Professor Shay Got It Right: Treasury Can Slow Inversions

By Steven M. Rosenthal

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In a recent *Tax Notes* article, Shay argued that Treasury could write regulations to reduce the tax incentives for U.S. corporations to expatriate. Rosenthal agrees with Shay and analyzes the legal support for regulations under section 385.

In July, Harvard professor Stephen E. Shay urged Treasury to write new regulations to limit the tax benefits that a U.S. corporation might anticipate from inverting (in effect, the U.S. corporation expatriates).[1] His article sparked strong reactions but little legal analysis.[2] I believe Shay is correct that Treasury has the legal authority to curb inversions.[3]

Shay suggested several ways — under several different code sections — for Treasury to reduce the tax benefits from inversions.[4] I will address the authority that appears to be most contentious — section 385, which, in my view, permits Treasury to administratively *treat* as stock some obligations issued by a U.S. corporation to a foreign affiliate, even if the obligations might be denominated as debt.

The Stakes

The treatment of an obligation by a corporation is important: Payments on stock (dividends) are not deductible, while payments on debt (interest) are.[5] After a U.S. corporation inverts, a foreign company wholly owns the U.S. corporation (and the former shareholders of the U.S. corporation own most or all of the foreign company). The U.S. corporation is still subject to U.S. taxes but can reduce its taxable income (and thus its U.S. taxes) by borrowing large amounts from its foreign parent and deducting interest payments on the loan (a practice known as interest stripping or earnings stripping). If the U.S. corporation did not invert, and borrowed from a foreign subsidiary, the borrowing would generally be deemed a distribution of unrepatriated earnings under section 956 and thus subject to tax.

The Tax Law

When enacting section 385 (and section 279) in 1969, Congress explained that "although the problem of distinguishing debt from equity is a long-standing one in the tax laws, it has become even more significant in recent years because of the increased level of corporate merger activities and the increasing use of debt for corporate acquisition purposes."[6] The staff of the Joint Committee on Taxation likewise summarized: "In many cases the characteristics of an obligation issued in connection with a corporate acquisition make the interest in the corporation which it represents more nearly like a stockholder's interest than a creditor's interest, although the obligation is labeled as debt."[7]

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[1]Shay, "Mr. Secretary, Take the Tax Juice Out of Corporate Expatriations," *Tax Notes*, July 28, 2014, p. 473.

[2]For a view similar to mine, see Samuel C. Thompson Jr.'s letter to the editor, "Professor Says Debt/Equity Regs Can Apply to Inversions," *Tax Notes*, Aug. 18, 2014, p. 883. For a contrary view on Treasury's legal authority, see Stuart L. Rosow and Martin T. Hamilton, "A Response to Professor Shay: Leave Inversions to Congress," *Tax Notes*, Sept. 8, 2014, p. 1187.

[3]Whether any particular regulation is desirable as a policy (or political) matter is beyond the scope of this article.

[4]He also suggested that many more ways may exist to reduce the benefits from inversion. There are hundreds of specific delegations in the code, and one general delegation (section 7805).

[5]Also, dividends are generally subject to withholding tax, and interest is subject to little or no withholding tax.

[6]S. Rep. No. 91-552, at 137 (1969).

[7]JCT, "General Explanation of the Tax Reform Act of 1969," JCS-16-70, at 123 (1970).

To deal with these problems and wider situations, Congress expressly authorized Treasury to write rules for particular factual situations, whether in connection with an acquisition or not.

> Section 385(a). Authority to prescribe regulations. The Secretary is authorized to prescribe such regulations as may be necessary or appropriate to determine whether an interest in a corporation is to be treated for purposes of this title as stock or indebtedness (or as in part stock and in part indebtedness).

Section 385 is unusual for the code: Its sole purpose is to provide Treasury with broad authority. Subsection (a), quoted above, authorizes Treasury to write appropriate regulations for all purposes of the code (including income tax, withholding tax, and other provisions). And subsection (b) directs Treasury, in these regulations, to set forth factors ''for a particular factual situation whether a debtor-creditor relationship exists or a corporate-shareholder relationship exists.''[8] Congress suggested five factors for Treasury to consider, but authorized Treasury to include other factors — or reject any of Congress' five factors — for any particular situation, anticipating the need for different tests in different situations.[9]

In the same 1969 legislation, Congress added a law that disallowed interest deductions on some debt incurred by corporations when acquiring the stock or assets of another corporation (section 279). But Congress explained that Treasury ''is not bound or limited by the [section 279 rules] for distinguishing debt from equity in the corporate acquisition context'' in writing regulations under section 385.[10]

In 1989, Congress expanded Treasury's authority under section 385: It permitted Treasury to treat an instrument having significant debt and equity characteristics as part debt and part equity.[11] But that legislation did not limit any of Treasury's authority under section 385.

