TEXAS DISTRICT COURT ON ANTI-INVERSION LEGISLATION – ONE DOWN BUT NOT OUT

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INTRODUCTION

In October, the U.S. District Court for the Western District of Texas struck down a provision under temporary anti-inversion regulations for violating the required notice and comment period under the Administrative Procedure Act ("A.P.A.").[1] This article summarizes the court's reasoning and discusses the impact its decision may have on the future of anti-inversion regulations.

The background of the decision is notable: The disputed provision (the "Rule") was part of broader temporary and proposed anti-inversion regulations hurriedly issued by the U.S. Treasury Department in April 2016 (the "2016 Regulations"). The 2016 Regulations target tax benefits that might otherwise arise when a U.S. company re-incorporates outside the U.S. (a transaction commonly referred to as a corporate inversion)[2] – essentially replacing the U.S. entity with a foreign entity,[3] often by means of a merger with a non-U.S. company as the acquirer. Depending on the ownership percentages of its shareholders, the new foreign parent company may be treated as a U.S. company subject to U.S. Federal income tax.[4]

This statute, which was designed to put a halt to the loss of U.S. tax revenues, was promulgated without the usual period for notice and comments that precedes implementation. As such, the temporary regulations took immediate effect. The Treasury's rush to release the temporary regulations had a specific reason. A pre-existing loophole in determining the ownership percentage would have allowed pharmaceutical giants Pfizer Inc. and Irish Allergan PLC to escape anti-inversion rules in their proposed $160 billion pharmaceutical merger.[5] In issuing these regulations without the usual safeguards, the Treasury accomplished the goal: Pfizer and Allergan abandoned the merger intended to place the multinational outside the

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1 *Chamber of Commerce of the United States of America and Texas Association of Business v. I.R.S.*, 16-cv-00944-LY, September 29, 2017; amended order dated October 6, 2017.

2 Code §7874.

3 The rule applies to both corporations and partnerships.

4 If Code §7874 applies to a U.S. company, the foreign parent corporation is considered a domestic corporation after the transaction, for U.S. tax purposes (even though it is organized under the laws of a foreign country), if at least 80% of its stock is owned by former owners of the inverted domestic company (Code §7874(b)). If the ownership by former owners is less than 80% but is at least 60%, the U.S. company generally pays U.S. tax on gains realized in the inversion transaction and other special rules apply (Code 7874(a)).

5 See *The Street*, "Treasury Department Was 'Targeting' Pfizer-Allergan Deal," April 26, 2016.

ambit of U.S. taxation.[6]

The decision itself, even if limited to procedural aspects, is no less remarkable. In it, the court addressed, *inter alia*, the following issues:

1. Do the plaintiffs, the U.S. Chamber of Commerce (the "Chamber") and the Texas Association of Business, have standing to challenge the Rule under the 2016 Regulations?

2. Would the plaintiffs be barred by the Anti-Injunction Act ("A.I.A.") from challenging the Rule prior to assessment or collection of tax?

3. If the plaintiffs are not barred from such a challenge, what standards apply to the Treasury in issuing the Rule under the 2016 Regulations?

As will be explained, the court held in favor of the plaintiffs.

CHAMBER OF COMMERCE V. I.R.S.

In 2016, the I.R.S. issued the Rule (Treasury Regulation §1.7874-8T) regarding the consideration of pre-acquisition stock to acquisitions or post-inversion transactions effected on or after April 4, 2016,[7] effective immediately and a proposed regulation[8] subject to notice and comment.[9] The Rule identified stock of foreign acquiring corporations that is to be disregarded in determining ownership relevant to the categorization because the stock is attributable to prior domestic-entity acquisitions.[10] The Rule applies if, within the 36-month period ending on the signing date, with respect to the relevant domestic entity acquisition, the foreign acquiring corporation completed one or more other domestic entity acquisitions that are not excluded under an exception.

The Chamber and the Texas Association of Business subsequently brought a suit against the Treasury, on behalf of [insert names of companies when confirmed]. The suit alleged that

- the Treasury violated its regulatory authority;
- the Rule was arbitrary and capricious; and
- the Treasury violated the notice-and-comment requirement of the A.P.A. in promulgating the Rule.

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6 See *Financial Times*, "Collapse of $160bn Pfizer and Allergan merger shocks corporate US," April 6, 2016.

7 Treas. Reg. §1.7874-8T(j). The regulations were published in the Federal Register on April 8, 2016, including both final and Temporary Regulations under Code §§367 and 7874. TD 9761, 81 Fed. Reg. 20, 858 (2016).

8 Prop. Treas. Reg. §1.7874-8.

9 On the background of the regulations see Notice 2015-79 discussed in "Anti-Inversion Rules Explained," *Insights* 10 (2015).

10 Specifically, the Rule included a new provision that for purposes of calculating the ownership percentage under Code §7874(a)(2)(B)(ii) excludes from the denominator of the ownership fraction stock of the foreign acquiring corporation attributable to certain prior domestic entity acquisitions.

The Chamber moved for summary judgment on its claims, while the Treasury moved to dismiss the case on the grounds that

- the Chamber lacked standing to challenge the Rule; and
- the suit was barred by the A.I.A.

