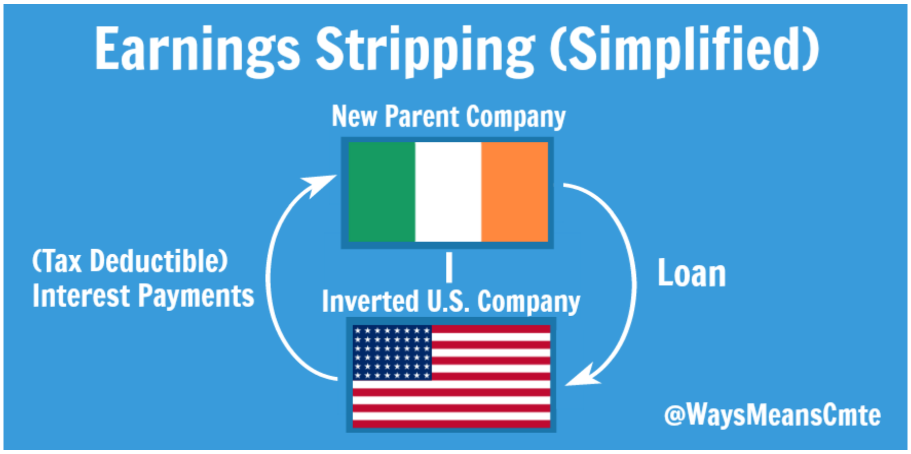
STOP CORPORATE EARNINGS STRIPPING ACT OF 2016

The Stop Corporate Earnings Stripping Act of 2016 (H.R. 4581) would limit a primary tax planning strategy – commonly known as earnings stripping – available to foreign-controlled U.S. multinational corporations following an inversion.

EARNINGS STRIPPING



A common tax avoidance strategy following an inversion transaction involves disproportionately leveraging the U.S. group with debt and "stripping" the U.S. tax base through deductible interest payments. The lending foreign parent or another foreign affiliate typically pays a reduced or zero rate of tax on the interest income under an existing U.S. tax treaty. A 2007 Treasury report indicated that foreign-controlled inverted corporations aggressively engage in earnings stripping practices.

Present law disallows a deduction for excess interest paid by a U.S. entity to a related party (where the interest payment is exempt from U.S. withholding tax) when the entity's: (1) debt-to-equity ratio exceeds 1.5, and (2) net interest expense exceeds 50% of its adjusted taxable income. Disallowed interest expense may be carried forward indefinitely for deduction in a subsequent year. In addition, the entity's excess limitation for a tax year (*i.e.*, the amount by which 50% of adjusted taxable income exceeds net interest expense) may be carried forward to three subsequent tax years.

However, foreign-controlled groups have been able to work around any limitations on interest deductions, because the present law requires the group to exceed both the debt-to-equity ratio threshold as well as the net interest expense threshold before excess interest deductions are disallowed. So long as the borrowing entity is able to maintain a debt-to-equity ratio of less than 1.5, it is not limited by the 50% net interest expense threshold.

H.R. 4581 - THE STOP CORPORATE EARNINGS STRIPPING ACT OF 2016

In the case of any U.S. corporation that inverts on or after May 8, 2014, this bill would further limit the foreign-controlled inverted group's ability to strip its U.S. tax base by:

- **repealing the debt-to-equity ratio threshold**,
- **reducing the permitted net interest expense threshold to no more than 25% of the entity's adjusted taxable income,**
- **repealing the excess limitation carryforward,** and
- **permitting disallowed interest expense to be carried forward only for five years (rather than indefinitely under present law).**

The foregoing limitations would apply if historical shareholders of the U.S. entity own more than 50% (but less than 80%) of the new foreign parent entity following an inversion.

BACKGROUND

On May 20, 2014, Rep. Levin and other Democrats first introduced legislation to amend Section 7874 in order tighten the restrictions on inversions ("Stop Corporate Inversions Act of 2014," H.R. 4679). The legislation would have applied to inversions completed after May 8, 2014.

Following the introduction of this bill, the U.S. Treasury Department released proposed regulations to address a number of tax planning techniques related to corporate inversions. However, despite these efforts, U.S. multinational companies continue to engage in inversions.

On January 20, 2015, Rep. Levin and other Democrats reintroduced the Stop Corporate Inversions Act (H.R. 415). The Stop Corporate Earnings Stripping Act of 2016 (H.R. 4581) is an additional measure designed to further deter corporate inversions.