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Would a Court Uphold the Application of Notice 2014-52 to Combinations Closed After September 21, 2014?

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Notice 2014-52 (the "Notice")[1] sets forth six rules relevant to so-called "inversion" transactions, ostensibly issued under §7874 of the Code,[2] that are proposed to be detailed in forthcoming Treasury regulations effective for transactions that close on or after September 22, 2014. This article will entertain the question whether a court would uphold the application of certain provisions set out in the Notice if challenged by a taxpayer who entered into a transaction that could be impacted by one or more of such provisions.

In a real sense, this question may be moot before it is even asked. The provisions of the Notice are manifestly not intended to be challenged at all; they are intended simply to discourage taxpayers from engaging in certain transactions that the Treasury Department ("Treasury") and the Internal Revenue Service (the "IRS") consider problematic. Taxpayers will not knowingly run afoul of the rules in the Notice, given the dire consequences of doing so, and thus will not purposefully engage a challenge to the rules in court.

But the question posed in this article is worth asking because many taxpayers may stumble into these provisions unknowingly. Some of the rules proposed in the Notice are so broad that they will, if applied literally, sweep in transactions that Congress, and even the IRS, almost certainly did not mean to cover. This creates an odd situation in which the IRS has no motivation to challenge innocent transactions, for fear of having its rules declared invalid. And so, it will be argued here, they are.

The first part of this article will briefly summarize the rules of the Notice. The next part will describe the legislative grants of authority to the IRS to promulgate rules implementing §7874. The third part will examine judge-made administrative law used to evaluate whether agency rules are within those grants of authority. Finally, this article will examine the authority for selected provisions of the Notice.

THE PROVISIONS OF NOTICE 2014-52[3]

Section 7874 will apply to find an inversion where three tests are met. First, a foreign acquiring corpora-

[1] 2014-42 I.R.B. 712.

[2] All section ("§") references are to the U.S. Internal Revenue Code ("Code"), as amended, or the Treasury regulations thereunder, unless otherwise indicated.

[3] This summary was adapted from an earlier article. *See* Blanchard, *Extensive New Anti-Inversion Rules Issued*, 145 Tax Notes 89 (Oct. 6, 2014). This article will assume that the domestic entity involved in a potential inversion is a corporation and not a partnership.

tion (FA) must acquire substantially all of the properties of a domestic target corporation (DT) directly or indirectly (including by acquiring the stock of DT). Second, at least 60% of the counted stock of FA must be owned by shareholders of DT by reason of their ownership of DT (the ''Ownership Condition''). If the Ownership Condition is met at the level of 80% or more, §7874(b) treats FA as a domestic corporation. Finally, if the ''expanded affiliated group'' (EAG) of which FA and DT are members following the transaction has substantial business activities in the country where FA is formed, §7874 will not apply (the ''Substantial Business Activities Test'').[4]

Notice 2014-52 is divided into two parts. The first part contains three new definitional rules intended to capture more transactions under the Ownership Condition, with the intended result being that FA is treated as a domestic corporation, or at least that the inversion rules will apply. In general, these ''status rules'' operate by manipulating the calculation of the Ownership Condition or fraction, excluding certain FA stock issued to persons other than shareholders of DT from the denominator and increasing the number of FA shares deemed held by DT's shareholders ''by reason of'' owning an interest in DT, which shares are included in the numerator of the fraction. The second part of the Notice sets out three operative rules applicable to corporations that have undergone an inversion at the 60%/80% level, where FA remains a foreign corporation.

The Three Status Rules

The Cash Box Rule

Assuming that a threshold test is met as described below, §2.01 of the Notice provides that a portion of FA stock issued to persons other than DT's shareholders (other than FA stock already excluded under existing regulations), corresponding to the proportion of foreign group assets that are treated as nonqualified property, is excluded from the denominator of the Ownership Condition. The consequent increase of the fraction makes it more likely that an inversion will occur.

Nonqualified property is all nonqualified property described in Reg. §1.7874-4T(i)(7), including importantly cash. There is an exclusion for property used in a banking, financing, or insurance business described in §954(h), §954(i), or §1297(b)(2)(A) of the Code. An anti-abuse rule disregards qualified property issued in exchange for nonqualified property.

The new rule applies only if more than 50% of the gross value of the properties of the foreign group members consists of nonqualified property. In making the threshold calculation, the denominator consists of all property of the foreign members of the EAG other than property owned by domestic members or their subsidiaries and other than intercompany obligations and stock.

Non-Ordinary Course Distributions

Section 2.02 of the Notice disregards non-ordinary course distributions (''NOCDs,'' as defined below) made during the 36-month period preceding the inversion. The effect of disregarding such distributions will be that the percentage of FA stock treated as owned by historic shareholders of DT — the numerator of the Ownership Condition — will be increased, although the Notice is silent concerning the precise mechanics for achieving this result. The Notice defines an NOCD as any distribution that exceeds 110% of the average annual amount of distributions made by DT over the prior 36 months. Distributions caught by this rule are not limited to dividends and can include distributions pursuant to a §355 spin-off as well as distributions made in connection with other tax-free reorganizations.

''Spinversions''

Section 2.03 of the Notice observed that two existing rules under §7874 can be combined to produce what the IRS considers to be an inappropriate result.[5] The first of these rules, which had been intended to be punitive, is the ''frozen numerator'' rule of Reg. §1.7874-5T. It provides simply that stock of FA owned ''by reason of'' owning DT stock does not cease to be so described as a result of any subsequent transfer of such stock by the former shareholder of DT, even if the subsequent transfer is related to the acquisition.

The second set of rules implicated here are two exceptions from the EAG rule found at Reg. §1.7874-1(c)(2) and §1.7874-1(c)(3). These pro-taxpayer rules are necessary to avoid the absurd results that would be obtained if §7874's mathematical rules were applied to certain situations in which stock is held in an EAG. But taken together with the frozen numerator rule, a corporate shareholder of DT that is a member of the EAG could transfer FA shares, received by reason of being a shareholder of DT, to a third party who is not a member of the EAG, without losing the benefit of the EAG exceptions. The apparent target of this new rule is the case in which a U.S. parent corporation drops stock of a domestic subsidiary into a new foreign subsidiary and then distributes the stock of the

[4] §7874(a)(2)(B).

[5] For a good description of the problem to which this rule was addressed, see Cummings, *Avoiding Accidental Inversions*, 146 Tax Notes 775 (Feb. 9, 2015).

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foreign subsidiary to its shareholders, often in a transaction intended to qualify as a tax-free spinoff.

Section 2.03(b) of the Notice seeks to forestall this possibility by turning off the EAG exceptions and counting the transferred shares in both the numerator and the denominator of the Ownership Condition when the subsequent transfer by the corporate shareholder is related to the acquisition. There are two exceptions to this treatment, both of which apply to transfers among members of an EAG. Although this new rule, like the others, purports to apply to inversions completed on and after September 22, 2014, taxpayers are permitted to elect into this rule for prior periods. A taxpayer might wish to do so in order to obtain certainty that the exceptions described in the Notice will apply to forestall any challenge to its reliance on an EAG exception under prior law.

Operative Rules

The second part of the Notice announces provisions ''to address post-inversion tax avoidance transactions.''

The Anti-Hopscotch Rule

Section 956 of the Code treats an investment in U.S. property by a controlled foreign corporation (a ''CFC'') as a deemed dividend that is included in a U.S. parent's income by reason of §951(a)(1)(B). Section 3.01 of the Notice treats as an investment in U.S. property the amount of any investment by a DT CFC in the stock or debt of a foreign member of the EAG (other than another historic DT CFC). Section 956 will apply only to such investments made during the 10-year applicable period of §7874(d)(1). The Notice makes clear that the usual pledge and guarantee rules of §956(d) apply. Thus, if a DT CFC guarantees the debt of FA or another foreign affiliate of FA, §956 will apply.

This provision is stated to be effective for investments made on or after September 22, 2014, but only if an inversion was completed on or after that date.

'Out-From-Under' Transactions

This set of rules, contained in §3.02 of the Notice, is by far the most complex set of rules in the Notice. Here the IRS is attempting to combine different grants of authority — specifically §7701(l) and §367(b) — to justify a truly novel approach to ending deferral.

But for this provision, a contribution of property (which might be stock of the foreign combining party in the inversion) by FA or an FA affiliate to a DT CFC for CFC shares would generally not give rise to an inclusion in income to DT under either §1248 or §367(b). DT's ownership of the CFC would be diluted, with the result that its share of the CFC's untaxed earnings and profits (E&P) will also be diluted. The CFC may even cease to be a CFC if the investment is large enough. The Notice refers to such investments that dilute DT's interest in a CFC as ''specified transactions.'' Specified transactions include any transaction, including a sale, in which stock of a DT CFC is transferred to a newly related foreign affiliate.