In the 1989 legislation, Congress also added a new subsection 163(j), which limited deductions for interest paid to related parties that are exempt from U.S. tax on the interest received. The rule disallowed a deduction for ''disqualified interest,'' but the disallowed deduction could be carried forward to future years. Congress apparently added this rule to address earnings stripping by foreign affiliates of U.S. corporations.[12]

But Congress did not — in section 163(j) or its legislative history — limit Treasury's authority to issue guidelines to treat obligations as equity under section 385. Rather, Congress continued to believe section 385 could coexist with other approaches to disallow interest. While enacting section 163(j), Congress considered whether to treat interest on parent-guaranteed debt as disqualified. Instead of extending section 163(j) to guaranteed debt, Congress authorized Treasury to write regulations to disallow interest on that debt ''where the use of guaranteed third-party debt is a device for avoiding the operation of the earning stripping rules.''[13] Congress also explained that its grant of authority ''was not intended to restrict Treasury's ability under current law to recharacterize certain guaranteed loans as equity.''[14]

The Administrative Law

As a general proposition, the Supreme Court has stated that in ''an area as complex as the tax system, the agency Congress vests with administrative responsibility must be able to exercise its authority to meet changing conditions and new problems.''[15] And agencies often use broad grants of authority to go beyond the specific problem that prompted Congress to legislate in the first place.[16] Congress can delegate without a crystal ball.

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[8]In 1992 Congress added section 385(c), which requires issuers and holders to classify an instrument consistently. But Congress did not add to or limit Treasury's authority to write regulations under subsection (a).

[9]Congress based its factors on both the characteristics of the debt instrument and the characteristics of the holder of the instrument (*i.e.*, whether the holders were also stockholders). In short, Congress granted Treasury wide latitude: It did not require Treasury to weigh exclusively, or disproportionately, any specific factors.

[10]S. Rep. No. 91-552, *supra* note 6, at 138-139; JCT, *supra* note 7, at 124.

[11]The Omnibus Budget Reconciliation Act of 1989; H. Rep. No. 101-386, at 562 (1989).

[12]Section 163(j) applies to both tax-exempt organizations and foreign persons, but tax-exempt organizations were already slowed by section 512(b)(13).

[13]Treasury never wrote these regulations, and Congress, in 1993 legislation, added interest on some guaranteed debt as disqualified interest under section 163(j).

[14]H. Rep. No. 101-386, at 567 (1989). The report cited the IRS's ability to challenge guaranteed loans in court as an example but, in my view, Congress also preserved Treasury's authority to recharacterize guaranteed loans as equity under section 385.

[15]*Bob Jones University v. United States*, 461 U.S. 574, 596 (1983).

[16]*See, e.g.*, *United States v. Southwest Cable Co.*, 392 U.S. 157, 172 (1968). (The Court observed that although Congress may not have foreseen the development of terrestrial delivery, the expansive language of 47 U.S.C. section 152(a) suggests that it intended to give the Federal Communications Commission sufficient flexibility to maintain ''a grip on the dynamic aspects of'' video programming so the agency could pursue the statute's objectives as industry technology evolves.) *See also Massachusetts v. EPA*, 549 U.S. 497, 532 (2007) (''While the Congresses that drafted [section] 202(a)(1) [of the Clean Air Act] might not have appreciated the possibility that burning fossil fuels could lead to global warming, they did understand that without regulatory

(Footnote continued on next page.)

