(C) Tax Analysts 2014. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

A Response to Professor Shay: Leave Inversions to Congress

By Stuart L. Rosow and Martin T. Hamilton

Stuart L. Rosow and Martin T. Hamilton are partners with the tax group at Proskauer Rose LLP, New York. The authors gratefully acknowledge the assistance of Jeremy Peskin in the preparation of this article.

Rosow and Hamilton argue that Stephen E. Shay's section 385 proposal is not within the intended scope of the contemplated regulatory authority and that any normative approach to inversion transactions should come from Congress and not through regulatory proposals.

The views expressed in this article are solely those of the authors and not of Proskauer Rose.

Copyright 2014 Stuart L. Rosow and Martin T. Hamilton.
All rights reserved.

In a recent article in *Tax Notes*,[1] professor Stephen E. Shay urged Treasury to prevent further corporate expatriations by taking regulatory actions to reduce tax incentives of U.S. corporations to expatriate through so-called inversion transactions.

Shay's proposed regulatory actions require no legislation. He argues that preemptive administrative action to halt ongoing inversion plans is critical. Shay says that in the "current political environment there is little reason to believe that a statutory solution will be enacted," so executive branch agencies should act. He offers two proposals that he contends could be issued under existing grants of regulatory authority: one under section 385, and another under a combination of sections 956(e), 7701(l), and 7874(g). This article discusses Shay's section 385 proposal.

While one may agree with Shay's goals, we believe his suggestion that Treasury take unilateral regulatory action is misplaced. We also respectfully disagree with Shay's proposed mechanism to address the problem.

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

This article argues two points. First, Shay's section 385 proposal is not within the intended scope of the contemplated regulatory authority. Second, any major normative approach to inversion transactions should come from Congress via the regular legislative process and not through regulatory proposals.

What Is an Inversion?

What is an inversion transaction?

For purposes of our discussion, we consider an inversion transaction to be one in which a non-U.S. corporation (FCo) acquires a U.S. corporation (USCo), and USCo's historic shareholders end up with an ownership interest, perhaps even a collectively controlling interest, in FCo. USCo's historic U.S. operations normally continue after the inversion as before and remain subject to tax in the United States, usually as a subsidiary of FCo that is subject to U.S. corporate-level tax. USCo's historic non-U.S. operations, however, are now accomplished directly by FCo or related entities that are not subject to U.S. tax.

As Shay notes and some companies have admitted, it is likely that the historic U.S. operations' net taxable income would be reduced by interest deductions on intercompany debt from FCo.[2] FCo might restructure various entities it controls, including controlled foreign corporations. Other intercompany arrangements between the U.S. and non-U.S. entities in the resulting structure would be subject to transfer pricing rules in the United States and in other jurisdictions. Those are the basic elements of an inversion that are relevant for U.S. tax purposes.

None of that transactional technology is novel. The contemporary history of corporate expatriations begins with the Helen of Troy inversion to Bermuda in 1994, and continues with the evolution

[2]Far from being a unique element of the debate over inversion transactions, the deductibility of corporate interest expense under the code is an inescapable element of any meaningful discussion of the scope of the U.S. corporate tax base. There are myriad provisions addressing the computation, allocation, and deductibility of interest paid by corporations in both the code (*e.g.*, section 163(e), (f), (j), (l); as well as sections 269, 453, 861, 881(c), and 1271-1288) and regulations. Therefore, the deductibility of corporate interest expense paid after USCo expatriates is not a unique policy concern.

of section 367 regulations followed by the U.S. tax policymakers' struggle with inversions in the section 7874 regulations.[3]

Similarly, interest paid on intercompany debt to a related non-U.S. entity has been the subject of some statutory provisions (for example, sections 163(j) and 881(c)). The interest deduction necessarily raises one of the oldest problems of the income tax: distinguishing indebtedness from equity.[4]

The basic U.S. taxation of the critical elements of inversions under current law is well understood.[5] Most inversions are undertaken by widely held, publicly traded corporations, and disclosure of their expected U.S. tax treatment and that of their stockholders in public filings is required.[6] Moreover, they are usually motivated primarily by business considerations — acquisition of, or merger with, a foreign target of considerable substance — with the tax consequences acting as an additional side benefit.

