



Americans For Tax Reform Foundation

Analysis of Administration Proposals to “Reform the U.S. International Tax System”

Limit Earnings Stripping By Expatriated Entities

Current Law

Under current law, a debt-to equity ‘safe harbor’ provision (of up to 50%) exists to protect companies. This is a provision that reduces or eliminates a company’s liability and protects them from IRS action, provided they act in good faith. If you stay within the ‘safe harbor’, you will not be pursued by the IRS. Furthermore, disallowed interest expenses may be carried forward for deductions in subsequent years, and the corporations’ excess limitation for a tax year may also be carried forward to the three subsequent years.

The ‘safe harbor’ provision has two parts. Firstly, you must have a debt to equity ratio of less than 1.5 to 1. Secondly, you must have a net interest expense less than 50% of adjusted taxable income. If you are not within the safe harbor, the IRS assumes you are trying to shift income, and will deny deductions for interest. This has the effect of limiting the interest that can be deducted by a company.

Proposed Change

This proposal would eliminate the debt-to equity safe harbor, and would reduce the 50% adjusted taxable income threshold to 25%. The carryforward for ‘disallowed interest’ would be limited to 10 years, and the carryforward of excess limitation would be eliminated. This would significantly further limit the interest that can be deducted by a company.

ATRF Analysis

If enacted, this proposal would have two effects on top of raising the overall tax burden on businesses: 1)it would put the IRS in a position of determining how much debt/equity a company can hold, and 2)would interfere in the relationship between a stockholder and a company.

The effect of this would be to significantly punish debt-financing as opposed to share-financing, and in doing so significantly interferes with a business’s ability to choose how to finance projects. This also significantly limits the ability of a company to pay interest to the owner/stockholders.

If passed, this would significantly interfere with fundamental business decisions made by a company.

10-year Revenue Estimate:

U.S. Department of Treasury: \$1.2 billion

Joint Committee on Taxation: \$1.25 billion