TESTIMONY OF PROF SAMUEL C. THOMPSON, JR., PENN STATE LAW
ON
REG-108060-15, TREATMENT OF CERTAIN CORPORATE INTERESTS AS STOCK OR INDEBTEDNESS
AT
INTERNAL REVENUE SERVICE AND U.S. TREASURY DEPARTMENT, PUBLIC HEARINGS, JULY 14, 2016, IRS AUDITORIUM, WASHINGTON D.C.

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I. INTRODUCTION

Since graduating from law school 45 years ago, I have worked as a tax lawyer in practice and in government service. I have also taught tax at numerous law schools. I am making these remarks in my capacity as a private citizen who has an interest in promoting good tax policy. As explained in my written comments, I have expressed my views on inversions in many articles and other publications. The views expressed are my own and are not made on behalf of any other person or organization.

My comments today will deal with the following questions:

- Does the Treasury have the authority to issue these regs?
- Assuming there is authority, are the regs a wise exercise of tax policy?
- Is the documentation requirement in the -2 Reg appropriate?
- Is the approach taken in the -3 Reg appropriate?
- Is the approach of the Regs likely to impose significant administrative burdens on taxpayers?
- And the following two related questions:
    - Should the anti-hop-scotch loan provision in the general inversion regulations be expanded?
    - Should the Treasury replace its minimum tax proposal with a Kennedy-Type imputation proposal?

II. DOES THE TREASURY HAVE THE AUTHORITY TO ISSUE THESE REGS? (THE AUTHORITY ISSUE)

Many of the comments assert that the Treasury does not have the authority to issue these Regs, particularly the -3 Regs, which automatically treat certain intercompany debt as stock. For the reasons stated in my written comments, it is my belief that the Treasury has clear and unambiguous authority under Section 385 to issue the Regs.

Without restating the points I have made, let me address the invalidity assertion that is premised on the following words in Section 385(b): "The regulations prescribed under this Section **shall set forth factors** . . ." The assertion is that because the -3 Regs rely on only one "factor" the Reg is invalid. This argument is flawed for at least the following three reasons.

> First, the -3 Reg does not rely on only one factor; rather, it relies on several factors, including the exceptions for (1) intercompany debt below the $50 million threshold, and (2) intercompany debt issued in the ordinary course.
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> Second, Section 385(b) must be read in the context of the full statute, and Section 385(a) grants the Treasury authority to issue regulations that "**may be necessary or appropriate**." Section 385(b) could not possibly be read to override the "**necessary or appropriate**" authority in Section 385(a), which the Treasury is exercising in promulgating these regulations.

Third, the use of the word "**shall**" in Section 385(b) is designed to be permissive and is not designed to foreclose the Treasury from focusing on one factor "**with respect to a particular factual situation**," which is the formulation in Section 385(b).

While several of the commentators confidently state that the Regs are invalid, I seriously doubt that these commentators would be so confident if asked by a client for an honest view on the authority issue.

Finally, if the Treasury has not already done so, it might consider getting the views on the authority question from the Tax Division of the Justice Department, which would represent the Treasury in any challenge to the Regs.

III. ASSUMING THERE IS AUTHORITY, ARE THE REGULATIONS A WISE EXERCISE OF TAX POLICY? (THE TAX POLICY ISSUE)

I had two of my Penn State Law Student Research Assistants review each of the 197 comments on these Regs for the purpose, among other things, of determining whether any commentator asserted that it was good tax policy to permit interest stripping. The students report that there was not one comment that asserted that the type of interest stripping the -3 Reg is designed to stop is a good thing from a tax policy standpoint.

This shows, I believe, that there can be no dispute concerning the wisdom of the tax policy purposes of the Section 385 Regs.

IV. IS THE DOCUMENTATION REQUIREMENT IN THE -2 REG APPROPRIATE? (THE DOCUMENTATION REQUIREMENT)

I strongly support the general approach taken to documentation in the -2 Reg. One of my former colleagues gave to me the perfect non-tax justification for the documentation requirement, that is, it is simply insisting upon good corporate practice in connection with the issuance of inter-company debt.

I have two suggestions for modification of the documentation requirement.

First, I would extend its applicability to all corporations that exceed the $100 million asset threshold, not just to such publicly held corporations.

Second, a provision should be added to the Reg that treats a debt instrument as such even though it does not satisfy the letter of the -2 Reg, provided the issuer can show by clear and convincing evidence that the failure to satisfy the documentation requirement was (1) not intentional, and (2) attributable solely to inadvertence.

V. IS THE APPROACH TAKEN IN THE -3 REG APPROPRIATE? (THE -3 ISSUE)

A. THE THREE RECHARACTERIZATION RULES

I strongly support the Three Recharacterization Rules in the -3 Reg. In fact, I commend the Treasury and IRS for thinking "outside the box" in developing the Three Recharacterization Rules and the related funding rules.

In a 2014 article on inversions, I explained that the "**note for stock transaction [in the Endo inversion] is artificial on its face and lacks a true business purpose**[.]"[1] The brilliance of the approach in the -3 Reg is that it treats a note like the one issued in Endo in accordance with its substance, which is equity.

