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US Treasury Department Loosens “Earnings Stripping” Rules

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The latest salvo in a years-long struggle to administer US “earnings stripping” rules took another turn on 31 October, when the US Treasury Department announced that it would loosen rules designed to limit the practice.

“Earnings stripping” or “interest stripping” refers to the practice of establishing intercompany debt from a US company to a foreign affiliate, creating deductions in the US and shifting income into lower-tax jurisdictions, lowering the group’s effective tax rate.

In 2016 the US Treasury issued tax regulations that deny debt status for any intercompany borrowing the proceeds of which were used to fund distributions by the borrower to affiliates. (The result of denying debt status is to treat the loan as an equity investment; this eliminates interest deductions and also, potentially, results in cross-border interest and principal payments on the loan being treated as dividends (subject to US withholding tax).)

The most controversial part of the 2016 rules was a per se rule that automatically treated intercompany borrowings as funding distributions if the borrower made distributions to affiliates at any time during the 36-month periods before and after the borrowing. The borrower’s actual purpose for the borrowing and the actual use of the funds were irrelevant: if a distribution occurred during the relevant 72-month period, the debt would be treated as equity.

Last week, the US Treasury reversed course and announced it would revoke the per se rule. Instead, only debt issued with a “sufficient factual connection to a

distribution" would be denied debt status and treated as equity. Debt issued without such a connection would be respected as debt.

The US Treasury also removed various documentation requirements relating to intercompany debt. These requirements had been necessary in order to preserve debt status. The US Treasury had previously identified the documentation requirements as unduly burdensome and designated them for removal.

These changes remove significant compliance burdens for multinational corporate groups with intercompany loans to US subsidiaries. They also make it easier to establish such intercompany loans with confidence that the government will respect them as debt.