In 1984, in *Chevron*, the Supreme Court established the framework to evaluate the exercise of delegated authority: ''If Congress has explicitly left a gap for the agency to fill, there is an express delegation of authority to the agency to elucidate a specific provision of the statute by regulation. Such legislative regulations are given controlling weight unless they are arbitrary, capricious, or manifestly contrary to the statute.''[17] For the treatment of an interest in a corporation as stock or debt, Congress explicitly gave Treasury such a gap to fill. The Court further stated, ''When a challenge to an agency construction of a statutory provision . . . really centers on the wisdom of the agency's policy, rather than whether it is a reasonable choice within a gap left open by Congress, the challenge must fail.''[18] Thus, the Court affirmed that disagreeing with the agency's policy decision is not grounds for objecting to its action.

In 2011, in *Mayo*, the Supreme Court unanimously held that tax regulations, like other regulations, are entitled to *Chevron* deference.[19] As the Court explained, ''Filling gaps in the Internal Revenue Code plainly requires the Treasury Department to make interpretive choices for statutory implementation at least as complex as the ones other agencies must make in administering their statutes.''[20]

In *Mayo*, the Court also held that ''the principles underlying our decision in *Chevron* apply with full force in the tax context.''[21] Under those principles, Treasury may change its regulatory approach and the new approach will still benefit from *Chevron* deference. The Court also noted that ''neither antiquity nor contemporaneity with a statute is a condition of a regulation's validity.''[22]

Mayo effectively laid to rest the notion of ''tax exceptionalism,'' the idea that tax rules should be subject to a different administrative review.[23] As a result, tax professionals must realign their intuition; they must apply administrative law principles to tax rules.

What Can Treasury Do With Section 385?

Treasury can identify different factors for different situations to treat corporate obligations as stock, not debt, under section 385.[24] Shay suggested that Treasury write a regulation to classify as equity any debt issued by an expatriated entity to a foreign affiliate to the extent that the debt was excessive based on a test of the expatriated entity's debt-equity ratio and the size of its interest deductions. I believe Shay's approach would work, but I suggest Treasury instead simply identify particular factors that, if satisfied, would automatically treat a corporate interest as stock. I think this factor approach aligns better with the delegation in section 385.[25]

For example, Treasury could treat obligations of a corporation as equity if (1) the obligations were issued in connection with an inversion in which its former shareholders retain a majority ownership of the corporation (or, if Treasury desired a broader factor, in connection with any specified corporate merger and acquisition transaction involving its shares); (2) the obligations were held by a related person (including a corporation) that is not subject to U.S. tax;[26] (3) the corporation's debt-equity ratio substantially exceeds the average debt-equity ratio of its affiliated group; and (4) the corporation's interest deductions exceed 25 percent of its earnings before interest, taxes, depreciation, and amortization.[27]

Of these four factors, the first two relate to the holder of the instrument, and the second two relate to the issuer. In the first factor, we test how the holder came about acquiring the interest. In the second, we test whether the holder is related to the

flexibility, changing circumstances and scientific developments would soon render the . . . Act obsolete. The broad language of [section] 202(a)(1) reflects an intentional effort to confer the flexibility necessary to forestall such obsolescence.'').

[17]*Chevron USA Inc. v. Natural Resources Defense Council Inc.*, 467 U.S. 837, 843-844 (1984).

[18]*Id.* at 848.

[19]*Mayo Foundation for Medical Education and Research v. United States*, 131 S. Ct. 704, 712 (2011) (the Court expressly rejected a lesser deference for Treasury regulations).

[20]*Id.* at 707.

[21]*Id.* at 713.

[22]*Id.* at 712 (quoting *Smiley v. Citibank (South Dakota) NA*, 517 U.S. 735, 740 (1996)).

[23]*See, e.g.*, Steve R. Johnson, ''Reasoned Explanation and IRS Adjudication,'' 63 *Duke L.J.* 1771, 1773-1774 (2014); Lawrence Zelenak, ''Maybe Just a Little Special, After All?'' 63 *Duke L.J.* 1897 (2014); and Kristin E. Hickman, ''Unpacking the Force of Law,'' 66 *Vanderbilt L. Rev.* 465, 466 (2013).

[24]Admittedly, Treasury's track record in writing regulations under section 385 is poor. In March 1981 it proposed regulations under section 385 and finalized them 11 months later. Less than two years later, it withdrew the regulations in the face of widespread criticism of the mechanical tests (which permitted taxpayers to manipulate the rules). But, as discussed in the administrative law section above, Treasury's past efforts are not a factor in evaluating the legality of any future efforts.

