AMERICANS FOR TaxFairness

COMMENTS TO THE U.S. TREASURY DEPARTMENT AND THE INTERNAL REVENUE SERVICE ON THE PROPOSED "EARNINGS STRIPPING" RULE
JUNE 10, 2016

Docket Number: IRS-2016-0014-0002
Docket Name: **Treatment of Certain Interests in Corporations as Stock or Indebtedness (REG-108060-15)**
Docket RIN: 1545-BN40
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Americans for Tax Fairness is a diverse coalition of 425 national and state endorsing organizations. Collectively, we represent tens of millions of members whose interests range from education and health care to labor rights and main street business, but our common interest is in a tax code that is fair and raises adequate revenue to meet our country's growing needs.

We are deeply troubled by the harmful tax avoidance practices of multinational companies, which have been reported widely. One recent study estimated that profit shifting by U.S. corporations costs the federal Treasury about $100 billion annually.[1] At least 55 percent of these profits are stashed in tax havens, with minimal tax.[2] And, although the details of these often highly complex profit-shifting transactions are understood by only a few, the public is aware that U.S. multinational companies, many of which are exceptionally profitable, are not paying their fair share of U.S. tax. This contributes significantly to the public's lack of trust in government, which further undermines our tax system and all that it funds.

We applaud Treasury's efforts to stem some of the worst of these abuses. In particular, we endorse Treasury's proposed earnings stripping regulations, which are a solid first step to limit the shifting by foreign parent multinationals of corporate profits from the United States to foreign countries through the use of deductible interest on debt. At the same time, we believe that there is much more that can and should be done to address earnings stripping through the use of deductible interest, royalties, rents, premiums and management fees. For example, Treasury should expand the bifurcation approach of the proposed regulations to limit the amount of an instrument that may be characterized as debt based on well-established metrics that are regularly used in the marketplace, such as interest expense to EBITDA.

Earnings stripping is a device by which a U.S. firm owned by a foreign parent—whether through an inversion, a merger or some other mechanism—generates deductible payments for the purpose of shifting profits offshore and avoiding U.S. taxes. Debt is commonly the vehicle,

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generating deductible interest payments. The U.S. firm purports to borrow money (often no money is actually borrowed) from its foreign parent, and then makes "interest" payments to the parent. The interest payments made to the foreign parent are tax deductible in the U.S. where the statutory corporate tax rate is higher, and the interest receipts are taxed at a much lower foreign rate. Such transactions must be stopped if federal tax receipts are to be protected.

Despite this ever-growing problem, no recent Congress has acted to stop it. Nor have the limitations on the deductibility of interest found in Section 163j of the tax code, which were enacted in 1989, been adequate to stop this practice. In the face of congressional failure and loss of federal revenues, Treasury must act.

Treasury aimed squarely at an important set of these abusive "debt" transactions in the proposed earnings stripping regulation of April 4, 2016. Treasury appropriately acted within its broad authority under Section 385, which provides:

> "The Secretary is authorized to prescribe such regulations as may be necessary or appropriate to determine whether an interest in a corporation is to be treated for purposes of this title as stock or indebtedness (or as in part stock and in part indebtedness)." 26 U.S. Code Sec. 385

We are especially pleased that the proposed rule not only covers post-inversion earnings stripping transactions, but all cross-border transactions where a U.S. company is owned by a foreign parent. Since Treasury issued its inversion rule notice in September 2014,[3] there has been a slowdown in inversions, where a larger U.S. firm becomes a subsidiary of a smaller foreign parent; however, tax-motivated mergers between companies of more equal size and, in some cases, between a larger foreign company and a smaller U.S. company continue. The new rules will level the playing field between foreign and domestic firms, reducing the availability of the debt-related earnings stripping tax advantage that foreign firms depend on to subsidize their takeover of a U.S. company. Similarly, we think the proposed rule also correctly extends to foreign firms that incorporate a U.S. subsidiary and use that subsidiary to create debt with the foreign parent to strip taxable earnings from the United States.

Treasury's April 4 action on earnings stripping will stop the most egregious uses of debt to strip earnings from U.S. corporations—those involving clearly artificial and unsubstantiated debt transactions. We encourage Treasury to proceed as expeditiously as possible on all of these actions and to continue its efforts to target the full range of multinational firms' tax avoidance techniques, which threaten the U.S. tax base and the many critical initiatives and programs it funds.

Again, we appreciate and strongly support Treasury's actions in the current debt-related earnings stripping notice and would be glad to respond to any questions regarding the views expressed in this letter.

[1] Kimberly A. Clausing, "Profit Shifting and U.S. Corporate Tax Policy Reform" (May 2016), available at http://equitablegrowth.org/report/profit-shifting-and-u-s-corporate-tax-policy-reform/.

[2] Gabriel Zucman, Journal of Economic Perspectives, Taxing Across Borders: Tracking Personal Wealth and Corporate Profits (Fall 2014), Figure 2, p. 128 and p. 130, available at http://gabriel-zucman.eu/files/Zucman2014JEP.pdf.

[3] U.S. Department of the Treasury, "Fact Sheet: Treasury Actions to Rein in Corporate Tax Inversions" (September 22, 2014), available at https://www.treasury.gov/press-center/press-releases/Pages/jl2645.aspx.