The Notice provides that if there is a ''specified transaction'' during the 10-year applicable period, the specified transaction will be recast as a pair of back-to-back transactions under the authority of §7701(l). That is, the simple transfer of property by FA to a CFC of DT will be treated as if: (1) FA first transferred the property to DT; and then (2) DT transferred the same property to the CFC. In the first transfer, DT is deemed to issue instruments identical to those actually issued by the CFC. In this way, when the CFC makes a payment on the actual instrument, it will be treated as if the CFC made the payment to DT, not FA, and as if DT made a corresponding payment to FA. Among other results, DT could recognize income on the deemed payment, and U.S. withholding tax could apply to the deemed payment by DT to FA.

The Notice also provides that if, as a result of a specified transaction, a CFC of DT is considered to receive a dividend by reason of §964(e) of the Code, such dividend will not qualify for any exclusion from Subpart F income such as that provided under §954(c)(6) and Notice 2007-9.[6] Thus, for example, if CFC1 were to sell stock of CFC2 to a foreign affiliate, any deemed dividend arising upon such sale would be Subpart F income to DT.

Finally, the Notice announced that the §367(b) regulations will be amended to require a U.S. shareholder to include in income the untaxed E&P of a CFC in the case of any specified exchange, regardless of whether the transferred CFC ceases to be a CFC. A specified exchange is an exchange in which a shareholder of a CFC exchanges its stock for stock of another foreign corporation in any transaction described in Reg. §1.367(b)-4(a) (generally any nonrecognition transaction). This is a fundamental change to the manner in which §367(b) has traditionally applied. Where this rule applies, the foregoing recast rule will not apply, since the untaxed E&P of the subject CFC will have already been taken into account by DT.

Like the anti-hopscotch rule, this rule is stated to apply to specified transactions and exchanges done on or after September 22, 2014, but only if an inversion was done on or after that date.

Section 304

Section 304(b)(5)(B) provides:

[6] 2007-5 I.R.B. 401.

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> In the case of any acquisition to which [section 304(a)] applies in which the acquiring corporation is a foreign corporation, no earnings and profits shall be taken into account under paragraph (2)(A) (and subparagraph (A) shall not apply) if more than 50 percent of the dividends arising from such acquisition (determined without regard to this subparagraph) would neither—(i) be subject to tax under this chapter for the taxable year in which the dividends arise, nor (ii) be includible in the earnings and profits of a controlled foreign corporation. . .

The purpose of this provision is to prevent taxpayers from stripping out E&P from a foreign acquiring corporation to a selling foreign person without going through a U.S. corporate taxpayer. The Notice expressed a concern that FA might sell some shares of DT to a CFC of DT in exchange for assets of the CFC in a §304(a)(2) transaction following an inversion. (It is worth noting that if this is all that happens, the CFC would have an investment in U.S. property within the meaning of §956.) Although this provision became effective on enactment in 1999, the Notice appears to reflect a concern that taxpayers may be taking the position that it does not apply where more than 50% of the deemed dividend is sourced from a U.S. corporation in a §304(a)(2) situation, even where that dividend would not be taxed by reason of a treaty. If the provision did not apply, E&P of the CFC could be permanently repatriated free of U.S. tax.

The Notice provides that in determining whether more than 50% of the dividends arising from the acquisition are subject to tax, only the E&P of the acquiring corporation will be taken into account. This rule will apply generally — it is not limited to inversions. Although this rule presents interesting authority questions,[7] because they do not relate to inversions *per se*, it will not be discussed further herein.

Reg. §1.7874-4T

Although issued prior to the Notice, these regulations are mentioned here because, from an authority standpoint, they have much in common with the rules of the Notice. The regulations were first announced in Notice 2009-78.[8] They exclude stock of FA from the denominator of the Ownership Condition if the stock is issued for cash of other tainted consideration. In a superficial and illogical way, they appear to have been the predecessor to the cash box rule of the Notice.

STATUTORY GRANTS OF AUTHORITY TO PROMULGATE RULES UNDER §7874

Congress has given Treasury very broad authority to write regulations under §7874. This is hardly surprising, given the numerous gaps in §7874 that Congress left for Treasury to fill. As just one example of a condition that would seem to require Treasury guidance, §7874(a)(2)(B) defines a ''surrogate foreign corporation'' in terms of three tests, each of which is modified by the phrase ''pursuant to a plan (or series of related transactions).'' Similarly, §7874(c)(4) refers to a ''plan a principal purpose of which is to avoid the purposes of this section.'' Although these and other provisions of the statute do not specifically grant authority to Treasury to write regulations thereunder, it is implicit in Treasury's general rulemaking authority that it may issue regulations fleshing out what is meant, *inter alia*, by a ''plan.''

Summarized below are the principal sources of authority relied upon by the IRS as authorizing the various provisions of the Notice.

Section 7874(g)

Section 7874(g) is a general delegation of authority to write needful regulations, accompanied by a few suggestions as to what those regulations might cover. It provides in full:

> The Secretary shall 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, including the avoidance of such purposes through —
>
> (1) the use of related persons, pass-through or other noncorporate entities, or other intermediaries, or
>
> (2) transactions designed to have persons cease to be (or not become) members of expanded affiliated groups or related persons.

There are at least two interesting aspects of §7874(g). First, the phrase ''to carry out this section'' seems awkward, as if words are missing. Normally, a grant of regulatory authority phrased in this manner would use the phrase ''to carry out *the purposes of* this section'' or ''to implement *the provisions of* this section.'' The reference to the purposes of §7874 ap-

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[7] For a discussion, see Calianno, *IRS Tightens Section 304(b)(5)(B)*, 42 J. Corp. Tax'n (Jan./Feb. 2015).

[8] 2009-40 I.R.B. 452. For a discussion, see Blanchard, *Notices 2010-41 and 2009-78: Thoughts on the Scope of IRS Authority*, 51 Tax Mgmt. Memo. 355 (Oct. 11, 2010).

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pears later in the same sentence, as if it were a subset of some greater delegation of authority ''to carry out'' §7874, a concept that remains rather vague.

Second, §7874(g) includes the phrase ''adjustments to the application of this section as are necessary'' to prevent taxpayers from avoiding the purposes of §7874. As will be discussed further below, it seems clear that the IRS has interpreted that phrase as a very broad grant of authority to enlarge and rewrite §7874 in certain key respects.

Section 7874(c)(6)

Section 7874(c)(6) provides:

> The Secretary shall prescribe such regulations as may be appropriate to determine whether a corporation is a surrogate foreign corporation, including regulations —
>
> > (A) to treat warrants, options, contracts to acquire stock, convertible debt interests, and other similar interests as stock, and
> >
> > (B) to treat stock as not stock.

Although this language might be interpreted to give Treasury authority to modify the statutory definition of ''surrogate foreign corporation,'' it is certainly not that sweeping. If Treasury were to issue a rule replacing the statutory 60% and 80% tests with a 55% test, no one would believe such a rule to be validly issued under §7874(c)(6). The rule of §7874(c)(6) must be read in context, especially giving effect to the two legislative suggestions. Congress was aware, for example, that Treasury might need to write rules to make the exclusion of EAG stock, contained in §7874(c)(2)(A), operate appropriately, and in fact Treasury has relied on this grant of authority to do exactly that.

Section 7874(c)(5)

Section 7874 also contains what might be called a ''negative'' grant of authority. Section 7874(c)(5) generally treats partnerships under common control as a single partnership for purpose of the inversion rules. However, this treatment can be ''turned off'' by regulation.

Section 7805(a)

The Code's general delegation of authority provision is found at §7805(a), which grants Treasury authority to prescribe ''all needful rules and regulations for the enforcement of this title.'' Most Treasury regulations derive their authority only from this provision, which is often referred to as a grant of authority to write ''interpretive'' or ''gap-filling'' rules and regulations. Where specific grants of authority are included in a Code section, as is the case with §7874, these are in addition to, and not in derogation of, the general authority contained in §7805(a).

Section 7805(b) and Retroactivity

Section 7805(b) sets out the rules governing when a rule or regulations may apply retroactively. It is very specific. Subject to only one exception relevant here, no regulation, whether final, temporary, or proposed, can apply to a taxable period ending before the earliest of three dates. The first of those dates is when the regulation is actually filed in the *Federal Register*. The second date, for final regulations only, is when the corresponding proposed or temporary regulation was so filed. The third date, relevant to the provisions of the Notice, is the date on which ''any notice substantially describing the expected contents of any temporary, proposed or final regulation is issued to the public.'' One exception, set forth in §7805(b)(3), allows Treasury to make a regulation retroactive ''to prevent abuse.'' It is very likely that the IRS would cite that exception to justify the retroactivity of the Notice.

Other Grants of Authority

While the status rules of the Notice generally rely on the specific grants of authority contained in §7874 itself, the operating rules in the second part of the Notice rely on various grants of authority found in other sections of the Code. These include §956(e) in respect of the anti-hopscotch rule, and §7701(l) and §367(b) in respect of the out-from-under rule.

