Zealotry and the new FTC regulations

Ray Wiacek, head of the global tax practice at Jones Day, argues that new IRS FTC regulations are contrary to some fundamental principles of tax administration


Raymond Wiacek

Proposed regulations issued recently by the IRS brand as abusive transactions these where a foreign tax is paid and a US credit claimed, at the same time another party gets a foreign benefit, such as a participation exemption. A foreign tax must be "compulsory" — that is, exacted at law — to be creditable in the US. The new regulations assert that any such transaction is planned, therefore voluntary, therefore not compulsory. Query this logic. Here, however, I want to query the regulation's apparent disregard of some fundamental principles of tax administration.

First some background. I have been a tax lawyer in Washington for 30 years. I am now the head of the tax practice at Jones Day, which by our count is second or third largest among law firms. Neither I nor my colleagues seek to do "abusive" transactions. I know, for example, we have never done a "listed" transaction — those the IRS tags as most abusive.

I think this is the case because we always apply basic principles. For example, we believe tax abuse is bad for all. It promotes the lowest common denominator and undermines a primary purpose of the tax bar, which is not only to advise clients what they can do, but what they cannot. It follows that reform and enforcement are commendable. Everyone benefits when true abuse is exposed. But zealotry in the name of enforcement is ultimately ineffective. It invites disrespect and resistance. Reformers can prefer administrability over complexity, but never over fairness or equity.

Next, we read the Internal Revenue Code and regulations repeatedly with our facts in mind. Where we conclude the law is express, we are entitled to rely on it.

Provided, however, that we also always apply the common law, which is as important as the codified law. So, no shams, no extraneous steps, no peppercorn returns. And we recognise that business purpose is paramount. If a transaction is intended to make lots of money, irrespective of tax, we believe it is virtually impregnable.

Finally, where a change in law is necessary, we expect it will be prospective.

Apply these principles to this transaction: The foreign subsidiary (FS) of a US bank (Bank) makes many loans to unrelated parties in Europe. FS makes a profit on the loans and pays tax in its home country. FS is equity-capitalised, with that equity borrowed by Bank in the US. A foreign lender approaches Bank, proposing to buy FS preferred stock from Bank provided they will buy it back at the same price in three years. The US will treat the funds raised as a loan and the foreign jurisdiction as a stock purchase by lender. As a result of the foreign treatment, the funds raised will cost less than Bank's current debt, because lender will get a participation exemption. Bank uses the funds raised to pay down its higher cost debt, maintaining spreads on FS's loans and increasing pre-tax profits.

You analyse the transaction. It has paradigmatic business purpose — raising money, lowering expenses, and increasing profits before tax. There is no way to recharacterise the transaction at common law. It is a loan from a US perspective — period — with no sham parties, no circular cash flows and so on. You read the regulations the IRS thinks are relevant. A compulsory tax is a tax imposed by law. You learn that the directors of FS will be personally liable if the tax on FS's home country profits are not paid. They tell you this is the highest form of compulsory. You also rely on express language in the existing compulsory regulations stating that one's choice as to the conduct of one's business or the form of any transaction does not go to compulsory. You think about potential reform in this area. You think, for example, that Bank's debt could be 100% allocated to FS under revised section 861 regulations. But you trust that any such change would be prospective. You endorse the transaction.

Completely wrong, according to the proposed regulations. Neither raising funds, reducing costs, nor increasing profits is a good business purpose. (Wow!) In fact, no business purpose may suffice, because administrability is paramount. Just as bad, the express language in the current compulsory regulations regarding a taxpayer's complete freedom to structure its transactions is deemed retroactively never to have said that.

You are confounded, but take heart that the regulations are "proposed." You understand they do good, for there are a number of abusive transactions out there, but you know they can be more discriminating. They really must accommodate business purpose. And they should tone down the rhetoric. (If administrability is paramount, good transactions — sacrificed to the cause — cannot be labelled "abusive.") Finally, if the regulations are to negate the express language of existing law, they should do so prospectively. Retroactive lawmaking is always unattractive.

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