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Business Transformations

IRC Section 163(j): Another Cost of Leveraging an Acquisition

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Ever since the economic crash of 2008, foreign and domestic corporations have fought hard to get back to the days of steady growth. A lot of corporations have grown organically, but many essentially expanded through acquisition. Without the luxury of having excess cash reserves, these corporations typically opt to leverage their acquisitions by taking on some form of debt. This allows for more manageable and projectable cash flows, and the interest payments are tax-deductible – as long as you do not get caught up by an earnings stripping limitation such as IRC Section 163(j).

Section 163(j) was enacted in 1989 as a means of limiting the interest expense deduction of a taxable corporation that pays to a tax-exempt, or partially tax-exempt, entity whose economic interests coincide with those of the payer. Most commonly, but not solely, this becomes an issue when a foreign parent issues debt through a U.S. subsidiary. This is relevant today as corporations look to reduce their IRS bill by restructuring using controversial tax inversions. Section 163(j) serves as a barrier to corporations who otherwise would have a rather straightforward and otherwise legal means of significantly eroding its U.S. tax base through excessive interest deductions. Prior to Section 163(j), a foreign parent corporation could essentially reduce taxable income of its U.S. subsidiary simply by capitalizing it with large sums of debt. The foreign parent, presumably organized in a lower tax jurisdiction, would pay nominal amounts of tax on the income it received from its U.S. subsidiary, while the U.S. subsidiary would enjoy the benefit of an interest expense deduction at 35 percent. In addition, it would be possible to avoid U.S. withholding tax on the interest received if the foreign parent corporation was organized in a country that had treaty benefits with the United States.

The stand-alone fact that you may have a domestic subsidiary paying interest to a foreign parent does not automatically mean Section 163(j) will apply. In fact, there are a few instances where Section 163(j) will not limit your interest expense deduction. For example, Section 163(j) only applies to C corporations and foreign corporations with effectively connected income. Also, if a corporation has a debt-to-equity ratio that is less than 1.5 to 1, then they have essentially met what is referred to as the "safe-harbor test" and 163(j) would not apply. It is important to note that the calculation for the debt-to-equity ratio must be done using the tax basis of all assets, as opposed to fair market value, and it must be performed on a consolidated basis. Moreover, certain affiliated but nonconsolidated groups are all combined into the calculation as a single entity under Section 163(j)(6)(C).

If you do not meet the safe-harbor test, then the earnings stripping calculation must be done to determine if you have what is referred to as disqualified interest. The basic rule provides that interest will be disallowed to the extent that the payer's net interest expense exceeds 50 percent of adjusted taxable income plus any excess limitation carryover. IRC Section 163(j)(6)(B) defines "net interest expense" as the excess of interest paid or accrued over the amount of interest includible in gross income during such taxable year. "Adjusted taxable income" is a corporation's taxable income modified by various items, including, but not limited to, net interest expense, net operating loss deduction, tax depreciation, tax amortization, and a Section 199 qualified production activities deduction. A more thorough list of modifications is noted in Section 163(j)(6)(A) and corresponding regulations. Any disallowed interest is carried forward to subsequent years and included as net interest expense subject to the limitation. However, if a corporation has substantial adjusted taxable income, then there would be no disallowed interest in the

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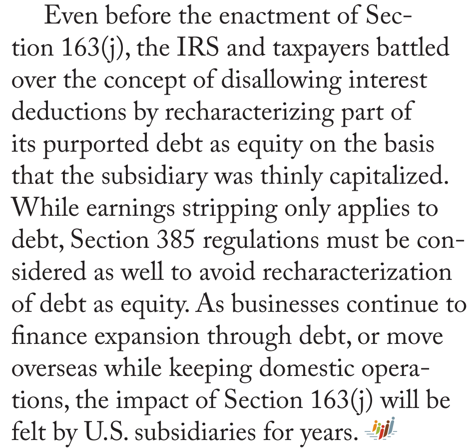
current year; it would have what is referred to as "excess limitation" as its net interest expense would most likely not surpass its adjusted taxable income. Any excess limitation is tracked and carried forward for a period of up to three years if unable to be used before then.

It is very important to carefully structure your debt agreements. Section 163(j) could still apply even if you thought you were in the clear because the funds were borrowed from an unrelated third party and went directly to the U.S. subsidiary. For example, if such a situation occurs as described above and a related tax-exempt entity simply guarantees the debt, presumably required by the financial institution, then Section 163(j) would be in play.

Even before the enactment of Section 163(j), the IRS and taxpayers battled over the concept of disallowing interest deductions by recharacterizing part of its purported debt as equity on the basis that the subsidiary was thinly capitalized. While earnings stripping only applies to debt, Section 385 regulations must be considered as well to avoid recharacterization of debt as equity. As businesses continue to finance expansion through debt, or move overseas while keeping domestic operations, the impact of Section 163(j) will be felt by U.S. subsidiaries for years.



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