COMMENTS ON REG-108060-15, TREATMENT OF CERTAIN CORPORATE INTERESTS AS STOCK OR INDEBTEDNESS

Date: July 7, 2016

To:
Internal Revenue Service and U.S. Treasury Department
Via Federal eRulemaking Portal at
http://www.regulations.gov (IRS REG-108060-15).

From:
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Re: IRS REG-108060-15 (Section 385 Proposed Regulations)

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I. WHO IS RESPONSIBLE FOR THIS COMMENT?

I am making this comment in my capacity as a private citizen who has had for a significant time an interest in promoting good tax policy with respect to inversions and related transactions.[1] The views expressed are my own and are not made on behalf of any other person or organization.

II. IS THERE AUTHORITY FOR THE SECTION 385 REGS?

Section 385(a) specifically grants the Treasury broad authority to:

> (1) issue debt-equity regulations that "**may be necessary or appropriate;"**
> (2) treat instruments as **"in part stock and in part indebtedness,"** which is one of the approaches taken in the proposed regulations, and
> (3) require **"such information as the Secretary determines to be necessary,"** which is the approach taken with the documentation requirement in the proposed regulation.

Also, Section 385(b) provides: "The regulations prescribed under this Section **shall set forth factors** which are to be taken into account in determining **with respect to a particular factual situation** whether a debtor-creditor relationship exists or a corporation-shareholder relationship exists."

While lawyers generally try to see both sides of a story, frankly, in view of the words of Section 385, I cannot see an argument that the Treasury does not have the authority to issue the 2016 Section 385 Regs. I took this position prior to the issuance of the Section 385 Regs,[2] and I continue to hold this position.

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[1] I have expressed my views on inversions in the following articles and other publications beginning in 2002 and continuing through 2016: *Section 367: A "Wimp" for Inversions and a "Bully" for Real Cross Border Acquisitions*, 94 Tax Notes 11 (March 18, 2002) and 26 Tax Notes International 587 (May 6, 2002); *Analysis of the Non-Wimpy Grassley/Baucus Inversion Bill*, 26 Tax Notes International 741 (May 13, 2002) and 95 Tax Notes 1515 (June 3, 2002); *Treasury's Inversion Study Misses The Mark: Congress Should Shut Down Inversions Immediately*, 26 Tax Notes International 969 (May 27, 2002) and expanded with comments on Treasury testimony in 95 Tax Notes 1673 (June 10, 2002); *Treasury Official Gives Unconvincing Reason for Not Blockading Inversions*, 2002 Worldwide Tax Daily 112-15 (June 11, 2002), expanded with comments on Treasury testimony in 95 Tax Notes 1673 (June 10, 2002), and 26 Tax Notes International 1321 (June 17, 2002); *Inversion Hearings Focus on Wrong Issues*, 96 Tax Notes 154 (July, 1 2002) and 27 Tax Notes International 193 (July 8, 2002); *New Inversions, the 'Joe Frazier Left Hook,' the IRS Notice, and Pfizer*, Tax Notes 1413 (June 23, 2014); *The Cat-and-Mouse Inversion Game with Burger King*, Tax Notes, 1317 (Sept. 15, 2014); *A Guide to the Treasury 2014 Notice on Inversions*, prepared for Webinar sponsored by the Penn State Center for the Study of M&A: The Treasury and IRS Notice on Tax Inversions (Oct. 2014); *A Guide to the IRS/Treasury Notice 2015-79 on Inversions*, prepared for Webinar sponsored by the Penn State Center for the Study of M&A: The Treasury and IRS Notice on Tax Inversions (Dec. 10, 2015); *A Basic Guide to the Treasury's April 2016 Regulations on Inversions and Inter-Company Debt*, prepared for Webinar sponsored by the Penn State Center for the Study of M&A: The Treasury and IRS Notice on Tax Inversions (April 27, 2016); and various sections of Chapter 22 of Thompson, Mergers Acquisitions and Tender Offers (PLI, 2010, updated semi-annually).

[2] Samuel C. Thompson, Jr. *Professor Says Debt/Equity Regs Can Apply to Inversions*, 144 Tax Notes 883 (Aug. 18, 2014).

