tax notes

Volume 151, Number 12 ■ June 20, 2016

Badges? We Don't Need No Stinking Badges!

By Ken Brewer and Albert Liguori

Reprinted from *Tax Notes*, June 20, 2016, p. 1685

taxanalysts®

Badges? We Don't Need No Stinking Badges!

by Ken Brewer and Albert Liguori


Ken Brewer


Albert Liguori

Ken Brewer is an international tax practitioner and a senior adviser with Alvarez & Marsal Taxand. Albert Liguori is the leading managing director of Alvarez & Marsal Taxand's northeast tax practice.

In this article, Brewer and Liguori discuss whether Treasury acted within the bounds of its congressionally delegated authority in releasing the proposed regulations under section 385.

The line of dialogue in the title, loosely paraphrased from the 1948 film *The Treasure of the Sierra Madre* (later borrowed by the 1974 Mel Brooks film *Blazing Saddles*), was the retort by the leader of a group of Mexican *bandidos*, posing as *Federales*, when asked to show proof of their authority.

In stark contrast to that of the *bandidos*, the explanation Treasury provided for its authority in the preamble to the recently released proposed regulations under section 385 (the earnings stripping regulations)[1] was far more dignified and professional. But it is not clear whether Treasury's authority to enact some of the rules in those regulations finds much more support in the law.[2]

There is no question that the regulations would promote highly important tax policy objectives of the Obama administration. But it is not as certain whether they are consistent with the policy objectives and the "intelligible principle" (as discussed in more detail below) that Congress had in mind regarding its delegation of authority to Treasury in section 385.

A. Treasury's Legacy Challenge With Section 385

Section 385 has been in the code since 1969. With the exception of a brief (approximately 2½-year) period in the early 1980s, there had been no regulations under section 385 in the 47 years since its enactment. The reason for that is because of the highly fact-sensitive nature of the determination of whether a given relationship is that of a debtor and creditor or that of a corporation and shareholder.

Attempting to provide an objective, mechanical formula for that determination is a daunting task. When Treasury attempted to do so back in 1980, it didn't take long for the investment bankers to figure out how to use those regulations to devise financial instruments that would qualify as debt for tax purposes but that could be treated as equity for financial statement purposes. Not long after those offerings began showing up in *The Wall Street Journal*, Treasury quickly withdrew the regulations.

The primary motivating factor for the new earnings stripping regulations was to curb specific related-party debt transactions undertaken by so-called inverted companies to enhance the U.S. tax benefits of their inversion. But it is critical to understand that these new rules would not be confined to inverted companies. They would apply to any purported indebtedness between parties that are related in the manner specified in the regulations.

In this latest set of proposals under section 385, Treasury has taken a very different approach to attacking the perceived abuses. This version is unlikely to suffer from the same infirmities that doomed the 1980 attempt. But as discussed in more detail below, some of the rules in this latest attempt may be vulnerable for a different reason.

---

[1]REG-108060-15.

[2]The earnings stripping regulations do not represent the only instance in which Treasury has been accused of exceeding its authority. For a discussion on whether Treasury did so with at least one of the new rules in the inversion regulations, see Ken Brewer, "The Latest Inversion Notice: Validity of the Third-Country Rule," *Tax Notes*, Feb. 29, 2016, p. 1047. For a discussion on whether Treasury did so with the August 2015 proposed
(Footnote continued in next column.)
regulations on outbound transfers of goodwill and going concern value, see Brewer, "Goodwill Hunting . . . Without a License: The IRS Takes Action," *Tax Notes*, Nov. 9, 2015, p. 803.

B. The Treasurer's New Clothes

Rather than trying to create a set of guiding principles that may be applied to distinguish bona fide debtor-creditor relationships from those that are more like corporation-shareholder relationships, the earnings stripping regulations basically declare that indebtedness incurred in specific related-party transactions that Treasury has determined to be contrary to U.S. tax policy will automatically be recast as stock, even if it would otherwise clearly be treated as debt under prior case law.[3]

Not surprisingly, the president, secretary of the Treasury, and other high-ranking Treasury officials have brushed aside any suggestion that Treasury might have exceeded its authority under section 385. But from far more objective quarters, several highly respected private sector commentators have also weighed in to pronounce Treasury's actions in the earnings stripping regulations to be more than adequately clothed in statutory authority.[4] Thus, anyone who fails to recognize Treasury's authority here might be branded as incompetent or politically motivated.

