

TAX PROCEDURE: CORPORATE INVERSION REGULATION INVALIDATED

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Corporate inversions have been controversial for some time. In these transactions, a U.S. company is acquired by a foreign corporation that has its tax residence in a jurisdiction with a lower corporate tax rate. Many in Congress considered these transactions to be abusive; in response, the American Jobs Creation Act of 2004 added section 7874 to the Internal Revenue Code.

Last week, a district judge in Texas invalidated an inversion regulation that the Treasury Department issued under section 7874, holding that the regulation had been promulgated in violation of the Administrative Procedure Act (the “APA”). *Chamber of Commerce of the United States v. IRS*, No. 1:16-CV-944-LY (W.D. Tex. Sept. 29, 2017). Before discussing the opinion, some background is in order.

Section 7874 addresses inversions in two distinct ways:

- For some transactions, it imposes a minimum federal tax on “inversion gain” for a series of years. I.R.C. § 7874(a)(1).
- For other transactions, the acquiring foreign corporation is deemed to be a domestic corporation. I.R.C. § 7874(b).

Acquisition of a U.S. corporation will potentially be subject to inversion gain if “at least 60 percent of the stock (by vote or value) of the entity” is owned “by former shareholders of the domestic corporation by reason of holding stock in the domestic corporation.” I.R.C. § 7874(a)(2)(B)(ii)(I). If continuity of ownership reaches 80%, then the acquiring foreign corporation is considered a U.S. corporation under section 7874(b).

Similar continuity of ownership rules apply to U.S. partnerships. The post-acquisition business structure of a transaction is also relevant; section 7874 only applies in situations where the restructured group of businesses does not have significant business activity in the jurisdiction where the foreign acquirer is taxed, as contrasted with the group of affiliated businesses as a whole. I.R.C. § 7874(a)(2)(B)(iii).

Section 7874 has an unusual feature; it specifically overrides treaty obligations: “Nothing in section 894 or 7852(d) or in any other provision of law shall be construed as permitting an exemption, by reason of any

treaty obligation of the United States heretofore or hereafter entered into, from the provisions of this section.” I.R.C. § 7874(f). While the effect of this on future treaty obligations is uncertain, it plainly abrogates all existing U.S. tax treaties, an indication that Congress had grave concerns with inversions.

Section 7874 contains a very broad grant of regulatory authority, permitting the Treasury Department to “provide such regulations as are necessary to carry out this section, including regulations providing for such adjustments to the application of this section as are necessary to prevent the avoidance of the purposes of this section.” I.R.C. § 7874(g). Congress also granted the Treasury Department authority to promulgate rules to address the details of one of the key technical terms under the statute, a “surrogate foreign corporation.” I.R.C. § 7874(c)(6).

In April 2016, the Treasury Department promulgated regulations that addressed multi-step transactions that were designed to work around the continuity of ownership rules under section 7874, thereby generating transactions subject to the same policy concerns Congress had previously raised, but arguably not falling within the scope of section 7874. TD 9761, 81 Fed. Reg. 20858 (April 8, 2016). In the government’s view, these transactions were structured to avoid the purpose of section 7874. As a result, the Treasury Department issued Treasury Regulation § 1.7874-8T (the “Rule”) as a temporary regulation effective immediately and simultaneously issued a notice of proposed rulemaking.

In 2016, the Chamber of Commerce of the United States of America (the “Chamber”) and the Texas Association of Businesses (the “Association”) filed an action challenging the validity of the Rule; their standing to challenge the rule was alleged to rest upon the fact that the Rule had eliminated tax benefits associated with a proposed merger involving Allergan plc and that Allergan was both a member of the Chamber and an affiliate of the Association. *Chamber of Commerce of the United States v. IRS*, No. 1:16-CV-944-LY, slip op. at 3. Allergan’s proposed merger transaction was described in contemporaneous press reports as a target of the Rule, and the transaction was abandoned after the Rule was promulgated. As a consequence, the court held that Allergan’s status as a target of the Rule also created standing. *Id.*, slip op. at 4-5

Although Allergan no longer had a proposed transaction that would be subject to the Rule, the court in *Chamber of Commerce* nonetheless held that the Chamber and the Association had organizational standing to challenge the Rule because of the Rule’s impact on Allergan:

Allergan need not engage in futile negotiations for deals that have been altogether foreclosed or made economically impracticable by the Rule. It is enough that Allergan identified a specific transaction that was thwarted by the Rule and asserted that it would actively pursue other inversions if this court were to set aside the challenged Rule.

Id., slip op. at 4.

