVEYS, http://online.ibfd.org/kbase/ (by subscription) (last visited June 23, 2011).

[23] Pérez Robles, *supra* note 17, ¶ 1.4.4.

[24] González-Bendiksen et al., *supra note* 7, ¶¶ 180, 645. *See also* Income Tax Law art. 18(IV), 31(XVI-c).

2011–005756

LAW LIBRARY OF CONGRESS

UNITED KINGDOM

TAX TREATMENT OF CORPORATE DEBT

Executive Summary

Although interest payments are deductible under the United Kingdom's corporate tax system, a number of provisions—including the UK's thin capitalization legislation and a "worldwide" debt cap—do exist that limit the deductibility of interest. However, dividends and other distributions are not deductible under the current corporate tax regime. The UK maintains an imputation tax system where companies are taxed through a corporation tax and shareholders are taxed at a reduced rate through the operation of an imputation tax credit. Though there is no exact equivalent to US Employee Stock Ownership Plans, the UK does operate Employee Share Ownership Trusts (hereinafter, ESOP trusts). In respect to ESOP trusts, the distribution of shares are only tax deductable at the time the employee acquires shares pursuant to the plan.

I. Introduction

Interest payments are generally deductable under the UK's corporate tax regime. However, such deductions are subject to specific anti-avoidance provisions, which primarily include thin capitalization rules and a "worldwide" debt cap.

II. Limitations on the Deductibility of Interest

A. Thin Capitalization or Equity-Stripping Rules

The current UK tax regime has included thin capitalization rules since April 1, 2004. Those rules apply to both domestic and cross-border loan transactions. The Finance Act 2004[1] introduced provisions to the Income and Corporation Tax Act 1988 (ICTA 88)[2] that extended the transfer pricing regime to include thin capitalization rules. Now, however, all of the transfer pricing legislation, including the thin capitalization rules, can be found in Part 4 of the Taxation (International and Other Provisions) Act 2010,[3] which, in essence, "represents a restatement" of all transfer-pricing rules enacted through ICTA 88 and subsequent amending legislation.[4]

---

[1] Finance Act 2004, c. 12.

[2] Income and Corporation Act 1998, c. 1.

[3] Taxation (International and Other Provisions) Act 2010, c. 8.

[4] PRICEWATERHOUSE COOPERS, INTERNATIONAL TRANSFER PRICING 2011 – 7002 STATUTORY RULES (updated through Mar. 1, 2010), http://www.pwc.com/en_GX/gx/international-transfer-pricing/assets/itp-2011.pdf.

The thin capitalization rules prior to April 1, 2004, "were changed in the Finance Act 2004 (2004 Act) with the intention of bringing them into line with the EC Treaty following the ECJ's decision in *Lankhorst-Hohorst*."[5] In 2007 the European Court of Justice found, in *Thin Cap Group Litigation v. Commissioners of Inland Revenue*[6] that the pre-2004 thin capitalization rules were "a restriction on the freedom of establishment, but that such a restriction is permissible in the context of wholly artificial arrangements entered into for tax reasons alone, provided certain criteria are met."[7] Subsequently on November 17, 2009, the UK High Court held, as summarized by IBFD, that the "UK thin capitalization rules, as applied before 2004, constituted a breach of freedom of establishment, and should therefore be disapplied in respect of transactions with a genuine commercial justification, in whole or in any relevant part."[8] However, the UK Court of Appeal overturned the decision and found that UK's thin capitalization rules did not infringe freedom of establishment.[9]

According to the UK's tax authority, Her Majesty's Revenue & Customs (HMRC), a UK company is thinly capitalized for tax purposes under the old and new rules when it has "more debt than it could and would have borrowed on its own resources, because it is borrowing either from or with the support of connected persons."[10] Thin capitalization is, therefore, normally seen within the context of intragroup borrowing. A typical scenario is when a UK holding company grants a loan to a UK subsidiary on favorable terms it would normally not receive given its borrowing capacity. With increasing indebtedness the UK subsidiary can claim tax deductions on the excessive interest payments, as a result reducing its UK corporate tax liability. Since "the interest remains within the group; the group as a whole is no less profitable, but the borrower has paid less tax, and, where the lender is in a country with a lower corporation tax rate than the borrower or has losses to absorb interest received, the group can end up far better off overall."[11]

---

[5] Practical Law Company, *Thin Capitalisation: The ECJ Weighs In*, PLC MAGAZINE (Mar. 23, 2007), http://plc.practicallaw.com/7-242-0133.