COURT REVIEW OF AGENCY REGULATIONS

It is axiomatic that all agency rules, including those promulgated by Treasury under the Code, must find their authority in a delegation by Congress.[9] A court will review an agency regulation to determine whether it is within the grant of authority delegated by Congress. The basic approach, set forth in *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.*,[10] is a two-step test. The first step is to ask whether Congress has directly spoken to the question; if it has, the regulation must not deviate from that unambiguous legislative language. Assuming that the statute is silent or ambiguous, such that Congress has

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[9] *City of Arlington v. FCC*, 133 S. Ct. 1863 (2013).

[10] 467 U.S. 837 (1984).

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left room for interpretation, the second step asks whether the regulation is a permissible construction of the statute.

Before applying the two-part *Chevron* test to the rules set forth in the Notice, some administrative law background is in order. First, there is little question that a court would accord little or no deference to the Notice *itself*.[11] Notices generally are not entitled to deference; only regulations are. This article assumes that Treasury will eventually issue regulations following up on the rules of the Notice, and asks the question whether those regulations would be entitled to deference.

Second, there was a time, very recently, when courts appeared to disagree whether Treasury regulations ought to be accorded deference under standards different from those applied to other agencies, and specifically, under a standard that accords less deference to Treasury regulations than would be afforded by *Chevron*. Much ink was spilled over whether a particular Treasury regulation was ''interpretive'' or ''legislative'' and whether it was issued pursuant to Treasury's general grant of authority under §7805(a) or pursuant to a specific grant of authority such as §7874(g). Fortunately for this author, the disagreement has largely been rendered moot by the Supreme Court's decisions in *Mayo*[12] and *Home Concrete*,[13] both of which involved disputed Treasury regulations.

In *Mayo*, the taxpayer unsuccessfully argued that because the relevant provision of the Code was ambiguous, a multifactor facts-and-circumstances test ought to be applied in lieu of the second step of *Chevron*. In *Home Concrete*, the government unsuccessfully argued that its regulations should be entitled to deference even though the relevant provision of the Code was unambiguous. Taken together, these cases confirm that the proper test for evaluating the validity of Treasury regulations is the two-part test set out in *Chevron*. For purpose of analyzing Treasury's authority to write the regulations proposed in the Notice, this article will assume that *Chevron* deference applies.

Not surprisingly, given the degree of deference to agency rulemaking in general, most cases in which taxpayers have challenged the validity of Treasury regulations have failed.[14] A case in which the expanded deference of *Chevron* arguably changed the result was *Swallows Holding*.[15] At issue was the validity of Reg. §1.882-4(a)(3), which imposed a requirement that a foreign person's tax return be ''timely'' filed in order to claim various tax deductions. The Tax Court had found the regulation invalid under the facts-and-circumstances approach to judicial review laid down in the earlier case of *National Muffler*.[16] The circuit court reversed and upheld the regulation. While the circuit court stated that the result would have been the same whether *National Muffler* or *Chevron* applied, the case has generally been regarded as the precursor to *Mayo*, settling once and for all that judicial review of Treasury regulations will proceed under the two-step *Chevron* analysis.

The first step of the *Chevron* test asks whether Congress has clearly spoken to the issue at hand. In many cases, the answer to this question will be no, because Congress foresaw the need for an agency having special expertise to write rules to fill known gaps in the statute. Where Congress has left technical and interpretive matters up to the agency having special expertise in the subject matter, such as Treasury in tax matters, the courts refer to the proper role of regulations as ''gap filling.'' When an agency is merely filling gaps left in the statute that Congress expected it to fill, ''there is an express delegation of authority to the agency to elucidate a specific provision of the statute by regulation.''[17] Courts often state that in these cases, ''[s]uch legislative regulations are given controlling weight unless they are arbitrary, capricious or manifestly contrary to the statute.''[18]

In some cases, a court will find that there is an ambiguity in the statutory language, such that it must turn to the second step of the *Chevron* analysis. Most of the cases dealing with ambiguity involve fairly clear cases of ambiguity. One might imagine that an agency would rarely write a rule that was clearly contrary to an *unambiguous* expression of congressional intent as set forth in the words of the statute. But such cases do exist, including in the tax area. A case in point is *Finfrock v. United States*.[19] *Finfrock* involved the election available to family farms to use a special valuation rule for estate tax purposes. To qualify for

[11] Courts may accord deference to a Notice or a Revenue Ruling where it represents ''a longstanding and reasonable interpretation of the agency's regulations.'' *See Morehouse v. Commissioner*, 2014-2 USTC ¶50,471 (8th Cir. 2014). This is obviously not the case here.

[12] *Mayo Found. for Medical Ed. & Research v. United States*, 131 S. Ct. 704 (2011) (applying *Chevron* to a Treasury regulation: ''this Court is not inclined to apply a less deferential framework to evaluate Treasury Department regulations than it uses to review rules adopted by any other agency'').

[13] *United States v. Home Concrete & Supply, LLC*, 132 S. Ct. 1836 (2012).

[14] *See, e.g., Jones v. Commissioner*, 642 F.3d 459 (4th Cir. 2011); *Tualatin Valley Builders Supply, Inc. v. United States*, 522 F.3d 937 (9th Cir. 2008); *Intermountain Ins. Serv. of Vail, LLC v. Commissioner*, 107 AFTR2d 2011-2613 (D.C. Cir. 2011).

[15] 515 F.3d 162 (3d Cir. 2008).

[16] 440 U.S. 472 (1979).

[17] *Finfrock*, n. 19, below, at 844.

[18] *Id.*

[19] 109 AFTR2d 2012-1439 (D.C. Ill. 2012).

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the special use valuation, one requirement set forth in the statute was that at least 25% of the value of the gross estate consists of farm real property. Treasury issued a regulation providing that, while the election need not be made for all qualifying property, the *property with respect to which an election is made* must constitute at least 25% of the value of the gross estate. The court held that the regulation was invalid for having added a requirement not found in the statute.

Most regulations are not purely contrary to the statute. However, a court will also find a regulation invalid under the first *Chevron* step if the regulation renders words contained in the statute superfluous. In its recent decision in *Pilgrim's Pride Corp. v. Commissioner*,[20] the Fifth Circuit rejected the IRS's interpretation of §1234A(1) on the ground that it would "render superfluous §1234A(2)" such that "§1234A(2) would not serve any function." A regulation that renders statutory language superfluous is invalid because it reads out of the Code words that Congress put there for a reason. In fact, the IRS had argued in *Home Concrete* that a later-enacted Code section rendered the words in the Code section at issue superfluous. In that particular case, the IRS lost, because the Court found that the later-enacted provision had another function to fill.

The rule of statutory construction based on superfluity can work both for and against the IRS — and taxpayers. In both *Square D Co.*[21] and *Tate & Lyle*,[22] the issue was whether Treasury had the authority to write Reg. §1.267(a)-3, which requires a U.S. subsidiary of a foreign related parent to use the cash method of accounting for related-party interest. In *Square D*, the taxpayer argued that the statute, at §267(a)(3), was unambiguous in requiring that only a matching principle be applied, and that the regulation was therefore unreasonable on its face. The court disagreed, largely on the basis that acceptance of the taxpayer's argument would render §267(a)(2), which applied to both foreign and domestic groups, "pure surplusage."

Most of the cases in this area involve the second step of the *Chevron* analysis. Where gap-filling is involved, or a statute is ambiguous, courts have developed various approaches to determining when an agency's rule is reasonable. There is no one set of rules to follow. As the Supreme Court recently stated in *City of Arlington*, "No matter how it is framed, the question a court faces when confronted with an agency's interpretation of a statute it administers is always, simply, *whether the agency has stayed within the bounds of its statutory authority*."[23]

The courts will closely scrutinize a regulation to determine whether it is consistent with congressional intent. For example, in *Enron Gas Processing*,[24] the court examined the relevant legislative history and found that Treasury had strayed beyond legislative intent in extending excise tax liability to plants that were not intended to be subject to the tax. Conversely, in *Hospital Corp. of Am.*,[25] the court upheld a Treasury regulation that was taken from the legislative history and thus found to be a reasonable interpretation of what the court found to be an ambiguous statute.

Where Congress has specifically delegated authority to an agency to write regulations, a court's review of those regulations will give effect to the words in the delegation itself. For example, Congress occasionally grants Treasury authority to turn off, modify, or otherwise adjust statutory provisions, in some cases even to disregard the words of a statute, if it is necessary to do so to implement the purpose of those provisions. This broad form of authority will be referred to herein as "adjustment power." Courts are reluctant to second-guess an agency where Congress has clearly delegated it adjustment power.