A quick survey of some of the legal commentary on the authority issue seems to show that most commentators reach the same conclusion. To start with Professor Steve Shay of the Harvard Law School, who was the first to urge the Treasury to use its authority under Section 385 says:

> Treasury should be commended for using its regulatory authority under section 385 to take action on earnings stripping. [The] proposed regs would target related-party financial leveraging transactions connected to foreign acquisitions of U.S. companies that go beyond inversions, [and he added] that "the debt reclassification as equity is aimed at cases where the new 'debt' would not result in increased real investment in the United States." . . .
>
> [T]he important thing is that Treasury has acted. "Even if after a close read there's more to be done, the fact that they have moved in that area, they have applied section 385, that's just a big move[,]"[3]

And reporting on the annual KPMG LLP international tax conference at New York University School of Law, Lee Sheppard of Tax Notes, says:

> There was general agreement that Section 385 grants broad authority to make the proposed rules. "It's broad enough to justify where they are going," said [David] Rosenbloom [of Caplin & Drysdale and a former International Tax Counsel], who would go further. "I basically don't think there is such a thing as related-party debt. Debt requires friction and countervailing interests on both sides." He noted that U.S. law has been "way too generous" to foreign-parented companies, which are not audited by the IRS unless they are banks.[4]

Jack Cummings of Alston & Bird LLP, is reported to have said:

> Treasury has finally taken out its meat cleaver, instead of trying to create delicate, finely balanced rules, and "definitely pushed the boundaries of its authority" regarding earnings stripping through interest deduction provisions. However, . . . if faced with a legal challenge, the regs would likely be sustained.[5]

On the other hand, in criticizing the regulations as being beyond the Treasury's authority, Scott Semer of Torys, in referring to the "shall set forth factors" language in Section 385, argued:

> Rather than provide a safe harbor or follow the clear congressional directive in Section 385(b) to "set forth factors" that are to be taken into account in determining whether a debtor-creditor relationship exists, the regulations instead impose a fairly onerous set of

[3] Andrew Velarde, U.S. *Moves on Earnings Stripping*, 82 Tax Notes Int'l 130 (Apr. 11, 2016).
[4] Lee A Sheppard, *Stack Defends Debt and Equity Rules, State Aid Stance*, 2016 Tax Notes Today 76-1 (April 19, 2016).
[5] Andrew Velarde and Amanda Athanasiou, *Earnings Stripping Regs Usher in Brave New World*, 82 Tax Notes Int'l 132 (Apr. 11, 2016).

> record-keeping requirements that are necessary, at a minimum, for an instrument to be treated as debt.[6]

By directing the Treasury to "set forth factors" does not prevent the Treasury from focusing on one factor where appropriate "**with respect to a particular factual situation**."

In an April 18, 2016 letter to the Secretary of the Treasury, a "bipartisan group of former Treasury officials," led by former Secretary George P. Shultz, urged Secretary Lew to "reconsider" the release of the inversion and Section 385 Regs. While they argue that the remedy to inversions is not to erect "higher barriers," the letter does not in any way argue that the Treasury does not have the authority to take the action it has taken. It would appear that if there were a credible argument that the Treasury does not have the authority, this bipartisan group would have made it.

In a June 29, 2016 letter on the Section 385 Regs to the Treasury and IRS, the New York State Bar Association addresses, *inter alia*, the authority issue as follows:

> For many of us, the problems with Prop. Treas. Reg. §1.385-3 are rooted in the choice of Section 385 as the statutory provision under which to issue rules curbing the types of planning that are of concern to the government.

Note that the statement (which I suspect was carefully constructed) states only that "many of us" are concerned about the authority issue under Section 385. Presumably many of the tax lawyers who were involved in drafting the letter do not believe that the Treasury lacks the authority under Section 385 to issue the regulations. In view of the predominance of the major New York law firms in large sophisticated corporate transactions, I suspect that either (1) some of the drafters of the letter themselves, or (2) other members of their law firms, were involved in every significant inversion transaction involving a publicly held corporation. If this is the case, it would appear that a significant number of the planners of interest stripping transactions associated with inversion and similar transactions believe that the Treasury has authority under Section 385 to issue the Regs. However, any such attorney is probably foreclosed from saying so publicly for ethical or business reasons.

The bottom line is that the Treasury has the authority under Section 385 to issue the regulations.

III. IS THE DOCUMENTATION REQUIREMENT IN THE -2 REG APPROPRIATE?

I strongly support the general approach taken to documentation in the -2 Reg, and I have one suggestion for an additional provision. I suggest that a provision be added to the Reg that will treat a debt instrument that does not satisfy the letter of the -2 Reg as a debt instrument provided

[6] Scott L. Semer, *How to Enact New Tax Laws Without Involving Congress: Analyzing the Proposed Section 385 Regulations* Bloomberg, BNA, Daily Tax Report (April 15, 2016).

the issuer can show by clear and convincing evidence that its failure to satisfy the documentation requirement was (1) not intentional, and (2) attributable solely to inadvertence.