[6] Case C-524/04, Thin Capitalisation Group Litigation v. Comm'rs of Inland Revenue, 2007 E.C.R. I-2107.

[7] *Id.*

[8] Belema Obuoforibo, *United Kingdom-Corporate Taxation* ¶ 10.3., *in* INTERNATIONAL BUREAU OF FISCAL DOCUMENTATION [IBFD]: COUNTRY ANALYSES (UNITED KINGDOM), http://ip-online.ibfd.org/eth/ (by subscription) (last visited June 20, 2011).

[9] Test Claimants in the Thin Cap Group Litigation v. HM Revenue & Customs, [2011] A.C. 127 (EWCA Civ) [57] (appeal taken from Eng.), *available at* http://www.bailii.org/cgi-bin/markup.cgi?doc=/ew/cases/EWCA/Civ/2011/127.html&query=thin+and+cap&method=boolean. *See also Court of Appeal Concludes UK's Thin Capitalization Legislation is Compatible with European Law*, BRICK COURT CHAMBERS (Feb. 22, 2011), http://www.brickcourt.co.uk/news/22-02-2011---court-of-appeal-concludes-uk-s-thin-capitalisation-legislation-is-compatible-with-european-law.asp.

[10] HM Revenue & Customs, *International Manual – INTM542005 – Introduction to Thin Capitalisation (Legislation & Principles)*, http://www.hmrc.gov.uk/manuals/intmanual/INTM542005.htm (last visited June 20, 2011).

[11] *Id.*

However, thin capitalization does not only apply within the context of intragroup debt financing. It can also apply if the borrower is an unrelated third party that has received a guarantee of support from the UK holding company or other members of the group.[12]

Under the UK's tax regime, there are general transfer pricing rules in Taxation (International and Other Provisions) Act (TIOPA) 2010, Part 4 that apply to thin capitalization and there are sections in the same Act that are specific to thin capitalization, in other words, debt financing between two companies. The UK tax regime "relies exclusively upon the arm's-length standard" to "regulate excessively leveraged financing structures."[13] The test that HMRC applies is whether "the borrower could have borrowed the amount in question were it dealing at arm's length."[14] The general transfer pricing rules in regard to thin capitalization can apply to tax-paying companies that are "either borrowers or lenders."[15] According to Fursdon's *British Corporate Tax Guide 2010-11*, "in respect of borrowers, the transfer pricing legislation will, generally, disallow a corporation tax deduction for an interest (or discount) expense if the interest (or discount as the case may be) exceeds what it would have been in the absence of the special relationship between the borrower and lender."[16] The guide further explains that "in respect to lenders, the transfer pricing legislation will, generally, apply to impute a higher rate of interest (or discount) if the loan has been made at more favorable rates (for the borrower)."[17]

According to the *HMRC Tax Manual*, the main general transfer pricing sections in TIOPA 2010 that apply to thin capitalization are

- s.147: The basic pre-condition;
- s.148: The participation condition;
- s.150: The provision can be made up from a single transaction or a series of transactions;
- s.155: The requirement that the provision under consideration gives rise to a potential UK tax advantage; [and]
- s.164: The requirement that the UK's transfer pricing legislation should be interpreted in accordance with OECD principles.[18]

---

[12] HM Revenue & Customs, *International Manual – INTM542090 – The Main Thin Capitalisation Legislation: Guarantees – What They Do and What They Are*, http://www.hmrc.gov.uk/manuals/intmanual/INTM542090.htm (last visited June 20, 2011).

[13] Stuart Webber, *Thin Capitalization and Interest Deduction Regulations*, Copenhagen Research Group on International Taxation – CORIT, Discussion Paper No. 8 at 34 (2010), *available at* http://corit.dk/login/spaw2/uploads/files/CORIT%208%20Thin%20Capitalization%20and%20Earnings%20Stripping%20Regulations%202%201.pdf (last visited June 20, 2011).

[14] JON FURSDON, BRITISH TAX GUIDE: CORPORATION TAX 2010-11 at 210 (Roger Barnard ed., Walters Kluwer (UK) Ltd., 2010).

[15] *Id.* at 209.

[16] *Id.*

[17] *Id.* at 210.