After briefly addressing the Anti-Injunction Act and holding that it did not apply, the *Chamber of Commerce* Court turned to the question whether the Rule violated the APA. In light of the two separate provisions in section 7874 granting broad authority to the Secretary of the Treasury to promulgate regulations, the court held that the Rule did not exceed the agency’s authority. *Id.*, slip op. at 7-8. The district court also held that the Treasury Department did not act in an arbitrary and capricious manner in promulgating the Rule, citing the thorough explanation in the preamble to the notice of proposed rulemaking. *Id.*, slip op. at 8-10.

Instead, the district court invalidated the Rule because it was made immediately effective as a temporary regulation. The court expressly limited its analysis to the immediate effective date of the Rule because

“Plaintiffs do not assert that Defendants have failed to undergo the notice-and-comment procedure required by the APA with regard to the Rule as a proposed regulation.” *Id.*, slip op. at 10.

Before summarizing the court’s ruling on the merits, an anomaly in its approach merits comment. There is a significant disconnect between the court’s analysis of standing and its limitation on the scope of its analysis. The district court held that the Chamber and the Association had standing based on the prospect that Allergan might look at other inversion transactions if the Rule were invalidated but only ruled that the Rule was improper because it went into effect immediately. This suggests that if Allergan pursued a transaction now that was subject to the Rule, the Rule would govern the transaction, particularly since the court holds that it is within the authority of the relevant agency and the Rule was not arbitrary and capricious. As a consequence, the court appears to have issued an advisory opinion on what it would have done if Allergan had sought to invalidate the Rule before the transaction was abandoned.

On the merits, the *Chamber of Commerce* court ruled that the section 7805(e) of the Code, which expressly authorizes temporary regulations, did not reflect clear Congressional intent to exempt temporary Treasury Regulations from the APA’s notice and comment requirements. *Id.*, slip op. at 11-13. Here, the court appears to have failed to consider the surrounding statutory context.

Section 7805 provides in relevant part as follows:

(a) Authorization

Except where such authority is expressly given by this title to any person other than an officer or employee of the Treasury Department, the Secretary shall prescribe all needful rules and regulations for the enforcement of this title, including all rules and regulations as may be necessary by reason of any alteration of law in relation to internal revenue.

(b) Retroactivity of regulations

(1) In general Except as otherwise provided in this subsection, no temporary, proposed, or final regulation relating to the internal revenue laws shall apply to any taxable period ending before the earliest of the following dates:

(A) The date on which such regulation is filed with the Federal Register.

(B) In the case of any final regulation, the date on which any proposed or temporary regulation to which such final regulation relates was filed with the Federal Register.

(C) The date on which any notice substantially describing the expected contents of any temporary, proposed, or final regulation is issued to the public.

(2) Exception for promptly issued regulations

Paragraph (1) shall not apply to regulations filed or issued within 18 months of the date of the enactment of the statutory provision to which the regulation relates.

(3) Prevention of abuse

The Secretary may provide that any regulation may take effect or apply retroactively to prevent abuse.

...

(e) Temporary regulations

(1) Issuance

Any temporary regulation issued by the Secretary shall also be issued as a proposed regulation.

(2) 3-year duration

Any temporary regulation shall expire within 3 years after the date of issuance of such regulation.

I.R.C. § 7805.

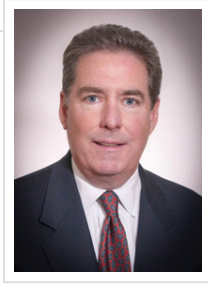
By its terms, section 7805 indicates that temporary regulations can be issued without notice and comment if there was prior notice issued of the general subject of the anticipated regulations because it provides that they can become *immediately effective*. I.R.C. § 7805(b)(1)(C). Similarly, it provides that temporary regulations can go into effect on the date they are published. I.R.C. § 7805(b)(1)(A).

Moreover, section 7805(b)(3) authorizes the issuance of retroactively effective regulations “to prevent abuse.” I.R.C. §7805(b)(3). The whole point of the Rule was to combat transactions that were perceived as abusive efforts to avoid the impact of section 7874, and section 7805(b)(3) permitted the Treasury Department to issue retroactive regulations.

The *Chamber of Commerce* Court also ruled that the Rule did not qualify as an interpretative rule that would not require the use of notice and comment procedures under the APA. *Chamber of Commerce*, No. 1:16-CV-944-LY, slip op. at 14-15. There are plausible arguments on both sides of that question, but the court should never have reached it. The standing of the parties before the court was dubious, and its ruling on the authority of the Treasury Department to issue temporary regulations without using notice and comment procedure appears to be inconsistent with the plain language of the Code.

By: [Jim Malone](#)

Jim Malone is a tax attorney in Philadelphia. A Principal at Post & Schell, he focuses his practice on federal, state and local tax controversies. [Learn more about Post & Schell's Tax Controversy Practice >>](#)



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