Nonetheless, the purpose of this article is to discuss a few aspects of the earnings stripping regulations for which Treasury's authority might appear (at least to the untrained eye) to be scantily clad, if at all.[5]

The comment period for these regulations ends on July 7. It is possible that some of the concerns discussed below may be addressed when the regulations are issued in final form.

C. Parsing the Literal Language of the Statute

Section 385(a) reads, in its entirety, as follows:

> The Secretary is authorized to prescribe such regulations as may be necessary or appropriate to determine whether an interest in a corporation is to be treated for purposes of this title as stock or indebtedness (or as in part stock and in part indebtedness).

Read in a vacuum, the literal and plain meaning of that language would appear to give Treasury complete and unlimited discretion to issue regulations specifying whatever conditions it wishes to impose in order for a purported debt instrument to be respected as debt for U.S. tax purposes, and allow Treasury to recast as stock (in whole or in part) any instrument that fails to satisfy those conditions.

Immediately after section 385(a), subsection (b) provides as follows:

> 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. The factors so set forth in the regulations may include among other factors:
>
> (1) whether there is a written unconditional promise to pay on demand or on a specified date a sum certain in money in return for an adequate consideration in money or money's worth, and to pay a fixed rate of interest,
>
> (2) whether there is subordination to or preference over any indebtedness of the corporation,
>
> (3) the ratio of debt to equity of the corporation,
>
> (4) whether there is convertibility into the stock of the corporation, and
>
> (5) the relationship between holdings of stock in the corporation and holdings of the interest in question.

Read together, subsections (a) and (b) arguably represent an authorization that is limited to providing guidance on the various factors that should be considered when determining whether a relationship more closely resembles the rights, obligations, and expectations that exist in a true debtor-creditor relationship or in a corporation-shareholder relationship. It is worth noting that none of the factors listed in section 385(b) suggests looking to the type of transaction in which the purported indebtedness arises. But senior Treasury officials have publicly stated that they reject any limitation of this type on section 385(a)'s broad grant of authority.

For example, speaking April 19 at a tax lecture series presented by New York University and KPMG LLP, Robert Stack, Treasury deputy assistant

---

[3]For an in-depth discussion of the earnings stripping regulations, see Jill-Marie Harding et al., "Section 385 Proposed Regulations: Treasury's Attempt to Clamp Down on Earnings Stripping and a Whole Lot More," *A&M Tax Advisor Weekly* (Apr. 19, 2016).

[4]*See, e.g.*, Lee A. Sheppard, "Treasury Goes After Earnings Stripping, Hits Cash Management," *Tax Notes*, Apr. 18, 2016, p. 263 ("In contrast to the arguments about the other inversion regulations, there is no authority question here. Section 385 is a huge grant of authority."). *See also* Sheppard, "Stack Defends Debt-Equity Rules, State Aid Stance," *Tax Notes*, Apr. 25, 2016, p. 407 (quoting similar remarks by David Rosenbloom at an April 19 event sponsored by KPMG LLP and New York University, to the effect that Treasury clearly has ample authority under section 385 and suggesting that it could have even gone farther).

[5]For an excellent discussion of other aspects of the earnings stripping regulations for which Treasury may lack authority, see Scott Semer, "How to Enact New Tax Laws Without Involving Congress: Analyzing the Proposed Section 385 Regulations," *DTR*, Apr. 15, 2016.

secretary (international tax affairs), made several comments in defense of Treasury's authority. Stack said that when Congress enacted section 385, "it threw up its hands and said the court cases are all over the place, so we are asking Treasury to go ahead and look at specific circumstances." He went on to say that Treasury is not "limited by particular elements that have been highlighted in the courts that help us distinguish debt and equity." Stack acknowledged that the court cases have generally recognized the possibility for a corporation to distribute a dividend in the form of a debt instrument if the debt instrument "has got the bells and whistles and creditor rights." That would no longer be the case (as a general rule) under the earnings stripping regulations.

