Debt-Equity Regs Won't Solve Larger U.S. Tax Problems

By

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Against the backdrop of Treasury's proposed related-party debt-equity regs, practitioners and an official with the Joint Committee on Taxation on May 25 explored alternatives for addressing U.S. corporate tax shortcomings, with much of the discussion focusing on the need to follow examples set in the rest of the world.

"I commend Treasury for its efforts, but ultimately I think it is a complete waste of time," Andrew W. Needham of Cravath, Swaine & Moore LLP said in reference to Treasury's proposed section 385 regs (REG-108060-15), released in April. Speaking at an event in Washington sponsored by the District of Columbia Bar Taxation Section, Needham argued that an inversion was in the eye of the beholder and that the focus on shareholder base was irrelevant, given that that base would often nearly turn over before a deal closed. He argued that earnings stripping was the "icing on the cake" of an inversion, but not much more than that.

The proposed regulations would generally treat related-party debt as equity unless it facilitated new net investment in the borrower's operations. The regs were packaged as a way to combat earnings stripping, including among inverters, but are in reality much broader in their application. (Prior coverage.)

Oren Penn of PwC remarked that the regs were a significant departure from the OECD's recommendation in action 4 of its base erosion and profit-shifting project that would limit intergroup borrowing by imposing a German-style interest barrier rule plus a worldwide debt cap. (Prior analysis.)

Viva Hammer, JCT legislation counsel, asked whether the regs could be viewed as presenting "a question that comes before the question," in terms of how the regs might relate to interest deductions under the BEPS project.

"The question of what is debt or equity has to be asked before we ask what we do with the interest. I think you could take the view that it is not a departure, that it is an addition, a sidecar," Hammer said.

Penn argued that Hammer's characterization is probably how Treasury would characterize the regs, but that it was such a fundamental shift from international standards on what to call debt and therefore something that could create an interest deduction, that it was hard to separate debt classification from interest deductions.

"I don't think it will be effective in the long run, if it goes that far," Penn said about the regs. "If the underlying theme of this approach is to say we can only treat a related-party transaction as debt if you can effectively show a net cash infusion, if that's now the proposed standard . . .

there are probably, both administratively and practically, other solutions [to base erosion] that should be considered." He added that the seismic shift in tax rules represented by the regs might require legislative action instead.

Other Solutions

Needham argued that given the global migration to territorial tax systems, it might be inevitable that the United States would need to adopt either territoriality itself or some other form of integration that substantially reduces corporate tax revenue.
"The one thing Americans do really well is to spend, and they are better spenders than almost any other developed economy," Hammer said, noting that her remarks embodied work undertaken for the committee but that the work should not be construed to represent the position of any member of the committee or Congress.

Hammer acknowledged that some experts, including her fellow panelists, viewed the corporate system as unsustainable. She cited as an alternative, without endorsing them, consumption tax proposals such as the Progressive Consumption Tax Act of 2014 (S. 3005), introduced by Senate Finance Committee member Benjamin L. Cardin, D-Md. "If we are no longer going to be able to rely on the corporate tax or on the business tax as being a major source of revenue, then we are going to have to find another source," she concluded. Hammer argued that while any consumption tax would be a significant departure from the current system and might be counterintuitive, the general view that the United States would not tolerate a goods and services tax might be changing. (Prior coverage .)

Robert H. Dilworth of Dilworth Law Office argued that the U.S. economy has evolved into a services and consumption economy and that the United States might need to get past the third rail of politics to figure out how to tax consumption or the income from consumption. He further cited the United Kingdom's diverted profits tax, which relies on the strength of its market to be successful. He argued that earnings stripping would not be very relevant in future economic discussions.

The diverted profits tax expands U.K. rights to tax nonresident income earned through arrangements that are contrived, lack economic substance, and are designed to reduce tax.

Penn also held up the United Kingdom as providing an example of where future U.S. tax policy might go, noting that it had enacted a dividend exemption system funded through consumption-based taxes to bring companies back to its shores. (Prior analysis .)

"The debate is really do you want to stopgap this issue through a proposed reg or do you really want to finally sit down and address the issue, whether it's dropping the corporate rate, going broadly with where the rest of the world has gone on territoriality? Do you want to consider these other approaches that are being considered on the Senate side?" Penn asked.