NEWS ANALYSIS

Did Treasury Weaken the TCJA?

by Mindy Herzfeld

A recent article in *The New York Times* claimed that in response to lobbying by big companies, the Trump Treasury's interpretive regulations have transformed the Tax Cuts and Jobs Act into a corporate windfall. Some academics have expanded on that thesis, arguing that unreasonably generous regulations, often issued with little or no statutory basis, have weakened the TCJA, thereby magnifying the act's harm to lower-income individuals in favor of large multinationals.

The law progressed from legislative proposals to enactment in a mere six weeks. The compressed time frame meant drafts were poorly reviewed and there was little time to coordinate provisions (both new and old). As a result, the government faced the monumental challenge of writing interpretive regs for a complex law with intricate and often poorly understood consequences. Treasury has spent the past two years working to provide taxpayers with guidance and has issued thousands of pages of proposed and final regulations. And its task still isn't complete.

This article reviews the rules that guide Treasury's rulemaking process, taking into account IRS regulatory guidelines and *Altera Corp. v. Commissioner*, 926 F.3d 1061 (9th Cir. 2019), *rev'g* 145 T.C. 91 (2015), as part of an evaluation of whether Treasury followed those guidelines or departed from them in response to pressure from corporate lobbyists. It also considers whether TCJA regs might have been issued in abuse of Treasury's statutory authority in order to grant unusually generous relief to multinationals.

The Regulatory Process

The Internal Revenue Manual contains instructions for IRS employees on agency organization, administration, and operation, including rules on the guidance process. Although those guidelines are neither mandatory nor binding (*Chrysler Corp. v. Brown*, 441 U.S. 281 (1979)), IRS chief counsel employees responsible for issuing guidance feel bound to follow them. And while the IRM technically doesn't apply to the Treasury Office of Tax Policy, it effectively applies to all tax guidance because IRS chief counsel must sign off on it — a process that ensures consistency with the chief counsel directives manual.

The guidelines for the rulemaking process mandate that IRS employees adopt a balanced approach. They state that it's the agency's duty "to correctly apply the laws enacted by Congress; to determine the reasonable meaning of various Internal Revenue Code provisions in light of the Congressional purpose in enacting them; and to perform this work in a fair and impartial manner, with neither a government nor a taxpayer point of view." They also provide that IRS employees have a duty to try to find the proper interpretation of a statutory provision, and not "adopt a strained construction in the belief that he or she is 'protecting the revenue.'" According to the IRM, the revenue is properly protected only when government employees "ascertain and apply the proper interpretation of the statute."

In a policy statement released last March, Treasury reaffirmed its commitments (and the IRS's) to a regulatory process that encourages public participation, fosters transparency, gives fair notice, and ensures adherence to the law. The statement also said that for all regulations, the government will follow the notice and comment process established by the Administrative Procedure Act (APA), which mandates that the public be given the opportunity to participate before any final rule becomes effective and ensures that all views are adequately considered.

Agency Rulemaking and the APA

The *Chevron* principles that guide administrative agency rulemaking are in some respects well settled but in others remain under debate. Under *Chevron*, an agency's rulemaking binds the courts so long as it's a reasonable interpretation of the statute and isn't procedurally defective, arbitrary, or capricious. It follows that questions of deference boil down to whether Congress has delegated authority to an agency generally to make rules carrying the force of law, and whether the agency interpretation claiming deference is a reasonable one promulgated in exercising that authority (*United States v. Mead Corp.*, 533 U.S. 218, 226-227 (2001)).

It's precisely those questions of proper procedure in rulemaking and how much latitude administrative agencies should have in interpreting statutory intent that are the subject of one of the most closely watched cases of recent years. *Altera* considers the proper deference to be given the IRS's interpretation of statutory intent when it conflicts with taxpayer comments. In June a Ninth Circuit panel reversed the Tax Court's decision that IRS regs interpreting section 482 regarding cost-sharing arrangements — in particular, the rules for allocating costs of compensatory stock options — were invalid under the APA because they failed to properly take into account taxpayer comments in applying the arm's-length standard.

