Chapter 15B Related Party Interest Expense

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References:

IRC §163(j)
R&TC §24344
R&TC §24344.7
Proposed Treas. Reg. §163(j)

Training Objectives:

This section of the Water's-Edge Manual provides an analysis of "earnings stripping" rules whereby interest deductions are **deferred** in connection with bona fide related party indebtedness or certain third-party indebtedness. These rules are applicable to both worldwide and water's-edge filers.

a. Introduction

IRC §163(j) (known as the interest stripping rules) was added to the IRC by the Omnibus Budget Reconciliation Act of 1989. Proposed federal regulations for §163(j) were issued in 1991 (which are still in proposed status).

Prior to IRC §163(j), a foreign parent could reduce the taxable income of its U.S. subsidiary by capitalizing it with large debt, while using treaty provisions to avoid U.S. withholding tax on interest received. Domestic parents could also take advantage of this loophole by borrowing money from a foreign subsidiary.

When the earnings stripping rules apply, the U.S. corporation is prohibited from taking a current deduction for that portion of its excess interest expense that is attributable to interest paid:

- to a related party which is wholly or partially exempt from U.S. tax on such interest
- on indebtedness to an unrelated person where the indebtedness is guaranteed by a disqualified guarantee. **(This criteria applies to tax years beginning on or after 12/31/93 for federal purposes, and to income years beginning on or after 1/1/96 for California purposes.**

Advantages of Taking an Interest Deduction versus Paying a Dividend

- Interest expense is deductible by U.S. corporations, while dividends are not.
- Most U.S. tax treaties reduce to zero the 30% U.S. withholding tax that ordinarily would apply to interest payments made by a U.S. corporation to its foreign parent or affiliate, while dividend payments, generally, are subject to withholding tax at treaty rates of 5% to 15%.

NOTE: Section 163(j) introduces a number of terms that are difficult to remember and keep straight. A glossary is included at Exhibit 15B-1 that you can refer to as you encounter these new terms. These terms are also defined in the text that follows.

b. Impact Of Section 163(J)

Section 163(j) applies to any corporation if such corporation has **excess interest expense** for a taxable year _and_ the ratio of debt to equity for such taxable year exceeds 1.5 to 1. The debt to equity ratio is computed at the close of the tax year (unless the IRS sets a different date in the regulations).[1]

If this section applies a portion or all of the taxpayer's disqualified interest expense may be disallowed in the current year .[2]

c. Disqualified Interest

Disqualified interest means any interest paid or accrued by the taxpayer to a **related person** if **no tax is imposed by the IRC (or Bank and Corporation Tax Law)** on the related person with respect to such interest. Disqualified interest also includes disqualified interest disallowed in an earlier year that is carried forward to the current year.

For years beginning before January 1, 1994, disqualified interest for federal purposes does not include interest paid or accrued under indebtedness with a fixed term:

- which was issued on or before 7/10/89, or
- which was issued after 7/10/89 pursuant to a written binding contract in effect on such date and all times thereafter before such indebtedness was issued.

California continued to exclude such interest from the definition of disqualified interest until years beginning on or after 1/1/96

For years beginning on or after January 1, 1994 (for federal purposes), disqualified interest also includes interest paid on indebtedness guaranteed by a disqualified guarantee if no **gross basis tax** is imposed on the interest income.[3] California conformed to this provision for income years beginning on or after January 1, 1996.[4]

d. Related Persons

"Related person" means any person who is related to the taxpayer within the meaning of IRC §267(b) or §707(b)(1). The constructive ownership and attribution rules of IRC §267(c) apply.[5] For corporations to be a related party, generally a more than 50% ownership interest is required.

Example 1:

U.S. Corporation A is owned 51% by Corporation B and 49% by corporation C. Corporations B and C are U.K. corporations. Since B meets the relationship test, A's interest payments to B are subject to the provisions of IRC §163(j) because B is exempt from tax on this interest income. The interest paid to C by A is not subject to the disallowance because C does not own more than 50% of A.

Example 2:

U.S. Corporation A is owned 50% by U.S. Corporation B and 50% by Corporation C, a U.K. corporation. Unless the substance of ownership differs from its form (constituting abuse), none of the interest paid by A is subject to disallowance under IRC §163(j) since the ownership requirement is not met. (i.e. no entity owns, directly or indirectly, more than 50%.)

NOTE: There is no requirement that the related person be a foreign corporation. A U.S. entity that is not a California taxpayer and is not unitary with a taxpayer falls within this definition.

e. Disqualified Guarantee

The term "disqualified guarantee" means any guarantee by a related party that is an exempt organization or a foreign person.

This term does not include a guarantee, identified by the Secretary by regulation, where the interest would have been subject to a **net basis tax** if the interest had been paid to the guarantor, or if the taxpayer owns a controlling interest (at least 80%) of the guarantor.