IV. IS THE APPROACH TAKEN IN THE -3 REG APPROPRIATE?

A. IN GENERAL

I strongly support the approach taken in the -3 Reg that treats inter-company debt instruments issued in (1) a distribution, (2) an exchange for stock, and (3) an internal non-divisive (D) reorganization as giving rise to a stock characterization (the Three Recharacterization Rules). In fact, I commend the Treasury and IRS for thinking "outside the box" in developing the Three Recharacterization Rules, because they will put significant limitations on the ability of companies' to engage in earnings stripping through the issuance notes.

In a 2014 article on inversions, I explained that the "note for stock transaction [in the Endo inversion] is artificial on its face and lacks a true business purpose[.]"[7] The brilliance of the approach in the -3 Reg is that it treats notes like the one issued in Endo in accordance with their substance, which is equity. One of the reasons the Treasury is hearing complaints about the approach from taxpayers is that the provision will be largely effective.

As with any complex regulation, there will be a need to refine the regulation to address such things as the following two items that are set out in a July 1, 2016 letter to the Treasury from Senate Finance Committee Republicans:

> • Ensure that S corporations, a critical component of America's small business community, do not lose their S corporation tax status by virtue of having their debt re-characterized as equity and are not penalized for their domestic-to-domestic transactions;
> • Ensure that non-tax motivated cash management techniques, such as cash pooling or revolving credit arrangements, are exempted.[8]

This letter from the Senate Finance Committee Republicans also makes the following statement: "Simply put, we believe finalizing these regulations will create new disincentives to investment in the United States and threaten to further exacerbate our current economic woes." In my view, adoption of the Regs will have the direct opposite effect; it will reduce the incentive for investment outside of the U.S., which is the direct result of interest stripping.

B. SUGGESTED ADDITION TO THE THREE TRANSACTIONS THAT GIVE RISE TO A PER SE EQUITY CHARACTERIZATION

While the Three Recharacterization Rules in Reg -3(b)(2) are likely to be very effective, I suggest that Reg -3(b)(2) be modified to encompass any other transaction having a similar effect. This would permit the Reg to apply in the event taxpayers are creative in developing surrogate transactions that have a similar effect to these three covered transactions.

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[7] Samuel C. Thompson, Jr. *New Inversions, the 'Joe Frazier Left Hook,' the IRS Notice, and Pfizer*, Tax Notes 1413, at 1421 (June 23, 2014)

[8] The letter from the Senate Finance Committee Republicans sets out other suggested changes that I do not support.

C. COMMENT ON THE FUNDING RULE

The Treasury has acted appropriately in setting out the "Funding rule" in -3(b)(3). For example, without a funding rule, the distribution rule could be avoided by (1) on day 1, having a U.S. Sub issue a debt instrument to its Foreign Parent for cash, and (2) on day 2, having the U.S. Sub distribute the cash as a dividend to its Foreign Parent. When the dust settles, the Foreign Parent holds the U.S. Sub's debt instrument in a situation that is the economic equivalent of a distribution of a debt instrument. Obviously, there needs to be a funding rule to prevent this result.

Notwithstanding the need for a broad funding rule, certain taxpayers may have legitimate concerns that the funding rule may be over-inclusive, and the Treasury should consider modifying the rule to address any such legitimate concerns.

D. COMMENT ON THE EXCEPTION IN -3(c)(1) FOR CURRENT YEAR E&P

I do not understand the rationale for this exception. My concern can best be illustrated by an example. Assume that there are three domestic corporations (A, B, and C) operating in the same line of business and that each is the wholly owned sub of a foreign parent. Assume also that although each business has the same revenues, because of the manner in which the corporations are financed between debt and equity, A, has $10M of current E&P, B has $5M of current E&P, and C has 0 current E&P. In such case, the corporations can issue to their foreign parents the following interest stripping notes:

CORPORATION	PERMISSIBLE INTEREST STRIPPING NOTE
A	$10M
B	$5M
C	-0-

I do not see the sense in this rule. I do not think there is a basis for the current E&P exception or any similar exception. While, the exception may not be significant in any one year, the cumulative effect of taking advantage of the exception could be significant. Consequently, I urge the Treasury and IRS to eliminate the exception. It appears that the $50M threshold exception in -3(c)(2) is more than generous.