[25]By contrast, Treasury's withdrawn regulations under section 385 provided a series of bright-line tests (and a safe harbor) to determine whether an instrument was debt or equity, rather than a multiple factor approach. T.D. 7747.

[26]A foreign corporation that is treated as a U.S. corporation under section 7874(b) would be subject to U.S. tax and, thus, not described in this factor.

[27]Treasury also might issue further guidance to define ''inversion,'' ''merger,'' ''related,'' ''substantially,'' ''large share,'' and other key terms in the regulations. Treasury's interpretation of an ambiguity in its regulations would be accepted, unless the interpretation was ''plainly erroneous.'' *Bowles v. Seminole Rock & Sand Co.*, 324 U.S. 410, 413-414 (1945).

issuer (which is similar to the relationship factor suggested already in the statute).[28] In the third and fourth, we test the financial condition of the issuer (which is suggested by one of the factors in the statute already, the debt-equity factor).

Congress expressly authorized Treasury to write ''appropriate'' regulations to treat an interest in a corporation as stock or debt in particular factual situations. The courts will uphold Treasury's regulations unless they are (1) procedurally defective, (2) arbitrary or capricious, or (3) manifestly contrary to the statute. Let's take those limitations in order.[29]

First, on procedure, Treasury must satisfy the Administrative Procedure Act's notice and comment process. It might apply the new rules only to obligations issued after the date the new regulations are announced — or to any interest accrued after that date if the relevant corporate M&A transaction occurred after a specified date. (Indeed, Treasury could apply the new rules to obligations issued after 1969, although as a policy matter, retroactive effective dates are disfavored.[30])

Second, Treasury must write regulations that are not arbitrary or capricious, which requires reasonableness.[31] A regulation would violate that rule if Treasury ''relied on factors which Congress has not intended it to consider, entirely failed to consider an important aspect of the problem, offered an explanation for its decision that runs counter to the evidence before the agency, or is so implausible that it could not be ascribed to a difference in view or the product of agency expertise.''[32]

Congress delegated broad authority to Treasury to *treat* an interest in a corporation as stock or debt. It also gave Treasury wide latitude to identify factors to determine whether a corporation-shareholder relationship or a debtor-creditor relationship exists for a particular factual situtation. It did not rule out any factors to consider — and it expressly authorized Treasury to add factors, as appropriate. My four factors, in combination, address a circumstance in which equity may, from a policy perspective, be improperly substituted for debt and, at a minimum, create an opportunity for abuse.

Some may object that the first factor (how the holder came about acquiring the interest) singles out U.S. corporations that invert (or, alternatively, engage in other specified M&A transactions). And perhaps that factor might better be characterized as a particular factual situation, and the other three factors applied to it. But, whether as a factor or a particular factual situation, this history warrants special consideration. That is because equity is often replaced with debt (and deductible interest payments) in an inversion or other corporate M&A transaction, as Congress observed in 1969.[33]

Moreover, several years ago Treasury studied the capital structure of U.S. corporations that invert. It concluded that ''there is strong evidence of earnings stripping by the subset of foreign-controlled domestic corporations consisting of inverted corporations (i.e., former U.S.-based multinationals that have undergone inversion transactions).''[34] Admittedly, in the report, Treasury cautioned, ''It is not possible to quantify with precision the extent of earnings stripping by foreign-controlled domestic corporations generally.'' The study supports Treasury's focus on inverted companies. But as part of the notice and comment process, Treasury should solicit public input on the extent of the earnings stripping of U.S. corporations that are inverted, of those that otherwise engage in M&A activity, and of all other corporations with borrowings from tax-exempt affiliates.

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[28]I think this factor would pass a treaty challenge, since it applies to both domestic and foreign persons that are exempt from U.S. tax.

[29]*Chevron* often is framed as a two-step test, and step one asks whether an agency's construction is invalid because the construction is contrary to a clear statute. In section 385, Congress explicitly authorized Treasury to write rules to *treat* an interest in a corporation as stock or debt — not a rule that defines stock or debt. If Treasury writes such a rule, it will hardly be contrary to a clear statute. That leaves *Chevron* step two (whether the agency's construction is permissible), which I analyze in the text above.