The term "guarantee" is broadly interpreted and can include any form of credit support, including a comfort letter.[6]

1. Pre Revenue Reconciliation Act Of 1993

Prior to the RRA 93, IRC §163(j) did not specifically refer to the treatment of guarantees. However, when drafting the initial statute the Conference Committee recommended that the anti-avoidance regulations should apply only to those related party guarantees that were used as a "device" to avoid the earnings stripping rules, and not to guarantees given "in the ordinary course" of business.[7]

As a guide (in absence of regulations), the 1989 Conference Report cited Plantation Patterns, Inc. v. Comr., 462 F.2d 712 (5th Cir.), cert. Denied, 409 U.S. 1076 (1972). The Plantation Patterns standard looks to whether the corporation could have obtained the loan at all without the guarantee and whether the guarantee created borrowing power for the corporation which normally would have existed only through the presence of more adequate capitalization. If, on the other hand, a parent guarantee served merely to lower the borrowing costs of a subsidiary that could have obtained the loan even without the guarantee (at less favorable terms), the subsidiary would not encounter problems under IRC §163(j) for any guaranteed debt. The test in Plantation Patterns requires a facts and circumstances analysis which is much more difficult to establish and sustain than the federal test enacted in RRA 93. (Under the Plantation Patterns standard, you must "sham" the transaction to treat the interest as disqualified interest.)

Proposed Treas. Reg. §1.163(j)-9 is "reserved" for regulations on guarantees and back-to-back loans, but to date has not been issued. Note, when the regulations are issued, they will reflect the law changes under RRA 93.

2. Post Revenue Reconciliation Act Of 1993

The 1993 RRA provided broader rules relating to loan guarantees and results in an automatic adjustment if the rules are met. California conformed to these changes for years beginning on or after January 1, 1996. For years beginning before January 1, 1996, there may be federal state differences since we will apply the Plantation Patterns test to these earlier years.

f. No Tax Is Imposed, Gross Basis Tax, & Net Basis Tax

1. No Tax Imposed

There is a federal/state difference concerning this issue. The actual language used in §163(j)(3) is as follows:

The term "disqualified interest" means any interest paid ... to a related person if no tax is imposed by this subtitle with respect to such interest."

The term subtitle means Subtitle A which includes IRC §1 - §1563. The federal tax in question will usually be the 30% withholding tax imposed by IRC §881. The tax can also be the federal income tax.[8] For state purposes, §23051.5(h)(3) requires us to substitute "this part" for "this subtitle". This part means Part 11 which consists of §23001 - §25141 (the Bank and Corporation Tax Law). There is no withholding tax on interest paid to foreign corporations for state purposes. Accordingly interest paid to a foreign corporation that is excluded from the water's-edge group generally will not be subject to tax under Part 11. Such interest payments will therefore constitute disqualified interest for California purposes.

2. Gross Basis Tax

Interest paid on indebtedness guaranteed by a disqualified guarantee is disqualified interest if no gross basis tax is imposed on the corresponding income. A gross basis tax is any tax imposed by Subtitle A of the IRC which is determined by reference to the gross amount of any item of income without reduction by deductions.[9] The gross basis tax that is relevant for purposes of §163(j) is the 30% withholding tax required by §881(a). Treaties usually reduce this tax to zero.

Since the Bank and Corporation tax law does not assess gross basis taxes, all interest paid on indebtedness guaranteed by a disqualified guarantee is disqualified interest for California purposes.

3. Net Basis Tax

A net basis tax is any tax imposed by Subtitle A of the IRC which is not a gross basis tax.[10] Interest paid to a related person or on a debt that is guaranteed by a disqualified guarantee is not disqualified it the interest income would have been subject to a net basis tax if the interest had been paid to the guarantor.

It is possible to have a net basis tax on interest income if the interest income is ECI. ECI of an affiliate would be includible in the waters-edge combined report. The problem is that for this to apply, it must be described by the secretary in regulations. No such regulations exist at this time. (There are not even any proposed regulations.)

g. Net Interest Expense

Net interest expense is the amount by which a bank or corporation's total interest expense exceeds its total interest income.[11]

Example 3:

Corporation A has total interest expense of $110 and total interest income of $10. Its net interest expense is $100 ($110 - $10).

h. Excess Interest Expense

Excess interest expense is the excess of **net interest expense** for the income year over 50% of its **adjusted taxable income** (see Chapter 15B(i), Water's-Edge Manual) for the income year plus any **excess limitation carryforward** (see Chapter 15B(k), Water's-Edge Manual).[12]

Example 4:

Corporation A has net interest expense of $100, current adjusted taxable income of $150, and $10 of excess limitation carryforward from a previous year. The excess interest expense is $15. (100 - [(50% x 150) + $10])

i. Computation Of Adjusted Taxable Income

IRC §163(j)(6)(A) provides that adjusted taxable income is computed as follows for federal purposes: (For California purposes, the computation should be based on net income after state adjustments but prior to apportionment, and the auditor needs to make sure that the federal adjustments are modified to reflect the items applicable to California. Those items which reflect obvious federal/state differences are noted in brackets [ ].)

