**Tax Regulations**

‘Altera’ Decision Casts Shadow Over Proposed and Adopted Rules

The U.S. Tax Court’s decision in *Altera* may provide ammunition to attack other regulatory actions where Treasury and the IRS arguably didn’t comply with the Administrative Procedure Act.

The Department of Treasury’s actions and reasoning Sept. 16 in proposing amendments to regulations regarding reorganization of controlled foreign entities bear similarities to the adoption of the regulations that were struck down in *Altera Corp. v. Commissioner*, 145 T.C. No. 3, 2015 BL 239795 (7/27/15).

Congress told Treasury to “draw a line” regarding the transfer of intangibles in a reorganization, and Treasury chose to ignore this direction.

The proposed amendments to regulations under tax code Section 367 completely reverse the prior treatment of goodwill when a foreign entity held by a U.S. corporation is reorganized as a corporation. If adopted as proposed, the Section 367 regulations (REG-139483-13) could be challenged based on *Altera*.

Pat Smith and Brian Davis of Ivins, Phillips & Barker, Chartered, told Bloomberg BNA recently that, as with the transfer pricing rules at issue in *Altera*, in Section 367 Congress told Treasury to “draw a line” regarding the transfer of intangibles in a reorganization, and Treasury chose to ignore this direction, deciding there was too much abuse, thus lumping the good in with the bad.

**Ignoring Reality.** In *Altera*, the Tax Court concluded that Treasury Regulations Section 1.482-7(d)(2) was invalid because Treasury and the Internal Revenue Service applied the same treatment to all qualified cost-sharing agreements between entities controlled by the same parent corporation, including stock-based compensation, when there was no rational reason to do so.

Tax code Section 482 and the regulations under it generally limit cross-border expense deductions arising from transactions between entities within the same corporate group to amounts that would be incurred in an arm’s-length transaction. Altera Corp. challenged the regulation regarding stock-based compensation on the basis that corporations don’t provide stock-based compensation to unrelated entities.

Altera argued, and the Tax Court agreed, that stock-based compensation never occurs in arm’s-length transactions.

**Treasury Isn’t Exceptional.** In *Altera*, the Tax Court said that Treasury—like any other federal agency—is bound by the Administrative Procedure Act (APA).

The court found that Treasury’s rule carried the force of law, because it changed existing law regarding the treatment of stock-based compensation in related-party international transactions.

Because the rule changed existing law, it was a legislative rule, rather than an interpretive rule, subject to the notice and comment requirements under APA Section 553(b). The court said the IRS agreed that the final rule had the force of law but disagreed that it was a legislative rule, declining “to argue this issue on brief or at oral argument.”

John Harrington, a tax practice member at Dentons in Washington, said “interpretive regulations have always been a touchy subject. Traditionally, Treasury and the IRS have tended to go beyond what would be interpretive in a narrow sense of the term, and practitioners frequently want substantive guidance.”

“*Altera* was an exceptional circumstance,” Harrington said in a telephone interview with Bloomberg BNA.

Treasury and the IRS chose to ignore numerous comments and empirical evidence that showed unrelated parties never share stock-based compensation costs. The Tax Court concluded that Treasury failed to satisfy the reasoned decision-making standard required by *Motor Vehicle Mfrs. Ass’n of the U.S. v. State Farm Mut. Auto Ins. Co.*, 463 U.S. 29 (1983), and was arbitrary and capricious in adopting the rule under APA Section 706.

The court said, “Treasury failed to respond to significant comments when it issued the final rule, and Treasury’s conclusion that the final rule is consistent with the arm’s-length standard is contrary to all of the evidence before it.”

Kristin Hickman, a tax and administrative law professor at the University of Minnesota Law School, told Bloomberg BNA in an e-mail, “After *Altera*, many final
and temporary Treasury regulations are likely to be susceptible to legal challenge under APA Section 706 and State Farm. The standard is deferential but flexible, accommodating a variety of complaints about Treasury’s failure adequately to explain and justify its choices in its regulatory preambles.”

**Abusing Goodwill.** With the Section 367 proposed rules, the IRS has taken the position that there is significant abuse when a U.S. taxpayer reorganizes a foreign-based entity from a passthrough form to a corporation.

Under the existing regulations, the transfer of foreign goodwill or going concern value is exempt from taxation under Section 367(a). The proposed regulations move goodwill to the list of intangibles under Section 936(h)(3)(B) that are subject to taxation upon transfer under Section 367(d).

“Abuse is in the eye of the beholder,” Harrington said. “Disputes between the IRS and taxpayers as to what is goodwill and going concern value are common. In the case of foreign transfers, Treasury and the IRS said it’s too hard to untangle this. Some amount is true goodwill. It’s the same argument you would get into in the allocation of value to assets in the acquisition of a business.”

Davis said the U.S.’s unique check-the-box system allows a U.S. taxpayer to set up a foreign branch as a passthrough entity what would be a corporation under another jurisdiction’s law. The passthrough or disregarded entity structure allows the branch to pass its losses up to the parent for the parent to use to offset other income. Once the foreign operation becomes profitable, the U.S. parent then reorganizes the entity in a corporate form.

**Taxable Transfers.** Existing regulations under Section 367 exempt the transfer of goodwill in the reorganization from taxation. The proposed regulations would treat such a transfer as a taxable transfer of property from a U.S. corporation to a foreign corporation.