The Tax Court found that the agency's decision-making process was fundamentally (and fatally) flawed because it rested on speculation rather than on hard data and expert opinions. Further, the IRS ignored important public comments, specifically those that pointed out that uncontrolled cost-sharing arrangements generally don't share stock compensation costs.

The circuit panel held that the IRS didn't exceed its authority in its interpretation, because section 482 didn't directly address the question under consideration. Applying the standards articulated by *Chevron* and its progeny, the court concluded that in the context of the stock compensation rule, Treasury reasonably understood section 482 as an authorization to require internal allocation methods rather than relying solely on comparables. It held that internal allocation methods were reasonable for reaching the arm's-length results required by statute.

Altera Corp. argued that the regulations were invalid in part because Treasury had improperly rejected comments submitted in opposition to the proposed rule, but the Ninth Circuit spurned those claims, saying the government had properly complied with the *State Farm* standard of "reasoned decision-making" (463 U.S. 29, 43 (1983)). It concluded that the comments were irrelevant to Treasury's rationale for promulgating its final rule, and that there was no failure in its refusal to consider them.

The circuit panel said *Chevron* first requires application of the traditional rules of statutory construction to determine whether "Congress has directly spoken to the precise question at issue," starting with the plain statutory text and reading the words "in their context and with a view to their place in the overall statutory scheme." If the statute is silent or ambiguous on the question at hand, the court should defer to the agency's interpretation so long as it's based on a "permissible construction of the statute."

More generally, the Ninth Circuit rejected the Tax Court's understanding of the arm's-length standard and the interaction of that standard and the commensurate with income statutory language enacted in 1986. Based on its understanding of that interaction, the Tax Court said the IRS couldn't require related entities to share some costs unless uncontrolled transactions also did so. The circuit court performed a fresh examination of the legislative history, and its willingness to uphold the IRS regulations ultimately rested on its interpretation of that history. It said the legislative change in which Congress articulated the commensurate with income standard reflected lawmakers' views that "strict adherence to the comparability method of meeting the arm's length standard prevented tax parity." Accordingly, Treasury had reasonably interpreted congressional intent as permitting it to dispense with a comparable analysis in the absence of actual comparable transactions. The Ninth Circuit found that given the legislative history, Treasury's decision to adopt a method that followed actual economic activity was reasonable.

Intent and Comments

The IRM and case law provide a helpful background in evaluating whether TCJA rulemaking has complied with statutory and judicial requirements.

Legislative Intent

The scarcity of legislative history for most TCJA provisions makes it extremely hard to write interpretive rules. That lack of — or ambiguity in — legislative intent is especially noticeable for some of the law's most complex international provisions such as the global intangible low-taxed income regime and the base erosion and antiabuse tax, but is also relevant for interpreting amended section 163(j), the repeal of section 958(b)(4), and the interaction of new rules with pre-TCJA law.

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The absence of legislative history for specific provisions means the law's general intent becomes relevant. That intent can be found in documents such as the administration's 2017 framework for tax reform and in statements made by Republican leadership, which most often refer to the law's international goals as improving U.S. competitiveness and driving economic growth. The framework suggests a general intent to move to a territorial tax system, saying tax reform would "transform" the U.S. "offshoring" model, end the "perverse incentive to keep foreign profits offshore by exempting them when they are repatriated to the United States," and "replace the existing, outdated worldwide tax system with a 100 [percent] exemption for dividends from foreign subsidiaries." It also said it included rules to protect the U.S. tax base by taxing at a reduced rate and on a global basis the foreign profits of U.S. multinationals "to prevent companies from shifting profits to tax havens."

Comments

Treasury has received hundreds of pages of substantive comments on the proposed regulations interpreting the TCJA's international provisions, mostly from individuals and groups directly affected by the law or representing those affected. There's nothing in the IRM or judicial doctrine to suggest that an administrative agency can grant less deference to comments based simply on who submits them.

This section reviews a few of the questions Treasury faced to help understand how it weighed competing considerations in how to address ambiguous legislative intent, taxpayer comments, administrability concerns, and government revenue needs.

