US Inbound Newsalert

A Washington National Tax Services (WNTS) Publication

February 15, 2012

IRS releases guidance on section 163(j) excess interest expense limitation and section 871(m) dividend equivalent payment sourcing

In Chief Counsel Advice ("CCA") 201202021 (released January 13, 2012), the Internal Revenue Service ("IRS") addressed whether removing the Internal Revenue Code ("Code") section 163(j) limitation on the deductibility of interest with respect to certain indebtedness qualifies as a change in accounting method under section 446. As discussed further below, the IRS concluded in this CCA that there was not a change in accounting method. The proposed regulations under Section 163(j), which were issued on June 18, 1991, are the main source of guidance for applying the earnings stripping limitation rules. Under the doctrine of the duty of consistency, taxpayers generally must consider the extent to which they must take consistent positions in complying with various requirements of these proposed regulations. The conclusion of CCA 201202021 further impacts these considerations.

The IRS also released new regulatory guidance on January 19, 2012 regarding swap contracts over US equities that call for "dividend equivalent payments" to be subject to up to 30 percent gross US withholding. The discussion below highlights the major points addressed in these temporary and proposed regulations.

CCA 201202021

Section 163(a) generally permits a deduction of all interest paid or accrued within a taxable year. Section 163(j), however, limits a corporation's interest deduction on related party indebtedness in cases where the corporation has "excess interest expense" during the taxable year and where the corporation's ratio of debt-to-equity at the close of the taxable year exceeds 1.5 to 1. For purposes of determining the amount of a corporation's interest expense that is disallowed during the taxable year, but which may be carried forward for use in subsequent taxable years, "excess interest" generally means the excess of the corporation's net interest expense over the sum of 50 per cent of the corporation's adjusted taxable income ("ATI") and any excess interest limitation carryforward.

The taxpayer that is the subject of CCA 201202021 is the US parent corporation ("US Parent") of a US affiliated group filing a consolidated federal income tax return. US Parent is jointly owned, indirectly, by foreign entities, which own another foreign entity ("Foreign Corp") that made loans to US Parent and members of US Parent's affiliated group.

For certain taxable years, US Parent viewed Foreign Corp as a related party for purposes of applying the section 163(j) limitation, thereby limiting its section 163(a) interest deductions. The disallowed interest expenses were carried forward to succeeding taxable years.

As a result of an audit, the IRS determined that Foreign Corp, the entity that made the loans to US Parent, was not a related party for purposes of applying the excess interest expense limitation of section 163(j). Accordingly, US Parent was not subject to the section 163(j) limitation, and the IRS questioned whether the removal of the section 163(j) limitation is a change in accounting method under section 446. To the extent that the removal of the section 163(j) limitation was considered a change in method of accounting, the IRS would be required to implement the change in the earliest open year under examination with a section 481(a) adjustment, which would take into account the cumulative amount of interest not previously claimed as a deduction by US Parent.

Section 446 and the corresponding regulations generally define the term "method of accounting" to include not only the over-all method of accounting of a taxpayer but also the accounting treatment of any item of income or deduction, such as interest expense. The regulations provide that an accounting method change includes a change in the overall plan of accounting for gross income or deductions, or a change in the treatment of any material item used in the overall plan of accounting. A "material item" is any item that involves the proper time for the inclusion of the item in income or the taking of a deduction.

The IRS concluded in CCA 201202021 that removing the section 163(j) interest expense limitation on interest paid by US Parent did not change the item of income or the treatment of the item but, rather, the limitation placed upon this specific item of income such that US Parent would be able to recognize the full amount of interest that is otherwise deductible under its accounting method in a tax year. As a result, there was a permanent change of the amount of US Corporation's taxable income over its lifetime, which is not merely a change in the timing of income, and therefore is not a change in US Corporation's method of accounting.

Observations

CCA 201202021 does not clearly state the reason for the change in determining affiliation between US Parent and Foreign Corp. As a result, it is difficult to assess the extent to which this CCA may apply to other taxpayers.