Taxable Income (before 163(j))
Plus:

1. Net Interest Expense
2. NOL deduction [California]
3. Depreciation [California methods]
4. Amortization
5. Depletion

NOTE: The proposed federal regulations provide for some additional adjustments. See Exhibit 15B-2 for a listing of these adjustments. Remember that proposed regulations have no force and effect so the adjustments in the regulations will not apply until they become temporary or final regulations.

j. Disqualified Interest Disallowed

If there is disqualified interest and excess interest expense, then a portion or all of the disqualified interest will be disallowed. The amount disallowed is equal to the lesser of the disqualified interest or excess interest expense. If any disqualified interest is disallowed, the disallowed portion is carried forward and treated as disqualified interest paid or accrued in the subsequent year.[13] (This carryover amount is not, however, added to the subsequent year's interest expense for purposes of computing net interest expense for that year.[14]) The taxpayer may deduct this amount in the subsequent year to the extent it has **excess limitation** (see Chapter 15b(k), Water's-Edge Manual).[15]

k. Excess Limitation Carryforward[16]

When 50% of the adjusted taxable income exceeds the net interest expense, the excess is referred to as an excess limitation amount.

Example 5:

Corp A has adjusted taxable income of $100, interest expense of $30, and interest income of $20. Its excess limitation is $40. (100 x 50%) - ($30-$20) = $40)

As discussed in Chapter 15B (j), Water's-Edge Manual**,** any disallowed interest carried forward from a prior year is added to any current year disqualified interest and may be deducted to the extent of the excess limitation amount. The excess limitation amount is then reduced by the amount of disallowed interest expense carryforward which was allowed as a deduction in the current year.[17]

Example 6:

Assume the same facts as Example 5 except $10 of disqualified interest was disallowed in the prior year. . The $10 carryforward can be deducted to the extent of the $40 excess limitation. (The amount deductible is the lesser of disallowed interest carryforward or the excess limitation.) The excess limitation of $40 is reduced by the $10 of disallowed interest expense carryforward allowed as a deduction in the current year. The excess limitation carryforward is $30. [(100 x 50%) - 10 - (30-20)]

The excess limitation (after reduction for any deduction allowed for disallowed interest expense carryforward) is carried forward to the subsequent year and added to 50% of the taxpayer's adjusted taxable income for that year. The excess limitation can only be carried forward to 3 succeeding income years. The taxpayer can use the excess limitation carryforward to reduce any excess interest expense in the subsequent year. The carryforwards are applied in the order in which they arose (FIFO).

The amount of excess limitation used in a subsequent year is the lesser of

- the excess limitation carryforward, or
- net interest expense less 50% of adjusted taxable income (excluding any excess limitation carryforward).

Example 7:

U.S. Corporation X has an excess limitation carryforward from 1993 of $1,000. During 1994, X does not pay or accrue disqualified interest. Thus, X is not subject to disallowance under IRC §163(j) for interest paid in 1994. During 1994, however, X has $600 in excess interest expense (i.e. net interest expense exceeds 50% of its adjusted taxable income by $600 (without considering any excess limitation carryforward)). Thus, $600 of the $1,000 excess limitation carryforward will be added to 1994 adjusted taxable income to reduce the excess interest expense to "0". The taxpayer will have an excess limitation carryforward to 1995 of $400 ($1,000 - $600 used in 1994).

I. Comprehensive Example (Example 8)

	12/91	**12/92**	**12/93**
Interest expense	10,000	5,000	9,000
Interest income	3,000	2,000	3,000
Disqualified interest – current year	5,000	1,000	3,000
Disqualified interest – carryforward		4,000	
Adjusted taxable income	6,000	18,000	7,000

(Assume debt to equity ratio exceeds 1.5 to 1 for all years.)