Taxation of foreign earnings. The legislative history indicates that broadly speaking, Congress intended to impose current tax on a large portion of U.S. multinationals' foreign earnings to prevent base erosion and profit shifting. How much tax Congress meant to impose becomes trickier when one drills into the details. The conference report (H.R. Rep. No. 115-466) indicates in a footnote that Congress may have intended the global effective rate on U.S. companies' foreign earnings to be capped at 13.125 percent, but its silence on how existing foreign tax credit regs would apply in calculating the GILTI FTC renders the meaning of that footnote uncertain.

> ***As various commentators have noted, the narrowness of the proposed high-tax election means it's often unclear how much taxpayers — including large multinationals for whom the election is allegedly a big windfall — will benefit.***

Taxpayers who believed, based on conversations with leading lawmakers, that the U.S. tax rate on their foreign earnings wouldn't exceed 13.125 percent were subject to a rude awakening immediately after the TCJA's passage, when they discovered that allocation of interest and other types of U.S. shareholder expenses to foreign earnings as required under long-standing FTC regulations could render the effective tax rate on their foreign earnings higher than expected. Their comments on proposed FTC regs requested broad exceptions to the general expense allocation rules.

Treasury compromised, leaving many expense allocation rules in place, while providing for more assurance on the creditability of taxes paid on GILTI tested income by allowing taxpayers to exclude some foreign assets from the expense allocation calculation and expanding the high-tax election. That expansion has allowed critics to complain that Treasury has weakened the rules, but the reality is much more complex: As various commentators have noted, the narrowness of the proposed high-tax election means it's often unclear how much taxpayers — including large multinationals for whom the election is allegedly a big windfall — will benefit.

In drafting the GILTI regulations, Treasury had to balance the clear, overarching reform objectives with the statute's ambiguity and the legislative history, while taking into account taxpayer comments and administrability concerns. In some cases, it may have gone beyond its statutory authority, with results that sometimes benefit groups of taxpayers but often hurt many others.

BEAT carveouts. Of all the international provisions in the TCJA, the BEAT is the one policymakers had no chance to debate and taxpayers had little opportunity to comment on. The legislative history is mostly silent on the purpose of the tax (although the framework says reform should "incorporate rules to level the playing field" between U.S.- and foreign-headquartered parent companies; a Senate Budget Committee report (S. Rep. No. 115-20) contains similar language).

In the preamble to the proposed BEAT regs, Treasury pointed to the legislative history for support for the proposition that Congress was concerned that foreign-owned U.S. subsidiaries were able to reduce their U.S. tax liabilities by making deductible payments to foreign related parties, thereby eroding the U.S tax base if the payments were subject to little or no U.S. withholding tax. It said that result could favor foreign-headquartered companies over U.S. ones, creating a tax-driven incentive for foreign takeovers of U.S. companies and enhancing the pressure for U.S.-headquartered companies to redomicile abroad and shift income to low-tax jurisdictions.

> ***In promulgating final BEAT regulations, Treasury mostly rejected taxpayer requests on the grounds that the relief requested was contrary to legislative intent and unsupported by statutory language. In some cases, its interpretation arguably conflicted with the broadly stated statutory intent.***

But those broad statements of congressional intent provided little direction on how to address the many interpretive questions a hastily written statute left open. Those include big-picture policy questions, such as whether Congress really intended the statute to have such a disparate impact on payments for services rather than goods, or actually wanted U.S. multinationals to effectively be subject to double tax on deductible payments includable in U.S. taxable income as GILTI or subpart F income.

In promulgating final BEAT regulations, Treasury granted carveouts from some of the most perverse consequences of the statute, such as by expanding the services cost markup, and it created a few other broad policy exceptions, such as for total loss-absorbing securities and amounts taxable as effectively connected income to the recipients of BEAT payments. Otherwise, it mostly rejected taxpayer requests on the grounds that the relief requested was contrary to legislative intent and unsupported by statutory language. (Prior analysis: *Tax Notes Federal*, Jan. 6, 2020, p. 21.) In some cases, such as in rejecting any relief for taxpayers whose BEAT payments are subject to double inclusion as subpart F or GILTI and again as BEAT, its interpretation arguably conflicted with the broadly stated statutory intent.