An example of a delegation of adjustment power can be found in §1275(d). That subsection grants broad discretion to Treasury to modify the statutory rules relating to the taxation of original issue discount. It provides:

> The Secretary may prescribe regulations providing that where, by reason of varying rates of interest, put or call options, indefinite maturities, contingent payments, assumptions of debt instruments, or other circumstances, the tax treatment under this subpart [the OID rules]. . . does not carry out the purposes of this subpart . . . , such treatment shall be modified to the extent appropriate to carry out the purposes of this subpart . . .

The power given to Treasury to modify the OID rules was quite clearly predicated on Congress's understanding that there are myriad ways in which debt instruments might be combined with related instruments, or might provide special terms, that could not possibly all be dealt with by legislation. Moreover, the OID rules, which were issued as a package, are extremely detailed and technical, practically necessitating this broad grant of adjustment authority.

Another example of this power to adjust in the face of great technical complexity is found in the grant of

[20] No. 14-60295 (5th Cir. Feb. 25, 2015).

[21] 438 F.3d 739 (7th Cir. 2006).

[22] 87 F.3d 99 (3d Cir. 1996).

[23] 133 S. Ct. at 1868 (emphasis in original).

[24] 85 AFTR 2d 2000-913 (D.C. Tex. 1996).

[25] 348 F.3d 136 (6th Cir. 2003).

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authority to issue consolidated return rules. Section 1502 provides simply:

> The Secretary shall prescribe such regulations as he may deem necessary in order that the tax liability of any affiliated group of corporations making a consolidated return and of each corporation in the group, both during and after the period of affiliation, may be returned, determined, computed, assessed, collected, and adjusted, in such manner as clearly to reflect the income tax liability and the various factors necessary for the determination of such liability, and in order to prevent avoidance of such tax liability. In carrying out the preceding sentence, the Secretary may prescribe rules that are different from the provisions of chapter 1 that would apply if such corporations filed separate returns.

Even though Treasury's grant of authority to write consolidated return regulations is among the broadest in the Code, it remains limited by the requirement that a regulation must not be manifestly contrary to the statute. In *Rite Aid*,[26] the Federal Circuit held that a portion of the consolidated return regulations violated that requirement, finding that the rule was not necessary to reflect income and in fact ran afoul of the clear reflection of income standard. This case demonstrates that even a broad grant of authority to write so-called legislative regulations remains subject to review under traditional administrative law standards.

Delegations of adjustment power are rare. Moreover, adjustment authority must be specifically delegated by Congress; there is no implied power of an agency to adjust the statute as it thinks fit, no matter how ''reasonable'' it might seem. Where a grant of adjustment power is made, it is invariably conditioned upon the necessity to achieve the purposes of the statute in question.

APPLICATION OF JUDICIAL REVIEW STANDARDS TO THE RULES OF THE NOTICE

There are several distinct questions of authority presented by the various provisions of the Notice. Some of the authority questions relate to more than one provision of the Notice. There is also the distinct question whether the rules of the Notice can be applied to transactions that had signed, but not closed, prior to September 22, 2014. Each of these issues is discussed below.

The Use of Objective, *Per Se* Rules

An important and overriding question presented by several of the rules of the Notice is whether Treasury has the power to substitute an objective, *per se* rule in place of a statutory rule framed in terms of ''a principal purpose.'' An approach common to many of the rules in the Notice is to supplant purposive rules set forth in the statute with objective rules. More broadly, there is the related question of whether Treasury has the power to adopt bright-line rules that can cause combinations to be treated as inversions even where the policies of §7874 are not implicated.

One rule of the Notice that supplants a principal purpose test with an objective test is the NOCD rule. To justify the NOCD rule, the IRS has claimed authority under §7874(c)(4), which provides that a distribution can be disregarded if it is ''part of a plan a principal purpose of which is to avoid the purposes of this section.'' Presumably, the basis for disregarding NOCDs is that where DT makes an NOCD, it must be presumed that the purpose of making such an NOCD was to reduce the value of DT, thereby facilitating avoidance of the 60%/80% ownership condition. But what if that was manifestly *not* the purpose for making the NOCD? How does the rule further the purpose of the statute?

Let us suppose, for argument's sake, that DT actually did make an NOCD in order to ''skinny down'' in preparation for its acquisition by FA. Usually, it would have done so in order to benefit its shareholders, who can enjoy a tax-free rollover in an otherwise qualifying reorganization only if FA is ''larger'' than DT.[27] This does not implicate any policy in §7874. Section 7874 is not concerned with whether FA is larger or smaller than DT; it is concerned only with whether DT's shareholders end up owning the requisite percentage of FA by reason of owning stock of DT. DT could skinny down to a dollar of value, but if it is acquired for cash, §7874 is not implicated.

The logical error of the NOCD rule lies in the erroneous assumption that, *but for* the NOCD, the DT-FA combination would have been an inversion. To believe this, one must assume that FA would have tendered its stock in exchange for the shares of DT that ''disappeared'' by reason of the NOCD. There is no basis whatsoever to make this illogical assumption.

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[26] *Rite Aid Corp. v. United States*, 255 F.3d 1357 (Fed. Cir. 2001). The *Rite Aid* court also based its decision on its finding that the rule in question was different from the rule that would have applied to the taxpayer had it not filed a consolidated return. This aspect of the court's opinion was effectively reversed by Congress's 2004 addition of the last sentence to §1502 as quoted above.

[27] Reg. §1.367(a)-3(a)(3).

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The arbitrariness of the NOCD rule can also be appreciated by contrasting it to another, and manifestly logical, rule promulgated under §7874.[28] Reg. §1.7874-3T(c)(1) describes the manner in which the Substantial Business Activities Test of §7874(a)(2)(B)(iii) is to be applied. Generally, an FA-DT group will be treated as having substantial business activities in the country in which FA is formed if 25% or more of each of three factors is located in that country. The three factors are set forth in Reg. §1.7874-3T(b)(1)–§1.7874-3T(b)(3) and consist of: (1) employees; (2) assets; and (3) income. Pursuant to the authority of §7874(c)(4), the regulation provides that any group assets, employees, or income attributable to business activities that are associated with properties or liabilities the transfer of which is disregarded under §7874(c)(4) are not taken into account in the numerator, but are taken into account in the denominator, of the 25% tests.

Note that this regulation refers to transfers, including distributions, described in §7874(c)(4); that is, distributions motivated by a principal purpose to avoid §7874. The regulation is a sensible rule in the context of such a tax-motivated distribution. For example, suppose that prior to its acquisition by an FA formed under the laws of Country A, DT owned 100% of the stock of a subsidiary, USS. Suppose that all of the assets, employees, and income of USS were located within the United States, and that USS is for all relevant purposes four times larger than DT. Finally, suppose that FA has no counted assets, employees, or income and that all of DT's assets, employees, and income are located in Country A.

If DT were to spin off all of the stock of USS to its shareholders with a purpose to qualify under the Substantial Business Activities Test, the above anti-abuse rule could apply. Under the anti-abuse rule, the assets, employees, and income of USS would be added back to the denominator of the fraction, yielding a fraction of 20%,[29] such that the test would not be met. If instead the purpose of the spin-off — let us assume made two years prior to the FA acquisition, before the acquisition was even dreamed of by either party — was to comply with an anti-trust order, the rule by its terms would not apply, and the test would be satisfied.

If Treasury were to apply a *per se* approach to §7874(c)(4) in this context, the above case would flunk the Substantial Business Activities Test under either assumption. Even more surprisingly, the following case, involving no possible potential abuse, would be covered. Suppose that each of DT and USS have exactly 30% of their assets, employees, and income in Country A, and that DT spins off USS. Assuming that the spin-off is a distribution that exceeds 110% of the average of the counted distributions during the 36-month look-back period, under the Notice it would be ''disregarded,'' and the test would be flunked. The fraction would be again reduced to 20% of what it would otherwise have been, here from 30% to 6%, because the factors of USS would be added to the denominator but not to the numerator of the fraction.[30] Obviously, no possible anti-inversion policy is served by applying the approach of the Notice to §7874(c)(4) in this way, since the Substantial Business Activities Test would have been separately satisfied by both DT and USS.

The Notice's NOCD rule is drafted in such a way that it appears to apply for all purposes of §7874, not just for purposes of calculating the Ownership Condition. But in abandoning any pretense that the taxpayer's purpose is relevant, and substituting a *per se* rule that is much broader than needed to deal with the identified ''abuse,'' the Notice upends the statutory design. It is thus not surprising that it would give rise to obviously incorrect results in other contexts.

There do not appear to be any cases entertaining the question whether Treasury, or any agency, has the power to substitute an objective *per se* or ''bright line'' test for a statutory rule requiring the presence of a principal purpose to avoid the purposes of a provision. This may be because agencies, including Treasury, very rarely engage in the practice. For example, there is no Treasury regulation that substitutes a bright-line rule for the principal purpose test of §269. The regulations under §269 do set forth a number of facts and criteria suggestive of a bad purpose, but they do not go nearly so far as to replace the statutory ''the principal purpose'' rule with one or more bright-line rules.