[18] HM Revenue & Customs, *International Manual – INTM542010 – The Main Thin Capitalisation Legislation: Introduction*, http://www.hmrc.gov.uk/manuals/intmanual/INTM542010.htm (last visited June 20, 2011).

Sections in the TIOPA 2010 that are specific to thin capitalization include

- s. 152: Requires certain factors to be considered when comparing the arm's length provision with the actual provisions in s.147(1)(d) of TIOPA 2010;
- ss. 181–184: Sets out the conditions required for a lender to make a valid compensating adjustment claim where a disallowance has been made in the borrower's computations;
- s. 153: Deals with the factors that are taken into account when a loan is supported by a guarantee, and the borrower and the guarantor have a special relationship; [and]
- ss. 191-194: Sets out the conditions required for a guarantor to make a valid compensating adjustment claim.[19]

According to the *HMRC Tax Manual*, the thin capitalization rules apply "as much to transactions between two or more connected UK companies as to cross-border transactions involving the UK and other countries, if the basic conditions and relationships . . . are present."[20] The only difference would be that one of the parties to a UK-UK transaction "may be entitled to claim a compensating adjustment."[21]

B. Limits on Borrowing for Tax-Exempt Income

There do not appear to be any rules that restrict the deduction of interest in respect to tax-exempt or favorably taxed income.

III. Tax-Related or Other Limitations on Debt Financing

A. Tax-Related Limitations

In the context of group taxation, besides the thin capitalization rules, UK's corporate tax regime also imposes a "worldwide debt cap" on the tax deductibility of interest expenses "of UK companies which form part of a large group."[22] According to an International Bureau of Fiscal Documentation tax analysis,

---

[19] HM Revenue & Customs, *International Manual – INTM542015 – The Main Thin Capitalisation Legislation: Summary of Sections Specific to Thin Capitalisation*, http://www.hmrc.gov.uk/manuals/intmanual/INTM542015.htm (last visited June 20, 2011).

[20] HM Revenue & Customs, *International Manual – INTM542070 – The Main Thin Capitalisation Legislation: UK-UK Thin Capitalisation*, http://www.hmrc.gov.uk/manuals/intmanual/INTM542070.htm (last visited June 20, 2011).

[21] *Id.*

[22] *Worldwide Debt Cap Rules Have Now Commenced – Are You Prepared?*, KPMG: UNITED KINGDOM: ISSUES AND INSIGHTS, http://www.kpmg.com/UK/en/IssuesAndInsights/ArticlesPublications/Pages/WorldwideDebtCapRuleshavenowCommenced-AreYouPrepared.aspx (last visited June 28, 2011).

> [for] UK companies (in a worldwide group) that have net finance expenses, the available aggregate deduction for interest (or similar payments) is restricted to the consolidated gross financing expense of the group. . . . The worldwide debt cap rules also provide for the exemption of financing income where there has been a disallowance as a result of the restriction. In such a case, there is to be disregarded, for corporation tax purposes, an amount of financing income received by the UK companies within the group.[23]

The United Kingdom does not have a general anti-avoidance rule (GAAR) established by statute. However, an anti-avoidance rule has been developed by the UK courts. According to the IBFD, the rule in *Furniss v. Dawson* states that

> transactions will be disregarded for tax purposes where:
>
> - there is a composite or a preordained series of transactions which may or may not include the achievement of business purposes; and
> - steps are inserted which have no commercial purpose other than the avoidance of a tax liability.[24]

In addition, specific anti-avoidance provisions have been enacted through various tax legislation that does attempt to limit the debt versus equity ratio of companies. For example, section 443 of the CTA 2009 "contains a general disallowance for interest payments made pursuant to a tax avoidance scheme."[25] Moreover, tax arbitrage rules exist that target "the use of hybrid entities and hybrid instruments in order to obtain a tax advantage."[26] As discussed above, transfer pricing rules, and specific thin capitalization provisions also exist to limit "not at arms length" loan transactions between connected companies.

The UK treasury announced in January 2011 the creation of a study group that would "explore the case for a GAAR in the UK."[27]

B. Other Limitations

There do not appear to be any other limitations on debt financing.

---

[23] Obuoforibo, *supra* note 8, ¶ 1.4.5.

[24] *Id.* ¶ 10.1.

[25] *Id.*

[26] *Id.* ¶ 10.6.

