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Obama Releases Details of Revenue Proposals, Including a Limitation on “Earnings Stripping”

On May 11, 2009, President Obama’s administration released its Fiscal Year 2010 Revenue Proposals (the “Revenue Proposals”). The Revenue Proposals include a proposal to tighten the limitation on the deductibility of interest paid by an expatriated entity to related persons.

Currently, section 163(j) of the Internal Revenue Code of 1986, as amended (the “Code”), operates to limit the deductibility of certain interest paid by a corporation to related persons (the “Section 163(j) Limitation”). The Section 163(j) Limitation applies to a corporation that (i) fails a debt-to-equity safe harbor of 1.5 to 1 or less and (ii) has net interest expense in excess of 50 percent of adjusted taxable income (computed by adding back net interest expense, depreciation, amortization and depletion, and any net operating loss deduction). Interest expense that is disallowed under the Section 163(j) Limitation may be carried forward indefinitely for deduction in a future tax year. Any excess limitation for a tax year (i.e., the amount by which 50 percent of the corporation’s adjusted taxable income exceeds net interest expense) may be carried forward to the three subsequent tax years.

The Revenue Proposals would tighten the Section 163(j) Limitation in the case of “expatriated entities,” which generally are foreign parent corporations that essentially have replaced a U.S. parent corporation through a merger or other form of corporation reorganization. The Section 163(j) Limitation would be revised with respect to expatriated entities

to (i) eliminate the current debt-to-equity safe harbor, (ii) reduce the 50 percent adjusted taxable income threshold for the Section 163(j) Limitation to 25 percent with respect to disqualified interest (other than interest paid to unrelated parties on debt that is subject to a related-party guarantee, with respect to which the 50 percent threshold would still apply), (iii) limit the carryforward for disallowed interest to 10 years and (iv) eliminate the carryforward for excess limitation. This proposal would be effective for taxable years beginning after December 31, 2010.

As currently described in the Revenue Proposals, the revisions to the Section 163(j) Limitation would not apply to corporations other than those that are affiliates of expatriated entities. However, it is clear from the Revenue Proposals that the administration is still studying whether the proposed changes to the Section 163(j) Limitation should apply more broadly. If the revisions were extended beyond the expatriated entity context, they potentially could apply to foreign-controlled U.S. corporations not involving an expatriated parent, as well as to taxable REIT subsidiaries. We will continue to monitor the Revenue Proposals and will update you as developments occur.

The tax lawyers at Hunton & Williams LLP are able to help you determine the impact of the Revenue Proposals on your business. If you would like to receive information about the Revenue Proposals, please contact any of the lawyers listed in this alert.