V. COMMENT ON THE ANTI-HOP SCOTCH LOAN PROVISION

Although not directly encompassed by this request for comments, I suggest that the Treasury and IRS adopt for the anti-hop-scotch loan provisions in Reg. § 1.956-2T(a)(4) the same universal principle that has been adopted for the Section 385 Regs; that is, the Section 385 Regs apply equally to inversion and non-inversion transactions, and the anti-hop-scotch loan provision should also.

To be specific, the anti-hop-scotch loan provision, which now only applies to inversions, should be extended to apply to all hop-scotch loans made by a CFC to an ultimate foreign parent (or one of its non-CFC subs) of the CFC's domestic parent without respect to whether the CFC is an expatriated foreign subsidiary. Thus, for example, the anti-hop scotch loan provision should

apply when a foreign corporation purchases for cash, in a non-inversion transaction, the stock of a domestic target, which owns one or more CFCs.

By limiting the anti-hop-scotch loan provision to inversion transactions, the Regs implicitly give pure foreign acquirors of U.S. targets a tax advantage over domestic acquirors of U.S. targets.

VI. COMMENT ON THE JOINT WHITE HOUSE, TREASURY REPORT ON BUSINESS TAX REFORM

At the same time, the Treasury and IRS issued the Section 385 Regs and the General Inversion Regs, the White House and the Treasury also issued the *Joint White House, Treasury Report, "President's Framework for Business Tax Reform: An Update."* In a section of this report entitled *Strengthen the International Tax System to Encourage Domestic Investment*, the White House and Treasury propose the adoption of a minimum tax on overseas profits. The report describes the proposal as follows:

> *Reducing firms' ability to avoid the U.S. tax system by shifting profits overseas*. The minimum tax on foreign earnings would ensure that no matter what tax planning techniques a U.S. firm engages in, and no matter where it reports its profits, it would still face a tax rate of at least 19 percent. Unlike the current system, there would be no "deferral" of tax—the minimum tax would apply to profits in the year they are earned. The minimum tax would stop our tax system from generously rewarding companies for moving profits offshore. In addition, other elements of the plan would make it harder to shift profits overseas by limiting interest stripping, transfer pricing abuses, and inversions.

While I believe the minimum tax would move the tax system in the right direction, it will not eliminate the incentive the tax system gives to overseas investment as compared to domestic investment. Consequently, as I have suggested many time in the past,[9] I again urge the White House and Treasury to propose the adoption of an imputation system for taxing foreign income on a current basis. Such a system would completely eliminate deferral, which is one of the largest tax expenditures and permit, on a revenue neutral basis, the corporate tax rate for all corporations to be significantly reduced, possibly to 25% or so. This is the type of system that was initially proposed by President Kennedy in 1963. Although the present Congress is not going to adopt an imputation system, it is also not going to adopt a minimum tax. Consequently, the benefit in the White House and Treasury proposing at this time an imputation system is that it would at least make imputation a visible alternative to our current system and to the territorial system that virtually all Republicans support. As I have noted previously, a territorial system would have the effect of making all U.S. businesses *de-facto* inverters.[10]

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[9] See my following articles arguing for an imputation system: *Logic Says No to Options Y, Z, and C, but Yes to Imputation*, Tax Notes 579 (May 5, 2014); *Hooray for Trump's Proposal to End Deferral*, 149 Tax Notes 157 (Oct. 5, 2015); *An Imputation System for Taxing Foreign-Source Income*, Tax Notes, Jan. 31, 2011; and *Obama's International Tax Proposal Is Too Timid*, Tax Notes, May 11, 2009, p. 738. *See also* Samuel C. Thompson, Jr. *Territoriality Would Make All U.S. Companies De Facto Inverters*, 149 TAX NOTES 1403 (Dec. 14, 2015).

[10] Samuel C. Thompson, Jr. *Territoriality Would Make All U.S. Companies De Facto Inverters*, 149 TAX NOTES 1403 (Dec. 14, 2015).

VII. REQUEST TO TESTIFY AT THE HEARINGS

I hereby request the opportunity to testify at the hearing on the Section 385 Regs. My testimony would build on the points made in this comment, and urge the Treasury and IRS to promptly finalize the basic principles in the Section 385 Regs.