The author has discovered no other instance in which Treasury has used solely objective tests to implement a statutory principal purpose test. A search of Code sections incorporating a principal purpose test reveals corresponding regulations that fall into two categories. One category uses a rebuttable presumption, often with a very high standard imposed on the taxpayer where certain objective factors are pres-

[28] This next section is adapted from the author's article, *Busting §7874(c)(4)*, 44 Tax Mgmt. Int'l J. 165 (Mar. 13, 2015).

[29] That is, without the add-back the fraction would be 1/1 or 100%, whereas with the add-back the fraction would be 1/(1+4) or 20%.

[30] That is, assuming that the ''value'' of DT's total attributes is $100, $30 would be attributable to Country A. Before the add-back, the fraction would be 30/100. After the add-back, the fraction would be 30/(100+400). The test is flunked because USS's foreign attributes of $120 are not added back to the numerator.

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ent.[31] The other category uses a facts-and-circumstances test.[32]

A particularly relevant example tied to a ''purpose to avoid'' test is found in §7701(l), which forms the basis for the Notice's out-from-under rule. The statute provides that Treasury ''may prescribe regulations recharacterizing any multiple-party financing transaction as a transaction directly among any 2 or more of such parties where [it] determines that such recharacterization is appropriate to prevent avoidance of any tax imposed by this title.'' The anti-conduit regulations at Reg. §1.881-3, issued pursuant to that authority, provide that the IRS may infer the existence of a tax avoidance plan from the facts and circumstances. In determining whether there is a tax avoidance plan, the IRS will weigh all relevant evidence regarding the purposes for the intermediate entity's participation in the financing arrangement.

There are many examples of Treasury regulations that make use of a bright-line test as a proxy for a principal purpose rule promulgated by Treasury itself, usually as a rebuttable presumption. For example, the disguised sale rules of Reg. §1.707-3 incorporate a facts-and-circumstances test but provide a bright-line two-year rebuttable presumption. However, the power of Treasury to promulgate an anti-abuse rule by regulation, and to back it up with one or more objective tests, is not the same as the power to replace a statutory test clearly requiring a bad purpose with an objective test.

Treasury and IRS officials are often heard to say that they chose bright-line tests for purposes of various provisions of §7874 because it would be too difficult for them to enforce a primary purpose rule. They also say that they would have great difficulty proving that a particular taxpayer had a principal purpose to avoid §7874. They may be correct about the practical problems of enforcing a primary purpose rule, although there are many examples of rules employing presumptions and principal purpose, including Reg. §1.881-3 and the ''device'' rules of §355, which operate well to control abusive taxpayer behavior. But whether or not their view is correct, those practical problems are irrelevant to the question of whether a regulation is a proper exercise of Treasury authority.

A court might uphold a bright-line regulation, even in the face of a statutory principal purpose rule, if the court were convinced that the bright-line test captured only those transactions intended to be captured by Congress. Indeed, Treasury and IRS spokespersons often speak as if every transaction that could conceivably be captured by the Notice is a transaction that Congress intended to capture. But this is quite manifestly erroneous, and not just at the margin. There is a fundamental disconnect between what Treasury believes it is targeting and what is actually targeted.

As just one example of this disconnect, a Treasury representative recently stated that if taxpayers were concerned about the impact of the NOCD rule, they should just ''wait out'' the 36-month testing period. This statement belies a fundamental misunderstanding of what is rightly worrying taxpayers. The definition of NOCD sweeps in many distributions that almost anyone would think of as ordinary course distributions. If a domestic corporation just happens to make a distribution to its shareholders in year one, having nothing at all to do with a plan to ''skinny down,'' and then is approached by a foreign corporation to undertake a cross-border combination in year three, the NOCD rule can cause that combination to be an inversion even if in fact it is nothing more than a merger of equals. It makes no sense to tell the taxpayer to ''wait'' to do the combination, because these kinds of deals with third parties become available only in limited windows of time. The Treasury representative who made this remark was operating from the erroneous assumption that the rules somehow target only those cross-border combinations that are planned into by a domestic corporation, when in fact the rules operate broadly without any planning or purposive activity by the domestic corporation.

Because the NOCD rule and other rules in the Notice sweep in many, many deals that have nothing to do with the policy or purposes of §7874, a court is unlikely to accept the argument that bright-line rules are

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[31] Examples of this type of regulation include Reg. §1.357-1(c), issued pursuant to §357(b), providing that an assumption of liabilities undertaken for a principal purpose of avoiding federal tax is not subject to §357(a). The regulation provides that in any suit or proceeding where the burden is on the taxpayer to prove that an assumption of liabilities is not to be treated as ''other property or money'' under that subsection, the taxpayer must sustain its burden by the clear preponderance of the evidence. Another example is found at Reg. §1.197-2, issued pursuant to §197(f)(9)(F), providing that a §197(f)(9) intangible acquired by a taxpayer after the applicable effective date does not qualify for amortization under §197 if one of the principal purposes of the transaction in which it is acquired is to avoid the operation of the anti-churning rules. Under the regulation, a transaction will be presumed to have a principal purpose of avoidance if it does not effect a significant change in the ownership or use of the intangible.

[32] Examples of this type of regulation include Reg. §1.382-1, issued under the authority of §382(l)(1), which provides that if a principal purpose of the issuance, transfer, or structuring of an option on stock is to avoid an ownership change, it is treated as exercised. Reg. §1.382-1(d)(6)(ii), §1.382-1(d)(6)(iii), and §1.382-1(d)(6)(iv) describe additional factors that are relevant in applying each test. The weight given to any factor depends on all the facts and circumstances. The presence or absence of any one factor does not create a presumption. Another example is found at Reg. §1.467-3, issued under the authority of §467(b)(4)(B). In determining whether a principal purpose of providing increasing or decreasing rent is the avoidance of federal income tax, all relevant facts and circumstances are taken into account.

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a proper substitute for the statutory principal purpose test.

It would seem obvious that an agency such as Treasury does not have the power to read words out of a statute, at least without being able to point to explicit authority for doing so. Cases such as *Finfrock* make clear that Treasury is not free to invent requirements not found in the statute; it should be equally clear that Treasury is not free to ignore clear words of the statute.

It is virtually certain that Treasury would defend its right to substitute objective tests for the purposive tests in the statute by reference to what it perceives to be a grant of adjustment power under §7874(g). However, the language of that subsection does not give Treasury carte blanche; it in fact limits the adjustment power to the extent ''necessary to prevent the avoidance of the purposes of this section.'' When a rule such as the NOCD rule causes an innocent merger of equals to be caught by §7874, Treasury cannot justify its rule as being necessary to avoid §7874's purposes.

Ultimately, the grant of authority that each provision of the Notice is relying upon comes down to whether a particular action contravenes the purpose or purposes of §7874. Therefore, any analysis of whether Treasury has authority for these types of rules depends on what one views as the purpose or purposes of §7874.

At a basic level, the purposes of §7874 are obvious based on the words of the statute itself. First, if FA has 80% of its owners in common with DT, then assuming the Substantial Business Activities Test is not met, FA is to be treated as a domestic corporation. This rule was quite clearly intended to pick up combinations of FA and DT where FA was close to a continuation of DT, which is why the statute uses the word ''surrogate.'' That is, Congress lowered the bar for finding an inversion from the 100% inversion typified by the early naked inversion cases to 80%. And in determining whether this condition is met, Congress made it crystal clear that issuances of FA stock in an IPO, as well as stock owned by a member of the EAG, would not be taken into account.[33] Second, if FA has at least 60% but less than 80% of its owners in common with DT, the statute's purpose is to apply the inversion gain rules of §7874(d) to the resulting company.

Nothing in the statutory language or legislative history suggests that one of the purposes of §7874 was to treat as an inversion any combination between DT and FA that did not rise to the level of the 60%/80% tests, taking into account the statute's counting rules. It is extraordinary that the rules of the Notice, as well as prior guidance under §7874, appear to have been motivated by a belief that an ''inversion'' is any acquisition by FA of DT *that fails to meet the 60%, much less the 80%, test*. According to accounts in the popular press, as well as statements from members of Congress and even the President, any combination of FA and DT that manages to satisfy the statutory test for not being an inversion, is in fact an inversion that has somehow taken advantage of a ''loophole.'' The current state of discourse on inversions is that any transaction structured to *comply* with the statute — in the sense that the 60% threshold is not met — is regarded as a transaction designed to *avoid* the purposes of the statute.

The Notice seems to emanate from a belief that there is a penumbra around §7874 not set forth in the statute or legislative history. The IRS may believe, for example, that any combination of FA and DT where DT is the larger company is somehow caught within this penumbra, and therefore that in order to further the purpose of §7874 it is necessary to write rules sweeping such transactions into the section. Alternatively or additionally, the IRS may believe that any combination undertaken for the principal purpose of avoiding U.S. tax should be targeted, even if it would otherwise pass muster under the terms of the statute.