Several other Treasury and IRS officials have made similar comments, defending Treasury's authority in recent public forums.

D. Possible Limits on Treasury's Authority

1. The Administrative Procedures Act. The fairly recent Tax Court opinion in *Altera*[6] provides a roadmap regarding the administrative process required by the Administrative Procedure Act (APA) for Treasury regulations. The Tax Court found the regulation in question in *Altera* to be invalid largely because it failed to satisfy those requirements. It is too soon to say whether the earnings stripping regulations may be subject to challenge under the APA, but that would seem unlikely if Treasury has learned anything from *Altera.*

2. The non-delegation doctrine. Article I, section 1, of the Constitution reads as follows:

> All legislative Powers herein granted shall be vested in a Congress of the United States, which shall consist of a Senate and House of Representatives.

Some of the early Supreme Court cases struck down congressional attempts to delegate legislative powers, hence the name "the *non*-delegation doctrine." But eventually the Supreme Court gave in to the reality that it would be impossible for Congress to address every last detail in legislation covering highly complex matters, and it recognized the authority of Congress, under Article I, section 8, of the Constitution, to delegate at least some legislative powers to administrative agencies entrusted to apply and enforce the laws in various areas. Thus, it has become firmly established by Supreme Court jurisprudence that Congress has the power to delegate discretionary authority to Treasury to issue regulations creating tax rules that are not specifically provided by the code.

However, the case law makes it clear that when Congress does delegate that authority, it must provide a specific level of guidance regarding the boundaries of the delegation and that any legislative actions by Treasury that transgress those boundaries are *ultra vires*.

An extensive analysis of the non-delegation doctrine is beyond the scope of this article. But the following excerpt from the not so ancient Supreme Court decision in *Industrial Union Department*[7] should corroborate the notion that the non-delegation doctrine remains alive and well. Further, it should provide a reliable and concise explanation of the limits that the non-delegation doctrine imposes on congressional authority to delegate legislative powers:

> First, and most abstractly, it [the non-delegation doctrine] ensures to the extent consistent with orderly governmental administration that important choices of social policy are made by Congress, the branch of our Government most responsive to the popular will. Second, the doctrine guarantees that, to the extent that Congress finds it necessary to delegate authority, it provides the recipient of that authority with an "intelligible principle" to guide the exercise of the delegated discretion. Third . . . the doctrine ensures that courts charged with reviewing the exercise of delegated legislative discretion will be able to test that exercise against ascertainable standards.[8]

If the non-delegation doctrine has any remaining life, it would certainly require that the language in section 385(a) be read together with any other congressional guidance — including the language in section 385(b) — to discern the intelligible principle limiting Treasury's discretion in this area. Congress would not be permitted, as suggested by Stack, to simply throw up its hands and abdicate its constitutional duty.[9] And by enacting subsection (b), it is fairly clear that Congress did not do that.

---

[6] *Altera Corp. v. Commissioner*, 145 T.C. No. 3 (2015).

[7] *Industrial Union Department v. American Petroleum Institute*, 448 U.S. 607 (1980).

[8] *Id.* at 685-686 (Rehnquist, J., concurring in the judgment).

[9] On the other hand, maybe there is no remaining life to the non-delegation doctrine. Maybe Congress *is* allowed to simply throw up its hands and leave it to agencies of the executive branch not just to implement but also formulate important policies and to make the rules necessary to promote those policies. After all, the executive branch has evolved into a massive organization, awash with highly intelligent and competent people who are perfectly capable of making important policy decisions and enacting rules to promote those policies, not just in the tax area but in all areas of federal law. At the same

(Footnote continued on next page.)

3. Treasury's authority to override case law. Because of the lack of regulatory guidance under section 385, a large body of case law developed to fill the void. There is no real doubt that the federal courts have the authority to provide guidance in this area, but the precedential value of any one court decision is limited to the fact pattern of that case. So for a comprehensive set of guidelines on how to distinguish debtor-creditor relationships from corporation-shareholder relationships, it is necessary to consider numerous cases that have addressed many different factual situations. The preamble to the proposed regulations presents a brief overview of a few of those cases.