As with any complex regulation, there will be a need to refine the regulation to address such things as possible exceptions for (1) cash pooling, and (2) the ordinary business operations of certain financial institutions. However, any such exemption should not apply if a principal purpose of the transaction is to engage in interest stripping.

I also recommend that the final regulations set out a procedure pursuant to which a taxpayer or group of taxpayers could seek an exemption from all or a portion of the Regs for a certain specified transaction or transactions, subject to an exception if a principal purpose is interest stripping.

B. SUGGESTED ADDITION TO THE THREE RECHARACTERIZATION RULES

While the Three Recharacterization Rules are likely to be very effective, I suggest that the Reg be modified to encompass any other transaction having a similar effect.

C. COMMENT ON THE FUNDING RULE

The Treasury has acted appropriately in setting out the "Funding rule" in the -3 Reg, because without a funding rule, the Three Recharacterization Rules could be easily avoided. However, certain taxpayers may have legitimate concerns that the funding rule may be over-inclusive, and the Treasury should consider modifying the rule to address any such legitimate concerns. However, any exemptions from the funding rule should not apply if the transaction or transactions are for a principal purpose of interest stripping.

D. COMMENT ON THE EXCEPTION IN THE -3 REG FOR CURRENT YEAR E&P

Finally on the -3 Reg, I do not understand the rationale for the current E&P exception. While, the exception may not be significant in any one year, the cumulative effect of taking advantage of the exception could be significant. Consequently, I urge the Treasury and IRS to eliminate the exception.

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

VI. IS THE APPROACH OF THE REGS LIKELY TO IMPOSE SIGNIFICANT ADMINISTRATIVE BURDENS ON TAXPAYERS? (THE ADMINISTRATIVE BURDEN ISSUE}

I believe that many of the commentators have grossly overstated the administrative burdens these Regs will impose. The documentation rules are simply promoting good corporate practice. Most taxpayers will likely be able to avoid the impact of the -3 Reg by ensuring that they do not issue any debt in one of the Three Recharacterization transactions. For most taxpayers the funding rule should be easily manageable, particularly if the 72-month period in the *per se* rule is reduced to, say, 24 months. As long as there is no temporal limit on the principal purpose rule, the Treasury can afford to be less expansive with the *per se* rule. All of the concern with what happens if there is a recharacterization can be largely dealt with when and if there is a recharacterization.

VII. SHOULD THE ANTI-HOP-SCOTCH LOAN PROVISION BE EXPANDED? (THE HOP-SCOTCH LOAN ISSUE)

Although not directly encompassed by this request for comments, I suggest that the Treasury and IRS adopt for the anti-hop-scotch loan provisions in the Section 956 Reg the same universal principle that has been adopted for the Section 385 Regs; that is, the anti-hop-scotch loan provision should apply to inversions and non-inversions.

VIII. SHOULD THE TREASURY REPLACE ITS MINIMUM TAX PROPOSAL WITH A KENNEDY IMPUTATION PROPOSAL? (THE TERRITORIAL ISSUE) [NOTE: TIME LIMITATIONS DID NOT PERMIT ME TO DISCUSS THIS IMPORTANT ISSUE AT THE HEARING]

At the same time the Treasury and IRS issued the Section 385 Regs and the General Inversion Regs, the White House and the Treasury jointly issued the *"President's Framework for Business Tax Reform*." A section of that *Framework* proposes the adoption of a minimum tax on overseas profits.

This minimum tax will reduce but not eliminate the incentive the tax system gives to overseas investment. Consequently, as I have suggested many times in the past,[2] I again urge the White House and Treasury to propose the adoption of an imputation system for taxing foreign income. Such a system would completely eliminate deferral, which is one of the largest tax expenditures and permit, on a revenue neutral basis, the corporate tax rate to be significantly reduced, possibly to 25% or so. This is the type of system that was initially proposed by President Kennedy in 1962.

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

Although the present Congress is not going to adopt an imputation system, it is also not going to adopt a minimum tax. Consequently, the benefit in the White House and Treasury proposing at this time an imputation system is that it would at least make imputation a more visible alternative to our current system and to the territorial system that most big businesses support.

As I have noted previously, a territorial system would have the effect of making all U.S. businesses *de-facto* inverters,[3] because every U.S. business would have the potential to engage in the base erosion and profit shifting transactions that inversions promote and that the OECD's BEPS project is fighting. On the other hand, an imputation system would virtually eliminate concern with outbound BEPS transactions, thus reducing the pressure on the Section 385 Regs. There would, however, still be a need for anti-inversion provisions like the one proposed in the Treasury's Green Book.

IX. CONCLUSION

Finally, I am confident that within a reasonable period of time, the Treasury and IRS can both: (1) effectively address the legitimate concerns raised about the Regs, and (2) promulgate final Regs that will effectively address the tax policy concerns at which the Regs are directed. I urge the Treasury and IRS to promptly do so.

Thanks

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