The preamble to the proposed regulations states that Treasury and the IRS believe that taxpayers are transferring goodwill and other intangible property created in the U.S. to a foreign subsidiary and “asserting that an inappropriately large share (in many cases, the majority) of the value of the property transferred is foreign goodwill or going concern value that is eligible for favorable treatment under section 367.”

Davis said in reality the goodwill usually has no connection to the U.S. parent, because the goodwill was created as a result of the foreign operation selling goods or services to customers in the jurisdiction where it is located. The IRS nevertheless perceived such transactions as an opportunity for abuse.

Jeffrey L. Rubinger, a tax partner at Bilzin Sumberg Baena Price & Axelrod LLP in Miami, told Bloomberg BNA that he didn’t think the IRS was exaggerating the amount of abuse at all. “It’s one of the biggest exceptions that taxpayers argue for,” he said.

Rubinger cited TAM 200907024 as an example. In that technical advice memorandum, the IRS determined that a series of contracts that created a business network didn’t represent foreign goodwill or going concern value as the taxpayer sought to characterize the network. Instead the contracts were intangibles subject to taxation under Section 367(d).

**Draw a Line.** The proposed regulations’ preamble quotes the legislative history of Section 367, noting that the relevant Senate and House committees contemplated that “ordinarily, no gain will be recognized on the transfer of goodwill or going concern value for use in an active trade or business.”

The preamble goes on to say that the committees didn’t “anticipate that the transfer of goodwill or going concern value developed by a foreign branch to a newly organized foreign corporation will result in in abuse of the U.S. tax system,” but notes that the committees didn’t provide any explanation for this statement—apparently as justification to disregard it.

“The IRS and Treasury seem to be focusing on perceived abuses of the exception and, therefore, are concluding that eliminating the exception is not in conflict with the legislative history,” Joseph Calianno, partner and International Technical Tax Practice leader at BDO, told Bloomberg BNA in an e-mail.

In *Altera*, the Tax Court criticized the IRS for not drawing a line. Davis said, “The legislative history suggests there should be some line drawing. Congress said some intangibles should get a pass. The IRS says it can’t decide how to draw the line, because something taxpayers are calling foreign goodwill is actually tied to U.S. activities. The IRS isn’t even making any effort to draw a line that Congress said should be drawn.”

Harrington said he didn’t see the proposed amendments to the rules under Section 367 “as analogous to those in *Altera* in that Treasury issued final regulations that ignored comments” that there were no arm’s-length stock-based compensation agreements in the real world. “There’s no question people transfer goodwill in arm’s-length transactions, he added.

**Bankers associations claim the adoption of Treasury regulations that require reporting to the IRS on nonresident aliens accounts violated the APA.**

“The question is can Treasury ignore the logic of the statutory language in Section 367(a) and (d)? Do they have the authority to say foreign goodwill comes under Section 367(d) and not 367(a)? One would expect to see this as a legislative change, not a regulatory change,” Harrington said.

Rubinger said the IRS had considered treating the goodwill issue with transfer pricing principles, but with
the requirement that taxpayers demonstrate that the value of such goodwill was created by activities conducted outside the U.S. through a foreign branch that had been in operation for a minimum number of years and be attributable to unrelated foreign customers.

Calianno said, “One may question whether a more targeted approach to the perceived abuses in which an exception for foreign goodwill nevertheless was retained would have been more appropriate, especially given the language in the legislative history supporting an exception for foreign goodwill/going concern.”

**Nonresident Accounts.** Smith said the adoption of Treas. Reg. Sections 1.6049-4(b)(5) and 1.6049-8, which require banks to report to the IRS the names, addresses, interest earned and other personal information regarding nonresident aliens whose accounts earn $10 or more of interest each year, also violated the APA.

Those regulations currently are being challenged by the Florida Bankers Association and the Texas Bankers Association, provided they are granted a rehearing by the U.S. Court of Appeals for the District of Columbia Circuit and receive a favorable ruling on jurisdictional issues.

In 2013, the bankers associations filed a lawsuit in the district court claiming that the adoption of Sections 1.6049-4(b)(5) and 1.6049-8 violated the APA. Treasury and the IRS originally proposed in 2001 expanding information reporting and international sharing of deposit information that applied only to nonresident alien Canadians to residents of all other countries. As a result of financial industry and congressional opposition, this proposal was withdrawn and replaced in 2002 with a proposal to apply the requirement only to residents of 15 other countries, according to the complaint.

**Significant Regulatory Action.** The proposal laid dormant until 2011, when it was resurrected by Treasury and the IRS making the Canadian model applicable to nonresident aliens from every country with which the U.S. has a tax treaty. Treasury and the IRS said the expanded reporting requirements didn’t constitute a “significant regulatory action,” and thus weren’t subject to the notice and comment requirements under APA Section 553. The rules were published as final in 2012.

According to the bankers associations, the 72 countries covered by the final rules included many with “unstable governmental and law enforcement systems.” Treasury and the IRS failed to explain “the basis, if any, for using Canada as a comparison for the unstable and insecure conditions in many of the additional countries.”

The banking associations argued that Treasury and the IRS “arbitrarily and capriciously failed to properly assess the Amendments’ costs and economic impact from the standpoint of deposit outflow from the United States.”

The district court found that the rules didn’t violate the APA. On appeal, the D.C. Circuit didn’t reach the APA question, instead ruling in a split decision Aug. 17 that the lawsuit was barred by the Anti-Injunction Act. Smith told Bloomberg BNA that it was very likely the court would agree to an en banc rehearing. As of publication, the D.C. Circuit hasn’t announced whether it will grant the rehearing.

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