Sam’s Ltr to Editor of Tax Notes, TN

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

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**HEADLINE:** 144 Tax Notes 883 - PROFESSOR SAYS DEBT/EQUITY REGS CAN APPLY TO INVERSIONS. (Section 385 -- Interest as Stock or Indebtedness;)
Section 163(j) -- Earnings Stripping;
Section 279 -- Acquisition Indebtedness (Release Date: AUGUST 14, 2014) (Doc 2014-20246)

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**CODE:** (Section 385 -- Interest as Stock or Indebtedness;)
Section 163(j) -- Earnings Stripping;
Section 279 -- Acquisition Indebtedness

**SUMMARY:**
Samuel C. Thompson Jr. advocates using the regs under section 385 to curtail inversion abuses.

**GEOGRAPHIC:** United States

**REFERENCES:**
Subject Area:
  Interest income;
  Asset taxation

**TEXT:**

Release Date: AUGUST 14, 2014To the Editor:

   In a letter I sent to the Secretary of Treasury and other officials on August 12, 2014,/1/ I express my views on the approach the Treasury should take both in its legislative proposals and in its administrative actions in addressing inversions and related transactions. The letter builds on a recent proposal I made regarding inversions./2/ One of the initiatives I supported in the letter is Professor Shay's proposal/3/ that Treasury use (code;section 385)section 385, which authorizes the Treasury to issue regulations distinguishing between debt and equity, to curtail some of the interest stripping abuses that inverters are engaging in.

   I explained in the letter that I am confident that Treasury has the authority to adopt regulations under section 385 that are targeted at inversion and related transactions. I explained that one of the problems with the previously proposed regulations was that they were attempting to deal with the universe of debt-to-equity issues, whereas regulations along the lines of those proposed by Professor Shay would be more focused and manageable and, therefore, more effective. I also explained that I strongly disagree with Robert Willens' view that since the prior regulations were "unworkable," Professor's Shay's proposal is merely "interesting reading with little, if any, practical significance."/4/

   By focusing on inversions, the regulations would be primarily concerned with artificial debt instruments issued in an inversion or related transaction by a U.S. corporation to its new foreign parent or related party, and not to the many situations that raise legitimate questions concerning the proper capital structure of a corporation.

   In a recent article by Alex M. Parker,/5/ he reports that several outstanding tax lawyers/professors (Kleinbard of USC, Taylor of NYU, and Avi-Yonah of Michigan) believe the Obama "administration would be on shaky ground" in taking action against inversions under section 385.

   Kleinbard said that while the proposed section 385 regulations are based on "laudable policy instincts, they are very strained readings of the relevant regulatory authority." Taylor said that such regulations would be a "really sketchy extension of the rules," and Avi-Yonah said that section 385 authorizes a "general rule that distinguishes debt from equity, [but not] a rule that only applies to inverted companies." The article also asserts that because the (code;section 163(j))section 163(j) limitation on interest stripping was enacted in 1989, "the courts likely would be skeptical if the administration were to claim that an older law [section 385] allowed it to enact restrictions harsher than those passed more recently."

   From my reading of section 385 and its legislative history, these three outstanding law professors are wrong for the following reasons. There is nothing in section 385 or its legislative history that prohibits the issuance of regulations dealing with specific situations. The Joint Committee on Taxation's General Explanation of section 385 makes it clear that the Treasury has broad authority to issue regulations "to the extent necessary or appropriate" for "determining in a particular factual situation whether a debtor-creditor relationship exists." Thus, the regulatory authority is very broad. Also, even though section 385 sets out several factors that the Treasury can use in promulgating regulations, the General Explanation makes it clear that these factors do not limit the Treasury's authority: "It is not intended that only these factors be included in the guidelines or that, in a particular situation, any of these factors must be included in the guidelines."

   The General Explanation also provides guidance for addressing the argument that section 163(j) preempts section 385. In addition to adding section 385 to the code in 1969, Congress also added (code;section 279)section 279, which disallows interest deductions on certain debt issued in corporate acquisitions. The General Explanation makes it clear that section 385 is independent of and not preempted by section 279. The General Explanation says that in adopting regulations under section 385, "Treasury is not bound or limited by the specific rules which [section 279] provides for distinguishing debt from equity in the corporate acquisition context."

   If Treasury's authority under section 385 is not limited by section 279, why would Treasury be limited by section 163(j)? There is nothing in section 163(j) or its legislative history that says that section 163(j) preempts section 385.

   Finally, the assertion in the DTR article that "Congress, in 1989 passed an anti-inversion measure" (that is, section 163(j)) is not accurate. Section 163(j) was concerned "particularly" with restricting the debt financing of cash acquisitions of U.S. targets by foreign acquirers; it was not directed at the issuance by U.S companies of debt to a foreign holding company in connection with an inversion transaction. The bottom line is that there is nothing about section 163(j) that prevents the Treasury from addressing inversion transactions under section 385.

   For the above reasons, I think it is clear from both the language of section 385 and its legislative history that Treasury is authorized to issue regulations specifying what types of instruments issued in inversion and related transactions are properly to be treated as debt.

                                   Samuel C. Thompson, Jr.
                                   Professor of Law
                                   Penn State Law
                                   Aug. 14, 2014

                          FOOTNOTES

   /1/ Samuel C. Thompson Jr., "Professor Offers Suggestions for Preventing Corporate Inversions," Tax Notes Today, Aug. 12, 2014 (2014 TNT 157-15).

   /2/ Thompson, "New Inversions, the 'Joe Frazier Left Hook,' the IRS Notice, and Pfizer," Tax Notes, June 23, 2014, p. 1413 (2014 TNT 121-7). See also Thompson, "Logic Says No to Options Y, Z, and C, but Yes to Imputation," Tax Notes, May 5, 2014, p. 579 (2014 TNT 87-4).

   /3/ Stephen E. Shay, "Mr. Secretary, Take the Tax Juice Out of Corporate Expatriations," Tax Notes, July 28, 2014, p. 473 (2014 TNT 144-10).

   /4/ Victor Fleischer, "How Obama Can Stop Corporate Expatriations, for Now," DealBook The New York Times, Aug. 7, 2014.

   /5/ Parker, "Corporate Inversions: Experts Examining Law on Inversions Find Scant Authority for Executive Action," BNA DTR, Aug. 12, 2014.

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