It is unlikely that a court would agree that there is any such penumbra surrounding §7874. The theory that the section was intended to encompass any combination where DT is larger than FA directly contradicts the words of the section itself, which looks only to whether shareholders of DT end up owning the requisite amount of FA stock by reason of their interests in DT. Section 7874 clearly has no application to a cash purchase of a large DT by a small FA.

Nor is there any indication in the statute or legislative history that there is an extrastatutory ''business purpose'' test attendant to the operation of §7874. While a tax-free reorganization described in §368 must have a good business purpose, many inversions are not structured as tax-free combinations. (Indeed, tax advisors often seek to ''bust'' tax-free treatment in these cases because §367(a) will usually apply to tax gains realized by U.S. shareholders but deny the claiming of any loss realized by a U.S. shareholder.) While Congress may well have desired to target combinations motivated solely or principally by tax concerns, it eschewed any reference to the purpose for which a combination was undertaken in favor of a bright-line 60%/80% test.

Even if there were a penumbra around §7874, the Notice is subject to challenge on the basis that it does not even attempt to limit its rules to transactions that have a bad purpose. In fact, it does the opposite, adopting bright-line rules that apply to innocent transactions as well as transactions motivated by a desire to place a new FA on top of DT. The statute provides

[33] §7874(c)(2).

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Treasury with authority to provide rules addressing situations where a taxpayer has a purpose to avoid the purposes of the statute. The Notice turns the statutory dictate on its head, providing rules that say it does not matter what the taxpayer's purpose is. Even if the taxpayer's purpose is completely unrelated to avoiding the purposes of §7874, a taxpayer can be caught by the rules in the Notice. It is doubtful that a court would uphold these rules in the Notice, given that they contradict the fundamental condition precedent of the statute.

The IRS could have solved this problem of authority by doing what it has done in every other case described above, adopting in lieu of the bright-line rules of the Notice a series of presumptions. Perhaps the IRS will reconsider when regulations are ultimately issued pursuant to the Notice.

Rendering the Statute Superfluous

While the adjustment power, especially when read together with §7874(c)(6), should give Treasury authority to promulgate rules for the counting of stock held by an EAG member and rules disregarding stock issued in an IPO, there is no indication on the face of the statute that Congress believed it had granted power to Treasury to invent entirely unrelated rules to adjust the Ownership Condition.

Reg. §1.7874-4T is a straightforward example of a regulation that clearly renders a related portion of the statute superfluous, and therefore should not survive a challenge in court. Section 7874(c)(2)(B) provides that in determining the Ownership Condition, ''there shall not be taken into account . . . stock of such foreign corporation which is sold in a public offering related to the acquisition described in subsection (a)(2)(B)(i).'' The regulation renders this language superfluous — ''mere surplusage'' — because it disregards stock of FA that is sold for cash or other nonqualifying property to anyone, not just in a public offering. The -4T regulations are particularly egregious in light of the well-known legislative history of §7874(c)(2)(B). Congress had considered, but ultimately rejected, a rule that would have disregarded stock of FA issued in a private placement. The regulation, of course, disregards such stock.

Treasury and the IRS might be expected to point out that there is no difference in policy or logic to distinguish between a dilutive issuance of FA shares in an IPO and in a private placement. But that is for Congress, not the executive branch, to decide. One reason Congress might have targeted only IPO issuances is that such issuances do not generally affect the management and control of a corporation, whereas a private placement could very well do so. Given that Congress focused on the managers of an inverted company by enacting the §4985 excise tax, it is not much of a stretch to suppose that it was more troubled by an issuance that would not affect management than by one which could.

The cash-box rule is, in part, an extension of Reg. §1.7874-4T. Once one posits that an issuance of FA shares for cash should be disregarded in calculating the Ownership Condition, it might be tempting to ask why a foreign corporation having ''old and cold'' cash should be in any better position. The obvious rejoinder to this fuzzy logic is that old and cold cash was not obtained through an issuance ''related to the acquisition'' as required by the statute.

In fact, there is no policy basis — at least not related to §7874 — for the cash-box rule. The rule is predicated on the idea that a combination with a cash-rich FA is motivated by no purpose other than tax avoidance. While this may be so in some cases, it is certainly not true in every case, as the exceptions for banks and insurance companies make clear. Another case in which a company may be sitting on a lot of cash is a company that has recently undergone an IPO or other capital-raising event, and plans to use the cash to develop a new project — very common in the high-tech and medical industries. And in any event, §7874 does not require a business purpose and is not triggered by the lack of one. Absent some limitation tied to a purpose to avoid §7874, the cash-box rule cannot be justified by reference to Treasury's adjustment power because it is not in furtherance of any purpose of the statute.

The authority that the IRS has cited for the cash-box rule is found in §7874(c)(6), which as noted above authorizes Treasury to treat stock as not stock. A natural reading of the authority granted by §7874(c)(6) is that it empowers Treasury to write rules treating what is a debt or a warrant in form as stock, and treating what is stock in form as debt or some debt-like instrument. Indeed, this type of grant of authority has been so interpreted elsewhere.[34] But there is no precedent for using such a grant of authority to treat stock as not stock solely for the purposes of not counting it in the denominator of a statutory ownership fraction. The rule is particularly suspect given that the statute itself, at §7874(c)(2), clearly stipulates when stock is to be disregarded for purposes of the Ownership Condition.

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[34] *See, e.g.,* the identical language at §382(k)(6)(B), implemented by regulations at Reg. §1.382-2T(f)(18)(ii) which provide, *inter alia*, that ''[a]ny ownership interest that otherwise would be treated as stock under paragraph (f)(18)(i) of this section shall not be treated as stock if—(A) As of the time of its issuance or transfer to (or by) a 5-percent shareholder, the likely participation of such interest in future corporate growth is disproportionately small when compared to the value of such stock as a proportion of the total value of the outstanding stock of the corporation.''

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Moreover, the circumstances in which stock is disregarded in the denominator of the fraction are so peculiar as to defy logic. We are told that the portion of the stock to be so excluded is the portion that corresponds to the cash and other non-qualifying property of the issuer. There is no precedent anywhere in the tax law for treating stock as not stock based on nothing more than the type of assets a corporation owns. Any such look-through rule is completely contrary to the principles of *Moline Properties*[35] and years of settled law.

The cash-box rule, as well as the regulations at Reg. §1.7874-4T, render the statutory scheme superfluous. The extant regulations render §7874(c)(2)(B) superfluous, since if the regulations are correct, there is no function left for §7874(c)(2)(B) to fulfill: Stock of FA issued in an IPO is no different from stock of FA issued to anyone for cash. The cash-box rule takes the offense one step farther, rendering the entire stock-counting test of §7874 superfluous. For this and other reasons, it is doubtful that a court would find the rule to be validly issued.

Authority to Expand

The status rules of the Notice are designed to treat as inversions certain combinations that would not otherwise be treated as inversions under the words of the statute. These rules are very different from ordinary rulemaking, which is aimed at interpreting and implementing the words of a statute. The status rules of the Notice are designed to expand the reach of the statute. One searches in vain for a delegation of authority to rewrite the rules so as to sweep in more transactions than those specifically targeted by Congress.

If Treasury were to write a regulation providing that any acquisition by FA of DT that closes on a Tuesday should be treated as an inversion, no one would suppose that such a rule was valid. The IRS must believe that the status rules in the Notice emanate from some logical or principled connection to the statute itself. But as argued above, it is not sufficient merely to claim that any broadening of the definition of the term ''inversion'' is consistent with the purposes of the statute.

Courts give agencies such as Treasury very broad leeway to issue rules and regulations necessary to further the purposes of a statute. But in the end, the rules of the Notice are not about furthering the purposes of the statute. While the statute grants authority to Treasury to write regulations designed to counter the avoidance of the *purposes* of the statute, the IRS has erroneously reinterpreted the grant of authority to allow Treasury to write regulations to prevent avoidance of the *application* of the statute. These are two very different things, and a court would not be confused by the sleight of hand.

Section 956 Anti-Hopscotch

The anti-hopscotch rule of the Notice is perhaps the clearest case of a rule that lacks authority because it expressly contradicts the statute. The stated authority for the rule is found in §956(e), which provides:

> The Secretary shall prescribe such regulations as may be necessary to carry out the purposes of this section, including regulations to prevent the avoidance of the provisions of this section through reorganizations or otherwise.

The ''provisions of this section'' clearly refers to the provisions of §956. Section 956 is entitled ''Investment of Earnings in *United States* Property'' (emphasis added). Section 956(c) contains a detailed definition of what constitutes U.S. property, and that definition has been subject to fairly extensive guidance in regulations and court cases. It is absolutely clear that the term U.S. property, for this purpose, does not include the stock or debt of a foreign person.