Some of the rules included in the proposed regulations are clearly inconsistent with prior case law. It is unclear whether Treasury can overturn case law precedent regarding a point of law for which Treasury was delegated authority to act but did not do so before a court decided on the issue. These proposed regulations, if finalized, may give rise to a new round of litigation on that question.

E. Examples of Rules of Questionable Validity

1. Irrebuttable presumption as to a principal purpose. Prop. reg. section 1.385-3(b)(2) provides a general rule that recasts debt issued as a distribution to an 80 percent (or more) shareholder and debt issued in specific acquisitions that are perceived to be motivated by the same tax avoidance purpose as a distribution of a note. Prop. reg. section 1.385-3(b)(3) provides what is referred to as the funding rule, which recasts debt that was incurred with the principal purpose of funding a distribution or acquisition of the type described in prop. reg. section 1.385-3(b)(2).

The funding rule includes an irrebuttable presumption that a debt is incurred with a principal purpose of funding a distribution or acquisition of the type described in prop. reg. section 1.385-3(b)(2) if the debt was incurred within 36 months of the distribution or acquisition in question (before or after). As a result, the IRS would be authorized (in fact, required) to disregard evidence, however compelling, that the taxpayer's purpose for issuing the debt instrument had nothing to do with the distribution or acquisition in question.

It is certainly legitimate as a rule of administrative convenience to presume that two transactions separated by only a short period are connected. But for Treasury to make that presumption irrebuttable (that is, to authorize the IRS to disregard real and compelling evidence to the contrary) seems patently unreasonable, except perhaps for very short time intervals.

In its defense, Treasury might point out that Congress did precisely the same thing in section 7874(c)(3) (irrebuttable presumption for acquisitions occurring within 24 months of when specific ownership requirements are met). Admittedly, an act of this nature by Congress might be immune from challenge. But Congress has considerably greater license than Treasury to enact unreasonable rules. And even Congress stopped well short of a 36-month irrebuttable presumption in section 7874. In the absence of some very clear direction from Congress, it is questionable whether Treasury has the authority to create an irrebuttable presumption under the funding rule, especially one that connects transactions that are separated in time by as much as 36 months. Nothing in the language of section 385, its legislative history, or the case law would seem to authorize such an arbitrary approach for establishing a taxpayer's nefarious purpose.

Several commentators have already noted that the irrebuttable presumption would be a death knell to cash pooling, a common business practice of most large multinational groups that has nothing to do with taxes. But it would also create havoc for traditional lending arrangements that arise for perfectly legitimate business reasons that have no causal link whatsoever with other transactions that might occur within 36 months of the loan.

2. Relatedness of the parties as grounds for a per se recast. One may question whether the intelligible principle set forth by section 385(b) permits a rule that, solely because of the relatedness of the parties, automatically recasts as stock indebtedness that would be respected if the parties were unrelated. That is precisely what prop. reg. section 1.385-3 would do for related-party indebtedness that is linked to specific distributions or acquisitions of related-party stock or assets.

Relatedness is one of the factors Congress specifically mentioned in section 385(b). But there is no indication in that subsection or in its legislative history that Treasury was authorized to provide

---

time, Supreme Court jurisprudence (as well as the Court itself) appears to have evolved to permit the executive branch to do that. Further, Congress doesn't seem willing or able to defend its constitutional turf.

So if there is no remaining life to the non-delegation doctrine and if Congress is willing to throw up its hands in favor of executive branch agencies, maybe Congress as an institution has outlived its constitutional purpose and should be eliminated as a redundant and wasteful expenditure of taxpayer money. And what better way to deliver true democracy than to allow the people to vote directly on the important policy matters of the day each time they vote for a president. Admittedly that's not exactly what the Founding Fathers had in mind. But with the passing of Justice Antonin Scalia, what the Founding Fathers had in mind may no longer be as relevant. So come to think of it, maybe Treasury is free to enact any rules it wishes under section 385 (as long as they comply with the APA). For those who believe that, the rest of this article is a waste of time.

that a single factor can require recasting a relationship that, on balance, when all other relevant factors are considered, closely resembles a true debtor-creditor relationship. So looking strictly at the language of section 385, it is debatable whether the per se recast approach of prop. reg. section 1.385-3 is valid.