[30]Section 385 permits Treasury to write regulations for debt instruments issued after 1969. In 1996 Congress enacted section 7805(b), which limits retroactive regulations except in the case of abuse. But section 7805(b) was effective for ''regulations which relate to statutory provisions enacted on or after the date of the enactment of'' the Taxpayer Bill of Rights II. So I believe the section 7805(b) limitation is inoperative here. For a contrary view of the effective date of section 7805(b), see John Bunge, ''Statutory Protection From IRS Reinterpretation of Old Tax Laws,'' *Tax Notes*, Sept. 8, 2014, p. 1177.

[31]Johnson, ''Preserving Fairness in Tax Administration in the *Mayo* Era,'' 32 *Va. T. Rev.* 269 (2012).

[32]*Motor Vehicle Manufacturers Association v. State Farm Mutual Automobile Insurance Co.*, 463 U.S. 29 (1983). *See* Patrick J. Smith, ''The APA's Arbitrary and Capricious Standard and IRS Regulations,'' *Tax Notes*, July 16, 2012, p. 271.

[33]Treasury also is mindful of today's circumstances: There are a large number of U.S. corporations ready to invert. And once a corporation inverts, it's gone from the U.S. tax base. So, Treasury might justifiably address the challenge at hand — and later write broader rules for borrowing by U.S. corporations from foreign affiliates.

[34]Treasury, ''Report to the Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties,'' at 3 (Nov. 2007).

Some also may object that the second factor focuses on attributes of the lender (that is, relatedness) as opposed to attributes of the debt instrument. But one of the factors already suggested in section 385(b) focuses on the nature of the lender (that is, whether the holder of the debt is also a stockholder). That relationship is important to distinguish debt from stock as a matter of tax policy: When stock and debt are always held in equal proportion across owners, there is little meaningful difference in the rights of the two types of holdings (and a strong incentive for the stockholders to shift more of their economic interest to debt). This is more obvious for a corporation that is wholly owned by its lender (which occurs in an inversion).[35]

Most importantly, the arbitrary and capricious standard is relatively easy for an agency to satisfy. The agency must only show that its policy decision is ''rationally related'' to the statute's policy goals and that the decision comports with the structure of the statute.[36] That is because Congress delegates legislative authority to allow Treasury to fill in gaps. And a court will test Treasury only on whether its choice is reasonable, not on whether its choice is, from the court's perspective, the best alternative on policy or legal grounds.

[35]Indeed, if the lender is the sole shareholder, key attributes of debt are irrelevant, like creditors' rights. As David C. Garlock and Amin N. Khalaf observed, it is ''difficult to see why creditors' rights are of great importance, or in fact of any importance whatsoever. A parent corporation obviously is not going to sue its wholly owned subsidiary to collect on an intercompany debt and would not force the subsidiary into a bankruptcy proceeding.'' Garlock and Khalaf, ''Debt vs. Equity: Myths, Best Practices and Practical Considerations for U.S. Tax Aspects of Related-Party Financings,'' 92 *Taxes* 37, 45 (2014).

[36]*See, e.g.*, *Verizon Communications v. FCC*, 535 U.S. 467, 542 (2002).

Finally, the new regulations would not be manifestly contrary to section 385. Congress tackled the problem of debt arising in corporate mergers with two rules, one that could apply in either corporate merger situations or other situations — or both (section 385) — and one that could apply only to corporate acquisitions (section 279). There is no indication that Congress limited Treasury's authority then or later.[37]

Ultimately, in my view, Treasury can reasonably write regulations under section 385 that apply to a narrow range of obligations, with a broad set of tax consequences (that is, for both income and withholding tax purposes). By contrast, other provisions (like section 163(j) or section 279) might apply to a broader range of obligations, but with narrower effect (for example, interest deferral, not permanent disallowance). These various approaches are easily reconciled.

Conclusion

Treasury can use its authority under section 385 to treat some obligations of inverted corporations as stock, not debt. And Congress expected Treasury to treat some corporate obligations as stock without regard to Congress's other efforts to limit interest deductions on those obligations. New Treasury regulations would not prevent inversions, but they would reduce the tax benefits of those deals. But ultimately, Treasury must decide, as a policy and political matter, how to proceed.

[37]A later statute will not be held to have implicitly repealed an earlier one unless there is a ''clear repugnancy'' between the two. *Georgia v. Pennsylvania Railroad Co.*, 324 U.S. 439, 456-457 (1945).