This raises an obvious authority question: How can a rule treating an investment in the stock or debt of a foreign person, clearly non-U.S. property, possibly be justified under authority that is tied to the avoidance of the provisions of a statute that looks only to U.S. property? Where is the authority to expand the definition of U.S. property to include non-U.S. property? It seems clear that the rule in the Notice is not only *not* in furtherance of the purposes of §956; it is actually *contrary* to the purposes of §956.[36]

Treasury might be expected to counter that it has ample authority to write rules to prevent the avoidance of the purposes of §956, including through use of related corporations. Indeed, existing regulations under §956 incorporate a fairly broad anti-abuse rule intended to reach conduit cases.[37] However, those regulations all assume that the property in question is, in fact, U.S. property; the only issue is which CFC is treated as having made the investment.

The Notice attempts to justify its extension of §956 to non-U.S. property this way:

> An inversion transaction may permit the top corporate parent in the newly inverted group,

[35] 319 U.S. 436 (1943).

[36] *See* Korenblatt, *The 'New Section 956 Anti-Hopscotch Rule' — Is Treasury Overreaching?* 42 J. Corp. Tax'n 21 (2015).

[37] Reg. §1.956-1T(b).

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> a group still principally comprised of U.S. shareholders and their CFCs, to avoid section 956 by accessing the untaxed earnings and profits of the CFCs without a current tax to the U.S. shareholders. *This is a result that the U.S. shareholders could not achieve before the inversion.* The ability of the new foreign parent to access deferred CFC earnings and profits would in many cases eliminate the need for the CFCs to pay dividends to the U.S. shareholders, thereby circumventing the purposes of section 956. Section 956(e) directs the Secretary to prescribe regulations to prevent the avoidance of the provisions of section 956 through reorganizations or otherwise; an inversion is an example of such a transaction.[38]

The most important sentence in the above passage is the highlighted sentence. The IRS here has adopted a ''but for'' approach to §956: If you couldn't do something before, you ought not to be able to do it after. In effect, the Notice is saying that nothing has changed, at least nothing that should be accorded weight for this purpose. However, this approach is illogical. In any cross-border combination, including an acquisition by a large U.S. corporation of a smaller foreign one that is not remotely similar to an inversion, the group acquires more foreign affiliates than it started with. A CFC of the U.S. party to the combination can invest its earnings in stock or debt of its newly related foreign affiliates, and no one would suggest that this avoids the purposes of §956. Why does the presence of a purported inversion turn §956 on its head?

Moreover, the presumption underlying the ''but for'' rule seems to be that FA is a shell whose existence as the top company in the group changes nothing of substance. That would clearly be accurate in a naked inversion. But in an inversion at only 60%, to which these rules are limited, FA will often be a very real and active operating company. The parties to any cross-border combination have a choice, indeed must make a choice, among putting the foreign corporation on top, putting the U.S. corporation on top, or forming a new corporation in a third country to put on top. While that choice may be relevant to the application of §7874, it cannot possibly be relevant to the application of §956.

In an inversion context, if FA needs to access funds of the CFC for use in the U.S. business, it would be forced to cause the CFC to declare a dividend to DT or another U.S. member of the group, incurring U.S. tax and potentially multiple levels of withholding taxes. If it does not need access to the funds of a DT CFC for use in the U.S. business, but only for use in its foreign business, it will cause the CFC to make an investment in a foreign affiliate. These are exactly the same choices faced by U.S.-parented groups. The fact that the E&P ''stays in the family'' is irrelevant to the purpose or operation of §956. CFCs of U.S.-parented groups routinely make investments in other foreign subsidiaries of such groups.

It cannot be relevant that having access to the funds of DT's CFCs might eliminate the need for those CFCs to pay dividends to a U.S. member of the group. By definition, if the funds are not needed in the United States, no such dividends would be paid. Since an investment by the CFC in stock or debt of a foreign affiliate does not allow the funds to be used in the United States, the statement in the Notice is irrelevant to the purpose of §956.

A court faced with a challenge to the anti-hopscotch rule would first inquire into the language of the statute and would also examine the legislative history to ascertain the purpose of §956. What it would find is that §956 was enacted in order to prevent U.S. shareholders from avoiding U.S. tax when assets of a CFC are made available *to a U.S. person within the group*, directly or indirectly. Here, that is manifestly not the case. Even adopting the broadest possible view of the scope of §956(e), it is nearly unimaginable that a court would find the anti-hopscotch rule to be a reasonable construction of the statute.

Out-From-Under Transactions

Without question, §3.02 of the Notice regarding the use of §7701(l) to combat out-from-under transactions is by far the most ingenious of the Notice's rules. Section 7701(l) refers to multi-party financing arrangements, and was principally aimed at (although not limited to) conduit financing structures. Treasury issued the so-called fast-pay rules in Reg. §1.7701(l)-3 to combat a particular abuse as described below. Even assuming that §7701(l) provides authority to recharacterize a transaction in the manner in which the fast-pay regulations do, there is a critical distinction between those regulations and the approach of the Notice that raises a significant authority question.

The fast-pay regulations apply when a single corporate issuer issues two classes of stock. One class frontloads distributions that reverse over time, creating dividends that reduce the issuer's E&P. At the back end, the other class, referred to in the regulations as the benefitted class, catches up on economics but enjoys an exemption from tax due to the fact that the dividends on the fast-pay stock have stripped out E&P. Not surprisingly, the fast-pay stock is issued to

[38] Notice at §3.01(b) (emphasis added).

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tax-indifferent shareholders, such as U.S. tax-exempt persons.

The fast-pay regulations recharacterize this type of arrangement as if the benefitted shareholders issued financial instruments to the fast-pay shareholders.[39] It is an interesting construct that stretches the boundaries of what §7701(l) was designed to address, which was conduit arrangements. But assuming its validity, this is nothing like what the Notice attempts to do. The fast-pay regulations stay within the boundaries of the statutory language; that is, they apply to multiparty financing arrangements. They accept the fact that both the fast-pay shares and the benefitted shares actually exist, and are held by two different parties who own what they own. They construct a financing of the benefitted shareholders by the fast-pay shareholders.

The Notice does something completely different from what is done by the fast-pay regulations. It applies where there is no financing arrangement, and does not construct a financing arrangement. Instead, it constructs a different chain of ownership, deeming a U.S. shareholder of a CFC to own something it does not in fact own, which is stock of the CFC that is actually owned by an affiliate of the foreign parent. Let us look at the simplest example of how this is intended to work, which is set out as Example 1 in this portion of the Notice:

Foreign affiliate FA acquires $10 of CFC stock in a direct issuance for cash, resulting in FA owning 60% of what was once a CFC. Without more, the CFC has ceased to be a CFC. The Notice recharacterizes this simple investment as if the U.S. shareholder of the CFC, DT, issued its own stock to FA for $10, which it then contributes to the CFC for additional CFC shares. Thus, the CFC remains a CFC.

The result of this recharacterization is that DT owns CFC stock that it does not in fact own, and FA owns DT stock that it does not in fact own. If a dividend is paid by the CFC to FA (its actual owner), it will be treated for all U.S. tax purposes as a dividend paid to DT, which in turn pays a dividend to FA. Not only will DT be subject to U.S. tax on the dividend, but U.S. withholding tax will apply to the deemed dividend from DT to FA.

This deemed ownership construct ventures very far afield of what the fast-pay regulations do. While the fast-pay regulations construct a deemed financing transaction between the fast-pay shareholders and the benefitted shareholders, the Notice inserts a party that is not actually a party to any arrangement into a simple investment arrangement. Under the Notice, DT is deemed to own something (the CFC shares owned by FA) that it does not in fact own, and to issue something (the stock deemed issued to FA) that does not actually exist. Moreover, there are independent tax consequences to this permanent deemed ownership fiction.

A court is very unlikely to respect this extended fiction. The Notice layers one grant of authority, §7701(l), on top of another, which is §367(b), addressing avoidance of the purposes of Subpart F. The grant of authority under §7701(l), which by the IRS's own admission was intended to combat three-party conduit arrangements, is itself highly strained. To pile it on by suggesting that the parties own something they do not in fact own goes very far beyond where even the fast-pay regulations dared to go.

Another new rule added in this section of the Notice modifies §367(b) in a wholly unprecedented manner. The underlying theory of §367(b) had been, until now, that a U.S. taxpayer would be subject to tax only when, by virtue of a nonrecognition rule, it ceased to be a U.S. shareholder of a CFC. The Notice changes this construct in a fundamental way. Under the Notice, a dilutive issuance by the CFC will require the U.S. shareholder to include in income the §1248 amount even if the CFC remains a CFC in the U.S. shareholder's hands.