In addressing each of these claims raised, the District Court decided as follows:

Standing

Because the plaintiffs demonstrated an actual, concrete injury that was considered to be traceable to the implementation of the 2016 Regulations, the District Court concluded that the plaintiffs had standing to challenge the rule. The Chamber based its standing specifically on Pfizer and Allergan's membership in its organization and asserted that the Rule eliminated the tax benefits associated with a planned merger between the two companies. Citing relevant case law, the District Court agreed that these companies (and potentially other members of the Chamber) would have standing to sue in their own right. The Chamber also presented evidence that the Treasury specifically targeted the merger of these two companies in promulgating the Rule. For these reasons, the District Court determined that the requirements for standing and standing-by-association were satisfied.

A.I.A.

The Treasury argued that the Chamber's claims were barred by the A.I.A., which provides that:

> No suit for the purpose of restraining the assessment or collection of any tax shall be maintained in any court by any person, whether or not such person is the person against whom such tax was assessed.[11]

In other words, the A.I.A. limits lawsuits challenging a tax before it is assessed or collected. In the case at issue, the court held that the plaintiffs' claims were not barred by the A.I.A. because the plaintiffs were not seeking to restrain assessment or collection of tax but rather to challenge the validity of the Rule that would affect a decision on whether to engage in certain future transactions. Moreover, the District Court reasoned that the Rule is not itself a tax rule but rather a rule determining who is subject to tax.

Treasury's Authority to Issue Regulations

The court held that Congress extended broad authority to the I.R.S. and the Treasury to promulgate regulations under Code §7874. Consequently, in issuing the 2016 Regulations, the agencies did not exceed their statutory jurisdiction. The District Court noted that the Rule calls for certain stock to be treated as "not stock" for purposes of certain calculations required under the statute — which corresponds to Code §7874(c)(6) stating regulations may "treat stock as not stock" to determine whether a corporation is a surrogate foreign corporation. Further, the Rule is in line with authority granted under Code §7874(g), *i.e.*, to prevent avoidance of the purposes of the statute.

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[11] 26. U.S.C. §7421(a).

Arbitrary or Capricious Rulemaking

According to the District Court the explanation and basis for the 2016 Regulations were thoroughly explained by the I.R.S. and the Treasury in the preamble to the regulations. Thus, the agencies were not deemed to engage in arbitrary and capricious rulemaking.

A.P.A.

Apart from the A.I.A. issue, perhaps the most significant District Court holding was that the I.R.S. and the Treasury violated the A.P.A.

First, the court ruled that the simultaneous issuance of corresponding proposed regulations did not release the issuing agency from the notice and comment requirement for temporary regulations provided under the A.P.A. It did not follow the Treasury's argument that Code §7805 would allow such exception from the general rules under the A.P.A. and noted that the legislative history did not support the Treasury's view.

Second, the District Court rejected the Treasury's view that the Rule was an "interpretive" regulation and therefore exempt from the notice and comment requirement under the A.P.A. Instead, the court held that the Rule was a "legislative" regulation, which has the "force and effect of law," and thus is subject to the A.P.A.'s notice and comment requirement. The court noted that the statute authorized Treasury to issue regulations modifying the application of the statute and to issue regulations "to treat stock as not stock," which changed the calculation for determining whether a corporation is treated as a surrogate foreign corporation. Thus, the District Court concluded the Rule was not an interpretation of the statute but a substantive modification.

WHAT NEXT?

It is unclear whether the Treasury will appeal this decision. No appeal has been filed as of November 10, 2017, but the window is still open.

Would the decision be upheld by an appellate court? This is also uncertain. The likelihood that the A.P.A. argument would withstand a challenge *per se* is not remote. The main question is whether the court will have to reach a conclusion on this issue because, before it can proceed, the court must decide whether the Chamber did in fact have standing and, if so, whether this bars a suit under the A.I.A.

A.P.A. Requirements – Interpretive v. Legislative Rules

The A.P.A. provides under §559 that a statute will not supersede or modify the notice and comment procedure except to the extent that it does so expressly. Under A.P.A. §553:

> (b) General notice of proposed rulemaking shall be published in the Federal Register, unless persons subject thereto are named and either personally served or otherwise have actual notice thereof in accordance with law. The notice shall include -
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> (1) a statement of the time, place, and nature of public rule making proceedings;

> (2) reference to the legal authority under which the rule is proposed; and
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> (3) either the terms or substance of the proposed rule or a description of the subjects and issues involved.
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> Except when notice or hearing is required by statute, this subsection does not apply -
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> (A) to interpretative rules, general statements of policy, or rules of agency organization, procedure, or practice; or
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> (B) when the agency for good cause finds (and incorporates the finding and a brief statement of reasons therefore in the rules issued) that notice and public procedure thereon are impracticable, unnecessary, or contrary to the public interest.

"Statutory requirements mandated in connection with the process of issuing rules must be upheld."

