

Source: Daily Tax Report: News Archive > 2016 > October > 10/17/2016 > Federal Tax & Accounting > Earnings Stripping: Voluminous Preamble Won't Stop Court Challenge to Debt Rules

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### Earnings Stripping

## Voluminous Preamble Won't Stop Court Challenge to Debt Rules



By Erin McManus

Oct. 14 — Reams of paper filled with detailed technical responses to comments won't stop court challenges to the government's new earnings-stripping rules.

Despite the Internal Revenue Service's removal or modification of some of the more onerous provisions in the proposed regulations on related-party purported debt transactions and the lengthy comments in the final regulations (T.D. 9790), released

Oct. 13, the agency's authority to issue the regulations remains in question.

Wade Sutton, a principal in the Mergers & Acquisitions group at PricewaterhouseCoopers LLP, told Bloomberg BNA Oct. 14 that the lengthy preamble to the rules "makes it clear that Treasury is really battering down the hatches for potential challenges. I would be very surprised if we didn't see a challenge to these regs."

### 'Altera' Lesson

Pat Smith, a partner at Ivins, Phillips & Barker, Chartered in Washington, told Bloomberg BNA Oct. 14 that the IRS "clearly learned their lesson from *Altera*." In *Altera Corp. v. Commissioner*, the U.S. Tax Court found that the IRS violated the "reasoned decision-making" standard of the Administrative Procedure Act (APA) when the agency adopted a rule that requires related companies to share the cost of stock-based compensation.

The IRS adopted the final stock-based compensation rules despite extensive testimony of tax professionals who argued that unrelated parties don't share stock-based compensation costs, the Tax Court found. The court noted that in adopting the final rules, the Treasury Department never responded to those comments and never explained its basis for concluding otherwise.

"They have done a very good and conscientious job of responding to comments, but they didn't alter the substance of the regulations. They did a good job of responding to the technical issues around the edges, but they didn't change the basic structure, because the basic structure was about earnings stripping, which is what they wanted to accomplish," Smith said.

### Statutory Authority

"The IRS and Treasury are saying that they have the scope and authority to issue these regulations under Section 385," Brian Kittle, a tax partner at Mayer Brown LLP, told Bloomberg BNA Oct. 14. "Whether they do is something the courts may have to decide."

"The basic structure of the regulations is inconsistent with Section 385," Smith said. Congress' intent in enacting Section 385 was to eliminate the confusion caused by varying multi-factor tests adopted by courts to determine whether a transaction was debt or equity, he added.

Kristin Hickman, a tax and administrative law professor at the University of Minnesota, told Bloomberg BNA Oct. 14, "it's very apparent that Section 385 gives Treasury tremendous discretion to develop appropriate regulations, but that authority is not unlimited and they cannot be arbitrary and capricious in adopting the regulations they choose to adopt."

Smith said, "There is absolutely no question that within the next few months, actions will be filed challenging these rules on the basis that they exceed the authority granted by Section 385."

Sutton said the broad carveouts in the final rules that benefit U.S. multinationals will make for a "much, much smaller class of taxpayers interested in challenging the regulations."

### Temporary Regulations

Kittle raised the possibility that taxpayers could challenge specific provisions in the regulations, rather than the whole guidance package. "People could be motivated by different concerns," he said.

The guidance included temporary regulations that were issued in response to some of the comments.

"Treasury's use of temporary regulations here arguably violates the APA's notice and comment rulemaking requirements," Hickman said.

### Snapshot

- Earnings-stripping rules may go beyond debt, equity distinction intended by Congress
- Lengthy preamble is effort to document reasoned decision-making by IRS, Treasury

Treasury's response to concerns regarding retroactivity—that they “continue to be inapposite”—may raise challenges. “It seems clear that Treasury's position regarding retroactivity, delayed effective date, and transition rules will be an area of contention,” Hickman said.

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