Treasury has very broad authority to issue regulations under §367(b). However, the statute by its terms is limited to transactions involving a nonrecognition provision of the Code. Section 367(b)(1) states, ''In the case of any exchange described in section 332, 351, 354, 355, 356, or 361 in connection with which there is no transfer of property described in subsection (a)(1), a foreign corporation shall be considered to be a corporation except to the extent provided in regulations prescribed by the Secretary which are necessary or appropriate to prevent the avoidance of Federal income taxes.'' Section 367(b)(2) further provides Treasury with broad authority to apply §367(b) to sales of stock by a U.S. shareholder.

A ''specified exchange'' triggering the new §1248 pick-up under the Notice is neither a nonrecognition transaction mentioned in §367(b)(1) nor a disposition by a U.S. shareholder mentioned in §367(b)(2). Treasury's authority to issue a regulation, purportedly under the authority of §367(b), to require income recognition in a situation not encompassed by the statute's terms is on very shaky ground.

Spinversions

The ''spinversion'' rule of the Notice is not particularly interesting from an authority perspective. However, it is mentioned here because it well illustrates the Notice's arbitrary, results-oriented approach to §7874 generally. The spinversion rule grew out of the

[39] Reg. §1.7701(l)-3(c).

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IRS's recognition that the interaction of the EAG rule of the statute with Treasury's "frozen numerator" rule in Reg. §1.7874-5T could facilitate certain transactions that it did not like. The targeted transaction was one in which a domestic corporation transfers stock of a domestic subsidiary to a foreign subsidiary of the transferor, followed by a spin-off of the stock of the foreign transferee to its shareholders. (While the spin-off would generally be subject to tax, this might not be of importance to a distributing company that has little gain or that has NOLs to absorb.)

An appropriate response to this problem would be to acknowledge that the frozen numerator rule makes no sense and should be removed. In testing for an inversion, the steps of a transaction should be integrated under normal tax rules.

Consider the application of the frozen numerator rule to a §304 transaction in which a foreign corporation sells stock of a domestic subsidiary to a sister foreign corporation. Section 304 would deem the seller to have contributed the stock of the domestic subsidiary to the foreign buyer in exchange for stock of the foreign buyer. So, even though the foreign seller's deemed stock of the foreign buyer would be deemed to have been immediately redeemed for cash, the frozen numerator rule might treat the seller as "owning" stock of the buyer by reason of its ownership of the stock of the domestic "target." This is only one obviously ridiculous result of the frozen numerator rule's refusal to apply ordinary step-transaction principles.

Retroactivity

The Notice purports to apply to transactions completed on or after September 22, 2014 (the "Effective Date"). This is an unusual form of retroactivity; the Notice is not fully retroactive in that it does not apply to transactions that closed prior to the Effective Date. But the Notice's approach is nonetheless a type of retroactivity. Normally, when a new rule is announced, considerations of equity require that it not apply to a transaction subject to a binding commitment before the rule was announced — especially where the rule is unexpected. In contrast, the Notice was intended to, and in fact did, cause the abrogation of several transactions that had already signed and in most cases gone through SEC filing.

The Notice's Effective Date might not survive a challenge in court. The Notice states that regulations will be issued pursuant to its rules. So far, no such regulations have been issued. Section 7805(b) bars any regulation from applying to a taxable period ending before the date on which "any notice substantially describing the expected contents of any temporary, proposed or final regulation is issued to the public." However, §7805(b)(3) allows Treasury to make a regulation retroactive "to prevent abuse."

The IRS is likely to insist that regulations issued pursuant to the Notice are validly applied to transactions signed but not completed on the Effective Date. It would argue, first, that the Notice "substantially describes" the expected contents of the regulations. Second, it would argue that the anti-abuse exception applies.

Some portions of the Notice do "substantially describe" what we should expect to see in regulations. The anti-hopscotch rule, for example, is quite straightforward. However, the important status rules contained in the Notice are so deficient in their detail that it is anybody's guess what the regulations will actually provide.

The NOCD rule is by far the vaguest: What does it mean for a distribution to be "disregarded"? How is the 36-month look-back period measured? How does the rule apply to a redemption of voting vs. nonvoting stock? Does the rule apply to an all-cash transaction in such a way as to deem FA stock issued for DT shares when in fact all of the actual DT shares are acquired for cash? One must know the answers to these and many other questions in order to apply the rule. Recently, IRS representatives have admitted that the IRS had not thought through many of the most basic questions that need to be answered in order to apply the NOCD rule.[40] For example, the IRS is currently considering changes that would limit the NOCD rule to measuring the value of shares, and disregarding voting power, for purposes of the rule, an invention totally at odds with the statute but obviously necessary to implement an NOCD rule not contemplated by the statute. The IRS has also come to recognize that many NOCDs do not actually shrink the value of DT, illustrating the logical failure at the heart of the rule and the error of adopting objective tests not limited to transactions having a principal purpose to avoid §7874.

The cash-box rule is similarly vague: At what point in time are the assets of FA taken into account? Why is there an exception for insurance companies described in §954(i) but not §1297(b)(2)(B)? Meanwhile, the out-from-under rule of the Notice is nearly impenetrable. It is unclear how the §367(b) regulations will be modified so as to cause a dilutive issuance of new CFC stock to be treated as a recognition event.

A court should take into account, in weighing whether the Notice adequately describes forthcoming regulations, the fact that the status rules of the Notice purport to define the circumstances under which a combination will be treated as an inversion or not.

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[40] *See, e.g., Antiabuse Rule Being Considered for Vote in 'Skinny-Down' Rules*, 2015 TNT 39-3 (Feb. 26, 2015).

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Given the very significant stakes of being treated as an inversion, which stakes have been raised by the Notice, a court would likely hold Treasury to a very high standard. It is manifestly unfair to taxpayers to announce rules that would fundamentally change the tax consequences of bona fide business combinations without providing sufficient guidance for taxpayers to determine whether or not the proposed rules apply to them.

It therefore seems likely that the IRS will need to justify the retroactive Effective Date of the Notice by reference to the anti-abuse exception in §7805(b)(3). But because the status rules are not limited to cases of abuse, but instead adopt objective rules that sweep in non-abusive transactions, a court is likely to hoist the IRS by its own petard, concluding that the IRS cannot rely on §7805(b)(3) absent a showing that the proposed rules apply only to abusive cases.

CONCLUSIONS

When §7874 was enacted in 2004, it was well understood that Congress intended it to shut down naked inversions such as one Stanley Works proposed to undertake at the time. And Congress went further: §7874 treats a foreign corporation as domestic even if it is only 80% (as opposed to 100%) owned by shareholders of the inverting domestic company. Going even further, Congress enacted post-inversion gain rules in §7874(d), as well as an excise tax on the stock compensation of ''insiders'' involved in inversions in §4985, that apply when the shareholders of the domestic target own only 60% of the foreign corporation. Clearly, Congress was unhappy with what it perceived to be tax-motivated expatriations of U.S. companies.

The structure of §7874 makes clear that Congress knew its limits. It would be preposterous to suggest that any foreign company that acquires a U.S. company for cash should be treated as a U.S. company, or that in a merger of equals that parties would be forced by U.S. tax law to place a U.S. company on top of the new group. Congress understood these limits and crafted a statute that respected them. The same cannot be said for recent guidance promulgated by Treasury under the ''authority'' of §7874.

The story of Treasury guidance under §7874 has been one of mission creep. Since the enactment of §7874, Treasury has issued no fewer than three versions of rules sequentially tightening the circumstances when the Substantial Business Activities Test, a key feature of the statute, would apply. The most recent version of those rules renders it virtually impossible to satisfy the test. In mid-2009, Treasury issued in proposed form what would become Reg. §1.7874-2, incorporating a large number of new rules expanding the circumstances in which §7874 would apply. It also issued Notice 2009-78, presaging Reg. §1.7874-4T, which disregards issuances of FA stock for cash whether or not pursuant to an IPO. When all of these actions failed to stem cross-border combinations that complied with §7874, the IRS issued the Notice. We have come a very long way from the original vision of the statute, which was to shut down naked inversions and to impose penalties on combinations falling into the 60%/80% Ownership Condition in which the Substantial Business Activities Test is not met.

In its mission to expand §7874, the IRS was quite clearly egged on by the press and by politics. Tax and lay journalists reported on so-called ''inversions'' that clearly were not inversions as defined in §7874, usually claiming erroneously that the U.S. companies were somehow magically transformed into foreign ones taxable at reduced rates and free to repatriate the earnings of their CFCs. Some members of Congress, as well as the President, apparently credited these reports, and began complaining that taxpayers were exploiting a ''loophole'' in the law, when in fact taxpayers were actually complying with both the letter and the spirit of the law. Amid growing hysteria, a great deal of pressure was brought to bear on the IRS to ''fix the problem.''

Fortunately, we live in a country that gives to the courts the ability to review the legality of administrative actions. Courts have the luxury of time to consider carefully, at some remove from the political fray, what the law requires. It seems likely that if challenged in court, most of the rules in the Notice would not stand.

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