Hence, the A.P.A. provides for an exception from the comment and notice period only if the rule in issue is interpretive. An interpretive rule advises the public of the agency's construction of the statutes and rules which it administers.[12] Since the underlying statutes usually contain the necessary legal authority for the action taken, rules or statements explaining the construction of statutes are considered interpretive. Regulations that fill the gap between the rules Congress provided will often be considered interpretive. A rule that repeats law from the underlying legislative will also more often be considered as interpretive.[13] On the other hand, a legislative rule has the force and effect of law, is much more substantive and has a larger impact on individual rights and obligations. A legislative rule creates law whereas an interpretive rule explains what the statute or regulation means.[14] If an end result is provided without much explanation, the rule will often be considered legislative.

With respect to the comment and notice obligation under the A.P.A. the District Court's decision is in line with previous case law.[15] Courts have set definite boundaries to the Treasury's practice of issuing *ad hoc* regulations.

In this case, the message to Treasury was clear: Statutory requirements mandated in connection with the process of issuing rules must be upheld. This applies to promulgating tax regulations accordingly. Neither issuance of proposed regulations simultaneously with temporary regulations nor qualifying the latter as interpretive may be used as an excuse for infringing upon these procedural requirements. In this respect, it is likely that the decision would be upheld in an appeal.

Standing vs. A.I.A.

To reiterate, the issue of standing and limitations under the A.I.A. would be the preliminary question in an appeal.

In holding for an infringement of the two Chamber members' rights, the District Court asserted standing. If this is the case, the question becomes whether this infringement causes a potential increase in taxes by eliminating a tax benefit that would

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[12] *Perez v. Mortg. Bankers Ass'n*, 135 S. Ct. 1199 (2015).

[13] I.R.M. 32.1.1 "Overview of the Regulations Process," (2017).

[14] *Phillips Petroleum Co. v. Johnson*, 22 F.3d 616 (1994).

[15] *E.g.*, *Altera Corp v. Commr.*, 145 T.C. No. 3 (2015).

have been available prior to the issuance of the Rule. This would mean *Chamber of Commerce v. I.R.S.* constitutes a suit that attempts to bar future assessments. Hence, the A.I.A. would apply. While the District Court reasoned that the plaintiffs contest the validity of the Rule and their actions do not fall within the scope of the A.I.A., this view is contradictory to prior case law.

In *Florida Bankers Association v. U.S*.[16] an association of bankers contested a regulation mandating a reporting obligation for interest paid to certain foreign account holders.[17] While the regulation did not affect the banks' tax liabilities, it would result in potential penalties in the case of non-compliance.[18] Similar to the plaintiffs in the *Chamber of Commerce* case, the Florida Bankers Association argued that they were not restraining an assessment but rather contesting the regulatory aspects of the regulations. The D.C. Circuit rejected this argument. Notwithstanding the plaintiff's claim to target the regulatory aspect of the regulations, the D.C. Circuit found that the A.I.A. applied to the case at issue. Because invalidating the regulation would directly prevent collection of the tax, this would constitute a violation of the A.I.A. or as the court put it, it is at the heartland of the A.I.A.[19]

In comparison to *Florida Bankers*, the Chamber is in an even weaker position to avoid A.I.A. application. The Rule does not affect the potential tax liability of third parties but the Chamber's own members. This is why they have standing in the first place.

However, even if an appellate court turns down plaintiffs, they are not barred from challenging the regulation. It is only a matter of timing.[20] As the D.C. Circuit stated:

> To be clear, our ruling does not prevent a bank from obtaining judicial review of the challenged regulation. A bank may decline to submit a required report, pay the penalty, and then sue for a refund. At that time, a court may consider the legality of the regulation. The issue here is when – not if – the bank may challenge the regulation.[21]

CONCLUSION

Chamber of Commerce is a landmark decision. Whether it will be upheld upon review is not certain.

With respect to the underlying Rule it must be noted that this case only addressed one item of regulatory anti-inversion measures. Moreover, it does not touch upon the statutory anti-inversion rule under Code §7874. The future of the anti-inversion

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[16] 799 F.3d 1065 (D.C. Cir. 2015).

[17] Treas. Reg. §§1.6049-4, 1.6049-8.

[18] Code §6721.

[19] 799 F. 3d 1065, 1071. As a side note: On the argument raised by the plaintiffs that the penalty was not a tax, the D.C. Circuit construed tax for purposes of the A.I.A. in a broad sense. Hence, invalidating the regulation would directly bar collection of the tax.

[20] Under a long-standing administrative law rule agency regulations may be challenged prior to enforcement, *e.g.*, penalties. However, this rule does not apply to the tax administration under the A.I.A.

[21] *Id*.

regulations remains to be seen. Under President Trump's Executive Order 13789, the Treasury is committed to decrease the burden of tax regulations by withdrawing and/or modifying an initial eight rules including the anti-inversion regulations.[22] This reaffirms the effort to simplify tax rules and modify what is either vague or excessive while slowing down the I.R.S.'s ability to deal with tax abuse.

[22] Most recently, it was announced that the debt-equity documentation rules under Code §385, which were heavily criticized as overreaching, will be revoked. See in detail, "Treasury Turns Back the Clock on 2016 Regulation," *Insights* 10 (2017).

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