Moreover, as Stack and the preamble have both acknowledged, the intervening case law (that is, opinions between the time of section 385's enactment and the issuance of these proposed regulations) makes it perfectly clear that related-party indebtedness, although subject to a higher level of scrutiny, should be treated as debt for U.S. tax purposes when a thorough analysis of all the relevant factors weighs in favor of debt classification. In fact, many of the cases that resulted in debt treatment involved what the earnings stripping regulations describe as ''highly related'' party transactions. Thus, it's questionable whether Treasury has the authority to override that case law by regulation (at least in the absence of some intervening directive by Congress to do so).

3. Magnitude as a determining factor. Nothing in section 385(b), its legislative history, or the case law suggests that the size of the taxpayer or of the purported debt instrument can be relevant factors in determining whether a transaction involves debt or equity. But the documentation requirements in prop. reg. section 1.385-2 apply only to large or publicly traded companies, and the recast rules in prop. reg. section 1.385-3 contain an exception for groups that have no more than $50 million of debt instruments that would otherwise be subject to recast under that section.

Thus the proposed regulations would tend to favor debt treatment for smaller taxpayers and smaller transactions. That seems to be inconsistent with actual marketplace evidence and political rhetoric suggesting that in real life, the system is rigged in favor of the borrowing capability of larger taxpayers, especially in larger transactions. But perhaps the de minimis exceptions in the proposed regulations can be justified as rules of administrative convenience.

4. Lack of contemporaneous documentation as grounds for per se recast. Prop. reg. section 1.385-2 requires taxpayers to maintain specific contemporaneous documentation for related-party indebtedness and to present it to the IRS upon request.[10] Failure to comply results in an automatic recast as stock (with the possible exception of reasonable cause relief at the IRS's discretion).

It is reasonable and appropriate for Treasury to make contemporaneous documentation a high-priority factor in the debt-versus-equity determination for specific aspects of related-party lending transactions. That approach is perfectly consistent with the language of section 385 and the case law. But to make contemporaneous documentation a super factor — resulting in an automatic recast regardless of other factors — seems highly arbitrary, especially when some of the documentation required by the regulations might not be maintained in lending transactions between unrelated parties.

Consider the approach to noncompliance in the penalty regulations under section 6662 as they apply to section 482 adjustments. In that context, the failure to comply with contemporaneous documentation requirements can result in significant monetary penalties, but it doesn't result in an automatic section 482 adjustment. Further, it results in penalties only if the IRS is successful in sustaining a section 482 adjustment based on all relevant facts and circumstances (of which contemporaneous documentation is not one).

In the section 385 proposed regulations, it might be more reasonable and supportable for Treasury to take the approach that Congress took regarding documentation requirements in section 6662 — that is, to make the lack of contemporaneous documentation a basis for denying a good faith exception from penalties if the IRS can successfully recast a purported debt instrument as stock. Contemporaneous documentation would remain an important factor to consider in the debt-versus-equity determination, as has been widely recognized in the case law, but would not be a super factor.

5. Partial recast available only to the IRS. Based on the authority provided by a 1989 amendment to section 385, prop. reg. section 1.385-1(d) authorizes the IRS commissioner to treat a purported debt instrument as in part indebtedness and in part stock. This provision does not appear to offer that same opportunity to the taxpayer.

Section 385 clearly authorizes Treasury to prescribe rules allowing partial recasts. But the statutory language authorizing partial recasts is in the same sentence that authorizes Treasury to prescribe guidance for all-or-nothing recasts. The authority for partial recasts was simply inserted parenthetically in that sentence.

By enacting section 385(c), Congress has explicitly recognized the right of taxpayers to recast debt instruments as stock in appropriate circumstances. Courts have also recognized this right of taxpayers. Nothing in the statute, the legislative history, or the case law discussed in the preamble suggests that

[10]For an in-depth discussion of the documentation requirements, see Albert Liguori et al., ''Proposed New Documentation Rules for Related-Party Debt: A Practical Approach,'' *A&M Tax Advisor Weekly* (Apr. 28, 2016).

the right to make partial recasts is different than the right to make total recasts and therefore may be reserved only for the government.