Special Application of Section 385

Shay suggests that Treasury use its regulatory authority under section 385 to implement a variation of the proposal found in the discussion draft by House Ways and Means Committee Chair Dave Camp, R-Mich., and, in a slightly different form, in the president's green book for fiscal 2015.[7]

Essentially, Shay's proposal would apply only to expatriated lenders. It would reclassify as equity some of the debt of the expatriated USCo if it would have a debt-to-equity ratio that exceeded specific thresholds. Shay contends that despite section 385 not being an antiabuse provision, the statute's plain language permits regulations that are necessary and appropriate to determine whether an interest in a corporation is treated as stock, debt, or a combination thereof.

However, Shay's proposal requires section 385 to be read in a way that would apply a debt-to-equity test to otherwise structurally identical situations when the only difference is the prior domestic status of USCo as compared with any other parent corporation's shareholder/lender. Tax law generally frowns on different treatment of similarly situated taxpayers.

Section 385 was enacted in 1969, long before inversions were common. Its legislative history indicates that section 385 regulations might contemplate many factual situations.[8] However, there is nothing in the statute or its legislative history that suggests Congress intended to treat borrowers differently based on a related-party lender's domestic or foreign status or prior domestic status.

Indeed, section 385's legislative history contemplates Treasury regulations setting forth factors to be considered in determining whether a debtor-creditor or a corporation-shareholder relationship exists.[9] The possibility that the tested relationship might be the result of a disfavored transaction is nowhere discussed and is certainly not contemplated.

Moreover, using section 385 as a lever to address the narrow problem of interest deductions in the context of inversions is not within the statutory grant of authority. It is correct that the standard of *Chevron* deference[10] gives agencies broad latitude to interpret ambiguous statutes when Congress has not "directly addressed the precise question at issue." But Congress has directly addressed the interest deduction question in section 163(j).

Chevron requires that a rule not be "arbitrary, capricious or manifestly contrary to the statute."[11] The question addressed in section 385, as explained in the legislative history, is the appropriate distinction between equity and debt, not the propriety of an intercompany interest deduction.

---

[3]*See*, *e.g.*, Donald J. Marples and Jane G. Gravelle, "Corporate Expatriation, Inversions, and Mergers: Tax Issues," Congressional Research Service report (R43568) (May 27, 2014); Treasury Office of Tax Policy, "Corporate Inversion Transactions: Tax Policy Implications" (May 17, 2002).

[4]*See*, *e.g.*, A. Polito, "Useful Fictions: Debt and Equity Classification in Corporate Tax Law," 30 *Ariz. St. L.J.* 761 (1998); D. Hariton, "Distinguishing Between Equity and Debt in the New Financial Environment," 49 *Tax L. Rev.* 499 (1995); and W. Plumb, "The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal," 26 *Tax L. Rev.* 369 (1971).

[5]*See*, *e.g.*, the extensive description of these transactions and their consequences in the sources cited at *supra* note 3.

[6]*See*, *e.g.*, Definitive Proxy Statement of Forest Laboratories Inc. (May 5, 2014), *available at* http://www.sec.gov/Archives/edgar/data/38074/000119312514182901/d686059ddefm14a.htm#rom686059_118 (describing the Actavis PLC-Forest Laboratories merger proposal, which includes 10 pages on U.S. tax considerations, eight pages devoted to Irish tax issues, and several pages on risk factors).

[7]*See* Camp's Tax Reform Act of 2014 discussion draft (Feb. 21, 2014); Treasury, "General Explanations of the Administration's Fiscal Year 2015 Revenue Proposals," at 42 (Mar. 4, 2014).