Addressing taxpayer planning. In many areas, congressional silence (or drafting glitches) left ample opportunities for taxpayer planning, and in at least two cases, Treasury acted without any clear authority to shut that down.

The first involves the inclusion required by section 956 (T.D. 9859). Purportedly enacted as a backstop to the inclusion rule for subpart F earnings, section 956 (which wasn't amended by the TCJA) requires an inclusion in earnings by a U.S. shareholder of a controlled foreign corporation with an investment in U.S. property. But a disconnect between the mechanics of section 956 and the rules for claiming GILTI FTCs (which allow no carryover), as well as the enactment of the participation exemption in section 245A, meant that the purpose behind section 956 was now questionable. Further, the less restrictive rules applicable to section 956 FTCs presented generous planning opportunities.

Treasury's response was to essentially write section 956 out of the code (for corporate shareholders) by providing that an inclusion mandated by that section wouldn't be subject to tax if an actual dividend from the same earnings would be exempt under section 245A. It also wrote a rule that no FTCs would be available for foreign earnings included under section 951(a)(1)(B). In justifying its proposed regulations

(REG-114540-18), Treasury said that as a result of the enactment of the participation exemption system, "the current broad application of section 956 to corporate U.S. shareholders would be inconsistent with the purposes of section 956 and the scope of transactions it is intended to address." It also said its rule "would significantly reduce complexity, costs, and compliance burdens for corporate U.S. shareholders of CFCs."

Treasury didn't receive any substantive comments on the section 956 regulations and finalized them largely as written. But it did receive comments on prop. reg. section 1.960-2, which denies an FTC for all section 956 inclusions, asking that the provision be modified, partly because not allowing credits for section 956 inclusions was inconsistent with the legislative history. Treasury rejected those requests, saying that attributing any FTCs to a section 956 inclusion would be inconsistent with congressional intent to eliminate the need for multiyear tracking of income and taxes and move to an FTC system based solely on current-year taxes and income.

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Treasury also arguably went beyond its statutory authority in writing temporary section 245A regulations (T.D. 9865) with an anti-taxpayer bent. Those regs contain two antiabuse rules; one addresses different effective dates applicable to different TCJA provisions, which resulted in taxpayers being able to repatriate earnings from CFCs that hadn't been subject to U.S. tax but were entitled to the section 245A dividends received deduction. Treasury relied on its interpretation of the statutory intent, which it said was to ensure that income derived by CFCs is eligible for the section 245A deduction only if the earnings being distributed haven't first been subject to the subpart F or GILTI regimes. It said the statutory scheme is best preserved by limiting the reach of section 245A when its literal effect would reverse the intended effect of the subpart F and GILTI regimes.

Commentators have claimed that Treasury acted without authority in issuing the temporary regs, arguing that they're based not on a grant of regulatory authority or the plain language of the statute but instead on Treasury's view of how Congress should have written the new international tax rules.

Conclusion

Treasury and the IRS face numerous constraints in drafting tax regulations, which require balancing the scope of their authority, congressional intent, taxpayer comments, and administrability concerns. At the same time, the Treasury Office of Tax Policy ultimately reports to the Treasury secretary, a Cabinet member nominated by the president and confirmed by the Senate. That means that policy calls — within the guidelines articulated by the APA, the IRS, and courts — inevitably reflect the administration's overall goals and policies. An example of that kind of political influence in rulemaking is the Obama Treasury's anti-inversion guidance, which was directly motivated by the administration's frustration over congressional inaction. In the Trump administration, there's less evidence that regulations are being used to thwart congressional intent, likely in part because the White House and Congress were under common control when the TCJA was enacted. And nothing in the administrative guidelines or case law suggests that congressional intent should be given greater deference when a law's stated intent is to support social justice rather than advance elected officials' ideas about how to promote economic growth, or that Treasury officials must substitute their own views of the perspectives of the voiceless in rejecting taxpayer comments while writing regulations. ■

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