A better interpretation of the intelligible principle provided by section 385(b), as that principle applies to partial recasts, might be that Treasury is authorized to provide guidance on the factors that are relevant in making a partial recast but that the determination may be made by the taxpayer as well as the IRS.

For comparison, consider the following authorization language that Congress chose to use in section 482:

> In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, *the Secretary may* distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, *if he determines that such distribution, apportionment, or allocation is necessary* in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses. [Emphases added.]

If Congress wished to make section 385 a one-way street, available only to the government, it could have used language similar to that in section 482 regarding the authority to make transfer pricing adjustments. But as discussed above, the language of section 385(c) specifically recognizes the right of taxpayers to characterize a purported debt instrument as stock if an analysis of the relevant facts and circumstances supports that characterization.

In spite of the highlighted language (above) in section 482, taxpayers arguably have a right (if not an obligation) to make their own transfer pricing adjustments based on authority found outside section 482.[11] Treasury recognized the unfairness of limiting the availability of section 482 allocations only to the government and issued a regulation extending it to taxpayers.[12]

The earnings stripping regulations and the preamble provide precious little to guide IRS agents in making partial recasts of purported debt instruments or to ensure that courts will be able to test that exercise against ascertainable standards. The closest thing to an intelligible principle for partial recasts was provided by Treasury itself, not Congress, in an example in the proposed regulations. It says that if the IRS commissioner's analysis supports a reasonable expectation that only a portion of the principal amount will be repaid, the instrument may be treated as indebtedness in part and stock in part. There would not appear to be any reason to believe that taxpayers would be any less capable than the IRS of performing an analysis following that guiding principle.

6. Lack of an intelligible principle for partial recasts. Even if Congress intended for partial recasts to be the exclusive province of the IRS, the preamble does not point to anything in the language of section 385 or its legislative history guiding Treasury on this issue. It appears that Congress really may have ''thrown up its hands'' in the case of partial recasts. If so, and if the non-delegation doctrine remains alive today, there may be a legitimate question about the validity of regulations permitting partial recasts by anyone, whether the IRS or the taxpayer.

7. Per se recast of intercompany trade payables. The documentation question discussed above may be particularly troublesome for trade payables if there is no exception for them in the documentation requirements of prop. reg. section 1.385-2 (which appears to be the case).

Similarly, a per se recast of related-party indebtedness, based on an irrebuttable presumption that the principal purpose for incurring a trade payable was to fund anything other than the product or service that gave rise to the trade payable, would be patently absurd. But that is precisely what the funding rule in prop. reg. section 1.385-3(b)(3) would do, except to the extent that the trade payable ''reflects an obligation to pay an amount that is currently deductible by the issuer under section 162 or currently included in the issuer's cost of goods sold or inventory, provided that the amount of the obligation outstanding at no time exceeds the amount that would be ordinary and necessary to carry on the trade or business of the issuer if it was unrelated to the lender.''

Trade payables are often incurred for items that are not deductible under section 162 and that are not includable in cost of goods sold or inventory. If those trade payables owed to related parties are incurred within 36 months of a distribution or acquisition described in prop. reg. section 1.385-3(b)(2), the trade payable would be subject to per se recast as equity. Congress could not possibly have intended that.

---

[11]*See* Brewer, ''*Intersport*: Amended Returns and Transfer Pricing Adjustments,'' *Tax Notes*, May 11, 2015, p. 641.

[12]Reg. section 1.482-1(g)(3). It should be noted, however, that this regulation purports to prohibit the affirmative use of section 482 by taxpayers to claim a refund on a late or amended return.

F. Conclusion

As mentioned at the outset, there is no question that the earnings stripping regulations would promote highly important policy objectives of the Obama administration. And there is no question that Congress has been aware for decades of the earnings stripping problem that the administration seeks to remedy and that Congress has been unwilling or unable to act on it. The question is whether Congress has made a valid delegation of authority for the action Treasury took.

On the other hand, if the non-delegation doctrine no longer has any effect, maybe a more technically correct answer to the question about Treasury's authority here would be: ''We don't need no stinking badges.'' ■