- **12/91**

Net interest expense	= 7,000	(10,000 – 3,000)
Excess interest expense	= 4,000	
Disqual. Interest disallowed	= 4,000	(7,000 – [50% x 6000])
Disallowed interest carryforward	= 4,000	(the lesser of excess interest or disqualified interest expense)

- **12/92**

Net interest expense	= 3,000	(5,000 – 2,000)
Excess interest expense	= 0	(3,000 – [50% x 18,000]) (Excess interest cannot be a negative number)
Excess limitation	= 6,000	([50% x 18,000] – 3,000)
Disqualified interest	= 5,000	(1,000 for 12/92 + 4,000 carryforward or excess limitation)
Excess limitation carryforward	= 2,000	(6,000 – 4,000)

- **12/93**

Net interest expense	= 6,000	(9,000 – 3,000)
Excess interest expense	= 500	(6,000 – [50% x 7,000] – 2,000) (The 2000 = excess lim. Carryforward)
Disallowed interest expense	= 500	(The lesser of excess interest or disqualified interest expense)

NOTE: The excess limitation carryforward reduces 12/93 excess interest expense, and thus would be reduced to zero in 12/93 even if there was zero disqualified interest or the debt to equity ratio was less than 1.5 to 1.

See **Exhibit 15B-3** for a flow chart of the §163(j) computation.

m. Water's-Edge Application Post 1991 Years

For years beginning on or after 1/1/92, CCR §25110(d)(2)(G) was amended to provide that a foreign entity must include both its ECI *and* it U.S. source non-ECI business income in a water's-edge combined report. Chapter 8, Water's-Edge Manual
discusses this amendment in detail. As a result of this amendment, IRC §163(j) is generally inapplicable to payments made to foreign corporations if the following conditions are met:

- The income has a US source under federal law,
- The foreign corporation is unitary with the taxpayer, and
- The income is ECI or business income.

IRC §163(j) generally does not apply because the foreign entity is required to be included in the combined report to the extent of the U.S. source interest payments.[18] (The source of interest income is the residence of the debtor.) In cases where this interest is included in the waters-edge combined report under CCR §25110(d)(2)(G), the interest income is subject to California tax. Thus the interest expense would not be considered disqualified interest. (Including the interest and expense in the same return will also create a wash.)

IRC §163(j) will continue to apply to payments to nonunitary domestic and foreign affiliates that are not subject to tax in California.

The IRS proposed regulations also cover situations where the interest income is paid to entities such as controlled foreign corporations (CFCs), passive foreign investment companies (PFICs), and foreign personal holding companies.[19] Such interest is considered subject to U.S. tax to the extent that it is included in the gross income of the U.S. shareholders (as subpart F income of example). California does not tax the earnings of these entities as deemed dividends to the U.S. shareholders. In most cases, the interest paid to these entities will only be considered subject to tax under Pat 11 of the B&CTL to the extent that the entity is partially included in the water's-edge combined report (WECR). For example, if interest is paid in a year beginning prior to 1/1/92 to a CFC whose inclusion ratio is 75%, then 75% of the interest would be considered subject to California tax. The remaining 25% would be disqualified interest. Beginning in 1/1/92, all of the interest paid to a unitary foreign corporation would generally be included in the WECR if the interest income is business income, so §163(j) will not usually be applicable.

The computation of the amount of to be disallowed for California purposes (under §167(j)) different than the computation for federal purposes. For federal purposes, the computation is made on an affiliated group basis.[20] For state purposes, the computation is made using amounts from the combined report.[21]

n. Summary

IRC §163(j) limits the deductibility of interest paid to related persons that are not subject to California tax.

The earnings-stripping rules disallow a deduction for interest expense paid or accrued in a taxable year in which the following conditions apply:

- The debtor's debt-equity ratio exceeds 1.5:1
- The debtor has paid or accrued interest to a related person and which is not subject to Caifornia taxation.
- The debtor has excess interest expense which exceeds 50% of its adjusted taxable income plus any excess limitation carryforward).

Footnotes

1. IRC §163(j)(2)
2. IRC §163(j)(1)
3. IRC §163(j)(3)
4. R&TC §24344.7
5. IRC §163(j)(4)
6. Committee on Ways and Means, fiscal Year 11994 Budget Reconciliation Recommendations of the Committee on Ways and Means, 103rd Cong., 1st Sess., WMCP (May 18, 1993), ("1993 House Report") at 249. See also Tax Management International Journal, Vol. 22, No. 11, (November 12, 1993), page 589.
7. H.R. Conf. Rep. No. 386, 101st Congress, 1st Session 567 (1989)
8. Proposed Treas. Reg. 1.163(j)-4(a)
9. IRC §163(j)(6)(E)(i)
10. IRC §163(j)(6)(E)(ii)
11. IRC §163(j)(6)(B)
12. IRC §163(j)(2)(B)
13. IRC §163(j)(1)(B)
14. Proposed Treas. Reg. §1.163(j)-1.163(j)-1d
15. Proposed Treas. Reg. §1.163(j)-1(c)
16. IRC §163(j)(2)(B)(ii)
17. Proposed Treas. Reg. 1.163(j)-1(d)
18. R&TC §25110(a)(4); CCR §25110(d)(2)(G)
19. Proposed Treas. Reg. §1.163(j)-4(b) and (d)
20. IRC §163(j)(6)(C)
21. R&TC §24344(e)