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Client Alert

Tax Practice Group

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Anti-Inversion Regulations Held to Violate Administrative Procedure Act

On September 29, 2017, the United States District Court for the Western District of Texas struck down a 2016 temporary regulation designed to limit corporate inversions (the "Rule").[1] The Rule was simultaneously issued as a temporary regulation effective immediately and as a proposed regulation. In a brief opinion, the court held that the Rule was subject to the notice and comment requirements of the Administrative Procedure Act (the "APA"),[2] and because those requirements had not been followed, the Rule was invalid.[3]

Background

In April 2016, the United States Department of the Treasury ("Treasury") issued the Rule as part of a package of regulations targeting corporate inversions (the "Anti-Inversion Regulations").[4] The Anti-Inversion Regulations aimed to limit transactions in which a multinational group with a U.S. parent is restructured so that a foreign company acquires the U.S. parent, thereby becoming the new parent of the multinational group. Such transactions, commonly known as "inversions," can result in the reduction or elimination of the group's U.S. tax liability. Section 7874—the Internal Revenue Code's primary anti-inversion provision—imposes tax on the "inversion gain" that results from such transactions, and may even subject the foreign corporation to U.S. taxation as a domestic corporation.

Section 7874 can be avoided altogether, however, if a company structures the inversion transaction so that the former shareholders of the inverting U.S. parent hold less than 60% of the new foreign parent's stock. One way to achieve that result is to have the foreign company acquire multiple U.S. target companies over a period of time, rather than all at once. Those serial inversions result in the foreign parent increasing in value with each acquisition in which the foreign company stock is used as consideration, and allows the foreign company to acquire progressively larger U.S. companies without triggering section 7874. The Rule discourages serial inversions by disregarding foreign company stock that is attributable to acquisitions of U.S. companies during a 36-month look-back period for purposes of applying the ownership thresholds of section 7874, thereby making it more likely that an inversion will be subject to section 7874.

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The plaintiffs in the case, the Chamber of Commerce of the United States of America and the Texas Association of Business, filed suit claiming that the Rule violated the APA, the principal statute governing the rule making authority of administrative agencies. The plaintiffs contended that the Rule exceeded Treasury's statutory jurisdiction, was arbitrary and capricious, and was promulgated without the required notice and comment period. The plaintiffs moved for summary judgment on each of the three grounds.

Application of the Administrative Procedure Act

The APA instructs courts to strike down agency actions and rules that exceed the authority granted to the agency by statute.[5] In issuing the Rule, the government principally relied on section 7874, which directs Treasury to "prescribe such regulations as may be appropriate" and "provide such regulations as are necessary" to achieve the anti-inversion purpose of section 7874.[6] The court held that the Rule fell within this "broad authority" granted by the statute, and thus did not exceed Treasury's statutory jurisdiction.

The APA also directs courts to invalidate agency actions and rules that are "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law."[7] A rule is arbitrary and capricious if "the agency has relied on factors which Congress did not intend it to consider, entirely failed to consider an important aspect of the issue before it, 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."[8] The court concluded that Treasury had thoroughly explained the basis for the Rule, relied on appropriate factors in formulating the Rule, and considered all important aspects of the issues involved. Therefore, the Rule was not arbitrary and capricious.

Finally, the APA requires agencies to publish notice of proposed regulations in the Federal Register, and provide a period of at least 30 days for interested persons to submit comments before the rule becomes effective.[9] The government argued that section 7805(e), which instructs Treasury to issue temporary tax regulations simultaneously as proposed regulations and sunsets them after three years, abrogated the APA's notice and comment requirement. Although section 7805(e) makes no direct mention of the APA, the government claimed that the legislative history of section 7805 reflects Congressional intent to eliminate notice and comment for temporary tax regulations. Under the APA, however, a "[s]ubsequent statute may not be held to supersede or modify [the notice and comment requirement] . . . except to the extent that it does so *expressly*."[10] Because section 7805(e) lacks an express exemption from the APA, the court held that notice and comment was required, and it would not "disregard explicit directives of the APA in favor of legislative history."

The government further asserted that the Rule was an "interpretive" regulation because it merely clarified the terms in section 7874 and advised the public on Treasury's interpretation of that section of the Internal Revenue Code. Notice and comment is required for substantive rules, also known as legislative rules, but not for interpretive rules. As the Fifth Circuit has explained, "'Substantive rules,' or 'legislative rules' are those which create law, usually implementary to an existing law; whereas interpretive rules are statements as to what the administrative officer thinks the statute or regulation means."[11]

The court rejected the government's argument that the Rule was only interpretive. It indicated that section 7874 imposes the 60% ownership rule with respect to the "stock" of the foreign company, but that the Rule treated certain stock as "non-stock" for that purpose. That regulatory exclusion marked a substantive change to the rule created by the statute, not a mere interpretive gloss on the statute. Therefore, the court held that the Rule was not excused from the notice and comment requirement.

In ruling in the plaintiffs' favor, the court also rejected the government's assertion that the Anti-Injunction Act required dismissal of the case.[12] The court held that the Anti-Injunction Act did not bar the suit because the plaintiffs were not seeking to restrain the government from assessing or collecting any tax, which is a prerequisite for application of the statute. This reading of the Anti-Injunction Act departs from a recent decision by the D.C. Circuit, which held that a similar challenge to a regulation imposing penalties on banks that fail to comply with certain reporting requirements was barred by the Anti-Injunction Act.[13]

Insights

The government has not yet indicated whether it plans to appeal. Should other courts follow suit and hold that temporary regulations are invalid if Treasury failed to provide a notice and comment period, a significant number of regulations could be at risk of invalidation. In such cases, one of the primary questions under the APA would be whether the regulation at issue was "interpretive" or "substantive." The government also invariably would seek to persuade reviewing courts to side with the D.C. Circuit in holding that the Anti-Injunction Act bars preemptive regulatory challenges such as these.

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[1] Treas. Reg. § 1.7874-8T.
[2] 5 U.S.C. §§ 500 *et seq*.
[3] *Chamber of Commerce of the United States of America v. IRS*, 1:16-cv-944, (W.D. Tex. Sept. 29, 2017).
[4] T.D. 9761 (Apr. 4, 2016).
[5] 5 U.S.C. § 706.
[6] Sections 7874(c)(6) and (g).
[7] 5 U.S.C. § 706.
[8] *Chamber of Commerce*, 1:16-cv-944, at *8-9.
[9] 5 U.S.C. § 553.
[10] 5 U.S.C. § 559 (emphasis added).
[11] *Phillips Petroleum Co. v. Johnson*, 22 F.3d 616, 619 (5th Cir. 1994).
[12] 26 U.S.C. § 7421.
[13] *Florida Bankers Association v. Treasury*, 799 F.3d 1065 (D.C. Cir. 2015).