At first glance, the conclusion of CCA 201202021 might seem favorable to many taxpayers because the result of the CCA was that the earnings stripping rules do not apply, and therefore, the taxpayer was not subject to the limitation on the deductibility of interest under section 163(j). Note, however, that interest expense subject to the section 163(j) limitation may be carried forward to future tax years without limitation, whereas if the section 163(j) limitation does not apply (if, for example, because the limitation has been removed), any excess interest expense likely would be included in a net operating loss ("NOL") for a taxable year. In contrast with the section 163(j) rules which permit an unlimited carryforward of excess interest expense, section 172(b) generally limits a taxpayer's ability to carry back NOLs for two prior tax years or carryforward such losses for 20 years. Accordingly, the result of the CCA may not necessarily benefit taxpayers that are unable to utilize expiring NOLs within the permitted timeframe.

The conclusion of CCA 2012002021 may present challenges to taxpayers that determine they should not have been subject to a section 163(j) interest expense limitation in tax years for which the statute of limitation on assessment has closed. In such cases, interest expense deductions attributed to closed tax years cannot be recovered by filing amended US federal income tax returns for the closed years. If, however, the statute of limitation on assessment has not closed for tax years in which the interest expense limitation of section 163(j) should not have applied, a taxpayer generally should be able to recover the interest deduction by amending the tax return for the year(s) in issue.

Overview of temporary and proposed regulations on dividend equivalent payments

On January 19, 2012, the IRS released temporary and proposed regulations regarding swap contracts over US equities that call for "dividend equivalent payments." The regulations implement changes in the law included in the H.I.R.E. Act of 2010. Prior to the change in law, payments under a notional principal contract ("NPC") made to a foreign counterparty generally were treated as foreign source income not subject to withholding. The H.I.R.E. Act added new section 871(m) making payments under certain NPCs US source income subject to withholding if the payment was determined based on dividend payments on US equities. The proposed rules provide a new, more expansive, standard for defining the scope of NPCs that are subject to US withholding. Although the expanded scope for NPCs over US equities giving rise to gross US-source dividends is only proposed, the proposed regulations highlight key factors in assessing which total return derivatives over US equities may be subject to future withholding. Given the expanded scope of those payments subject to withholding, the new rules issued in proposed form are intended to apply for payments made after December 31, 2012, and the current rules as set forth in the temporary regulations will remain applicable until that date. The newly issued regulations are relevant to entities engaging in derivatives transactions involving US equities, including asset managers as well as bankers and securities dealers.

For additional background information on the temporary and proposed regulations, see PwC's Banking, Capital Markets & Insurance Tax Alert ("New Guidance on US Withholding on Dividend Equivalent Payments on Swaps over US Equities").

Reminder of officers'/employees'2012 FBAR-related reporting obligations

Officers and employees who are US citizens or residents may be required to file Form TD F 90.22-1 (Report of Foreign Bank and Financial Accounts) ("FBAR"), by June 30, 2012 to report a financial interest in, or signature authority over, foreign financial accounts. In addition, individual taxpayers must affirmatively state on their US federal income tax returns whether they have a financial interest in, or signature authority over, foreign financial accounts and whether they are required to report these accounts on an FBAR. As a result, companies may need to provide officers and employees who are US citizens or residents and who have signature or other authority over company-owned foreign financial accounts with information about the accounts now to allow these individuals to meet their individual income tax reporting obligations.

For more information, please contact:

Ron Bordeaux	*(202) 414-1774*	*ronald.a.bordeaux@us.pwc.com*
Bernard Moens	*(202) 414-4302*	*bernard.moens@us.pwc.com*
Oren Penn	*(202) 414-4393*	*oren.penn@us.pwc.com*
Steve Nauheim	*(202) 414-1524*	*stephen.a.nauheim@us.pwc.com*
Susan Conklin	*(202) 312-7787*	*susan.j.conklin@us.pwc.com*
Alexandra Helou	*(202) 346-5169*	*alexandra.k.helou@us.pwc.com*
Eileen Scott	*(202) 414-1017*	*eileen.m.scott@us.pwc.com*