[8]Tax Reform Act 1969, P.L. 91-172, 82 Stat. 487.

[9]*Id*. at 123.

[10]*Chevron U.S.A. Inc. v. Natural Resources Defense Council Inc.*, 467 U.S. 837 (1984).

[11]*Id.* at 844. Note that it is of course possible that Treasury could attempt to issue regulations under section 385 as an interpretive rule that is subject to overall *Chevron* deference (see *Mayo Foundation for Medical Education and Research v. United States*, 131 S. Ct. 704, 712 (2011)), rather than under the specific grant of regulatory authority under section 385. However, that potentially runs into an issue because Congress has already addressed the treatment of expatriated corporations under section 7874. A special rule applicable to expatriated entities under section 385 arguably would exceed the general grant of authority in section 7874.

(C) Tax Analysts 2014. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

Indeed, the preamble to the proposed, but never finalized, regulations under section 385 asserts that the legislation was intended to clarify — not override — debt and equity law because so many cases had not produced a satisfactory method for resolving the problem.[12] The regulations were withdrawn because they did not fully reflect the IRS and Treasury's position on debt and equity matters.[13] It is doubtful that the concept of an appropriate distinction between debt and equity was ever intended to include criteria that are wholly detached from the common law concepts of debt and equity. Section 385 should not be invoked to deter just one type of disfavored transaction.

Congress Should Set Inversion Policy

The issues involved in inversions are sufficiently complex and involve such high-level policy issues that Treasury and the IRS should defer to Congress. Deference would make sense, given that Congress has already addressed inversions directly in section 7874 and indirectly with interest deductions on related-party debt in section 163(j).

Moreover, Treasury has already promulgated regulations under those sections, as well as under section 367(a). Still, corporations have continued to invert via transactions that are intended to comply with the rules as corporations and their advisers understand them. To issue a new set of regulations[14] in an effort to stop inversions would punish corporations that have waited to see how the current rules will develop and that are still considering whether an inversion makes sense, while letting those that have already inverted benefit from having moved quickly.

Further, congressional attention to inversions is ongoing. Senate Finance Committee member Charles E. Schumer, D-N.Y., has introduced legislation that would tighten section 163(j) and have effects comparable to those of the ideas that Shay proposed.[15] Sen. Richard J. Durbin, D-Ill., has publically encouraged one company not to invert, a sign that Congress could take up comprehensive legislation on inversions.[16]

That the current political environment is nonconducive to the passage of legislation is an overstatement. Shay's argument that regulatory action must be taken is tantamount to saying that Treasury and the IRS have the plenary authority to be the first actor on tax policy. We respectfully disagree with that proposed reversal of the general process of policymaking.[17]

The reasons why corporations invert raise policy issues that are much larger than the negative effect of a handful of transactions undertaken by domestic corporations. In particular, rules that would make it effectively impossible to extract USCo from the United States by means of a commercially viable combination could deter foreign enterprises from investing capital in the United States. Most of the proposals, including Shay's, would exempt foreign-parented groups for that reason.

When a foreign corporation acquires U.S. businesses, shareholders — both domestic and international — receive an economic benefit. An inversion is merely a form of foreign direct investment. Rules targeting inversions need to be broad enough to encompass issues that extend beyond interest deductions, implicating the taxation of offshore earnings of U.S. multinational corporations.

Any anti-inversion rules should minimize their disruptive effects on the investment of capital into U.S. corporations. They should level the taxation of

---

[12]*See* 45 F.R. 18,957 (Mar. 24, 1980) (''The question of whether an interest in a corporation is stock or indebtedness has created considerable difficulties and led to much litigation. A large body of case law has failed to produce any fully satisfactory method for resolving the problem. Because of the significant difference in the Federal tax treatment of stock and indebtedness, Congress has enacted legislation designed to clarify the law'').