[27] Press Release, HM Treasury, Details of Avoidance Study Group Set Out (Jan. 14, 2011), http://www.hm-treasury.gov.uk/press_04_11.htm.

IV. Deductions for Corporate Profit Distributions

A. Basic Principles of Taxing Corporate Income

Currently, the UK's corporate tax structure is based on the imputation system, where companies are charged through a corporation tax and dividends of shareholders "are taxable at a reduced rate due to operation of an imputation tax credit system."[28]

Between 1965 and 1973 the UK tax regime was structured along the lines of a classical system where company profits were charged through a corporation tax and the distributions of shareholders were charged through an income tax. Between 1973 and 1999 a partial imputation system was maintained where the profits of corporations continued to be taxed while shareholders who were recipients of dividends were entitled to an income tax credit. According to Fursdon's *British Corporate Tax Guide*,

> If the company paid a dividend or made any qualifying distribution during the accounting period, prior to 6 April 1999, it had to make a payment on account of its corporation tax liability for that period. This was called advance corporation tax (ACT). Subject to certain limits, this corporation tax paid in advance (ACT) could be deducted from the company's corporation tax liability.[29]

After April 1999 the ACT system was abolished; however, "a notional tax credit, associated with dividends, of one-ninth of the dividend," was maintained.[30]

B. Deductibility of Distributions

According to IBFD, "[d]ividends and other distributions paid by a company are not deductible in computing profits for corporation tax (Sec. 338(2) ICTA)."[31]

V. Deductions for Distributing Dividends Under an Employee Stock Ownership Plan

Unlike the U.S., the term "ESOP" is used in the UK as a broad term "for any employee share ownership plan, or trust."[32] UK ESOPs are not restricted to being a part of an employee's retirement plan but operate "as a means to deliver shares to employees, at intervals, throughout their career with the company".[33] Though there is no exact counterpart, the closest equivalent to a U.S. Employee Stock Ownership Plan (ESOP) is an employee benefit trust (EBT) set up as an employee share ownership trust (ESOT) (also known as an ESOP trust). According to HM

---

[28] Obuoforibo, *supra* note 8, ¶ 6.1.2.

[29] FURSDON, *supra* note 14, at 2.

[30] *Id.*

[31] Obuoforibo, *supra* note 8, ¶ 1.4.4.

[32] POSTLETHWAITE, UK SHARE PLANS FOR US COMPANIES, http://www.postlethwaiteco.com/documents/US-share-plans-guide-updated-12-2-08.pdf (last visited June 20, 2011).

[33] *How Esops Work*, THE EMPLOYEE SHARE OWNERSHIP CENTRE, http://www.mhcc.co.uk/esop/esop/bak/abesop2.htm (last visited June 20, 2011).

Revenue & Customs, EBT is a "trust set up by an employing company or its group parent company to provide employees with benefits which may take a variety of different forms."[34] An ESOT or ESOP trust is set up if the company seeks to "provide employees with benefits in the form of shares or options over shares in that company"[35] in the form of a trust.

According to Fursdon's *British Corporate Tax Guide*,

> In its current form, any act or omission by an employer (e.g., payment of a contribution to the EBT) which results in value being added to an employee benefit trust, will result in a disallowance for corporation tax purposes for the employer company. A deduction can be obtained subsequently where, broadly, remuneration is paid out of the EBT to an employee.[36]

In respect to share awards, "[t]he deduction is prescribed by statute at the time the employee acquires his shares pursuant to the option or units."[37] However, in order for the employer to receive a corporate tax deduction for an award of shares certain conditions in CTA 2009, Part 12 need to be fulfilled.[38]

VI. Treatment of Debt Cancellation

There do not appear to be any rules under UK's corporate tax regime that treat cancelled or reduced corporate debt as taxable income. It appears, however, that under accountancy principles in the UK a written-off debt is treated as income for corporation tax purposes.[39]

Prepared by Tariq Ahmad
Foreign Law Specialist
June 2011

---

[34] HM Revenue & Customs, *Specific Deductions – BIM4401 Employee Share Schemes: Glossary*, http://www.hmrc.gov.uk/manuals/bimmanual/bim44001.htm (last visited June 20, 2011).

[35] *Id*.

[36] FURSDON, *supra* note 14, at 445.

[37] *Id*. at 446.

[38] *Id*. at 447.

[39] Information obtained from an expert on UK accounting. Due to time constraints in drafting this report this statement could not be substantiated.