[13]Withdrawal of T.D. 7747 on debt and equity, 48 F.R. 31,053 (July 6, 1983); *see also* ''Treatment of Certain Interests in Corporations as Stock or Indebtedness,'' 45 F.R. 86,438 (Dec. 31, 1980).

[14]We note that it seems unlikely that the form of guidance issued in response to Shay's urgent call would be a notice of proposed rulemaking with a complete and detailed regulatory proposal. The approach to recent regulatory projects, particularly when controversial (*e.g.*, the Foreign Account Tax Compliance Act (Notice 2011-34, 2011-19 IRB 765) and section 871(m) (Notice 2014-14, 2014-13 IRB 881)), has been for the IRS and Treasury to issue one or more notices or announcements setting out the general structure for proposed regulations and a request for comments. That notice-based approach to rulemaking — while helpful in communicating the government's thinking about the form that future guidance will take and putting taxpayers on notice about the government's intent to change current market practices — is not a substitute for the careful and deliberate process of drafting fair and administrable Treasury regulations to address particular situations. We think it is possible that a notice expressing an intention of Treasury to open a regulatory project under section 385 would cause considerable uncertainty among taxpayers generally about the stability of debt-equity analysis under the code. That would serve only to magnify the existing uncertainty resulting from what is reputed to be the heavy docket of pending cases that have the treatment of lending transactions as a central issue (see Lee A. Sheppard, ''Defending Cross-Border Debt-Equity Cases,'' *Tax Notes*, Jan. 27, 2014, p. 385).

(Footnote continued in next column.)

[15]Lindsey McPherson, ''Schumer Unveils Anti-Inversion Plan to Limit Interest Deductions,'' *Tax Notes*, Aug. 18, 2014, p. 776.

[16]Durbin, ''Durbin Urges Illinois-Based Hospira Not to Turn Its Back on America to Dodge Taxes'' (Aug. 14, 2014).

[17]A detailed consideration of the proper role of the executive and legislative branches in tax policymaking generally would lead this article far afield, but we suggest as a general matter that that discussion may be overdue.

(C) Tax Analysts 2014. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

U.S. and foreign corporations doing business in the United States and abroad. Those policy decisions require legislative consideration. If changes cannot be adopted in the current political environment, that is a good reason for Treasury not to act, but to wait until the political environment resolves itself.

In conclusion, there continues to be a debate about when and in what form the U.S. income tax should be reformed. The U.S. system of international taxation, and the disparate treatment of enterprises that are controlled inside the United States vis-à-vis those controlled outside the United States, must be reformed in a way that reflects the reality of a globally competitive economy.

National governments worldwide have adopted their corporate tax codes to promote inbound investment as well as revenue generation. Instituting more stopgap approaches to particular transactions that are a response to the fundamental questions raised by the existing international provisions misses the point. The underlying policy issues can only be resolved completely through congressional action. It may be time for Treasury and the IRS to stop trying to cure symptoms and to encourage Congress to enact the cure.

Practitioners made perfect.

Tax Analysts' Expert3® package gives you the three online daily publications that tax experts at the world's leading firms rely on: *Tax Notes Today*, *State Tax Today*, and *Worldwide Tax Daily*. Unlike other publishers which provide limited international and state tax coverage, Tax Analysts keeps you completely up to date on all the news and issues each and every day. We cover Capitol Hill, more than 180 nations, and all of the U.S. states and territories using an unparalleled network of correspondents and tax practitioners. Plus we offer one-of-a-kind tax analysis from leading experts like Lee Sheppard, Martin Sullivan, David Brunori, Joseph Thorndike, and many more. With Expert3,® you'll always have the reliable information you need on critical tax law changes and policy shifts at every level.

To learn more or to contact a representative, please visit **taxanalysts.com/expert3**.

taxanalysts®

(C) Tax Analysts 2014. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.