Third Circuit Upholds CFC Guaranty Regulations

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We recently reported on the Treasury's proposal to harmonize the regulations governing CFC pledges and guaranties with the "participation exemption" for foreign-source dividends under Code Sec. 245A. [*See generally* Donald P. Board, *New Code Sec. 245A and Pledges of CFC Stock*, The M&A Tax Report 1 (May 2019).] In the course of that discussion, we briefly considered *SIH Partners LLLP* [150 TC No. 3, Dec. 61,108 (Jan. 18, 2018)].

In *SIH Partners*, a pair of CFC guaranties forced a U.S. partnership to report about $375 million of undistributed CFC profits pursuant to Code Sec. 951(a)(1)(B). Acceleration of income is never fun, but the Subpart F inclusion was especially painful for the partnership's individual investors. Amounts included under Code Sec. 951(a)(1)(B) are treated as *ordinary income*, even if an actual distribution would have been taxed as a qualified dividend under Code Sec. 1(h)(11).

The case focused on Code Sec. 956, as implemented by Reg. §1.956-1(e)(2) and 1.956-2(c) (the "Credit Support Regulations"). Although the Credit Support Regulations are cast in general terms, they appear to have been drafted with a *single* guarantor in mind. In *SIH Partners*, the Tax Court upheld the IRS's literal application of the regulations to a situation involving *multiple* guarantors, which is what triggered the $375 million inclusion.

On appeal to the Third Circuit, the U.S. partnership argued (as it had in the Tax Court) that the Credit Support Regulations are invalid. According to the partnership: (1) the adoption of the regulations in 1964 was defective because the Treasury failed to provide an adequate explanation of the basis for the new rules; and (2) the regulations are "arbitrary and capricious in substance." On May 7, 2019, the court of appeals rejected the taxpayer's challenges. [*SIH Partners LLLP*, CA-3, 923 F3d 296 (2019).]

Background

In 2007, one of the partnership's U.S. corporate affiliates borrowed $1.485 billion from Merrill Lynch. No fewer than 39 entities, including two CFCs owned by the partnership, provided guaranties. The two CFCs' combined earnings and profits (about $375 million) were five times greater than their *per capita* share of the loan they were guaranteeing (about $75 million).

Under Secs. 951(a)(1)(B) and 956, a U.S. shareholder of a CFC must include its *pro rata* share of any increase in the amount of the CFC's investments in U.S. property, up to the amount of the CFC's earnings and profits. "United States property" includes indebtedness of any U.S. shareholder of the CFC. If a CFC lends to its U.S. parent, it is investing in U.S. property and the parent must include the amount of the loan, up to the amount of the CFC's available E&P.

To prevent the circumvention of the loan rule, Code Sec. 956(d) treats guarantors and pledgors as if they lent the amounts they are guaranteeing or securing:

> For purposes of [Code Sec. 956(a)], a controlled foreign corporation shall, *under regulations prescribed by the Secretary*, be considered as holding an obligation of a United States person if such foreign corporation is a pledgor or guarantor of such obligation. [Emphasis supplied.]

The statutory language is straightforward, and its application to prototypical, single-guarantor arrangements does not raise special policy issues under Subpart F. The Credit Support Regulations do not treat Code Sec. 956(d) as in any way problematic. Reg. §1.956-2(c)(1) simply rephrases the statute.

Reg. §1.956-2(c)(2), however, states that a CFC will be treated as a pledgor or guarantor with respect to an obligation even if its assets only *indirectly* serve as security. A stock pledge will be treated as a pledge of the underlying assets if the pledged shares represent at least 66 ⅔ percent of the corporation's voting power.

From a commercial-law perspective, pledging shares and pledging assets are as different as chalk and cheese. Reg. §1.956-2(c)(2) expands the scope of Code Sec. 956(d) beyond the statutory language, but it provides hardly any details about *how* Code Sec. 956 is supposed to apply to indirect pledges and guaranties.

Unreasoned Decisionmaking?

The U.S. partnership in *SIH Partners* argued that the Credit Support Regulations were subject to the notice and comment requirements of the Administrative Procedure Act (APA) [5 USC §550 *et seq*.]. When promulgating regulations by informal rulemaking, an agency must first publish a notice of proposed rulemaking in the Federal Register and provide interested persons an opportunity to submit written data, views, or arguments.

After the agency has considered any comments, it is supposed to "incorporate in the rules adopted a concise general statement of their basis and purpose." The agency must engage in "reasoned decisionmaking" and provide a "reasoned explanation" of its actions. [*See Motor Vehicle Mfrs. Ass'n of the U.S. v. State Farm Mut. Auto Ins. Co.*, SCt, 463 US 29 (1983).]

However, the preamble to the Treasury Decision adopting the regulations stated only that they were supposed "to conform to ... section 956 of the Internal Revenue Code." Is that a "reasoned explanation"?

The Tax Court saw nothing in the legislative history or the administrative record suggesting that anybody was worried about the treatment of multiple guaranties in 1964. With no issue to address, Reg. §1.956-2(c)(1) had simply restated the statute. What more was there to say?

The U.S. partnership countered that the IRS itself had recognized that literal application of the Credit Support Regulations could be problematic. Field Service Advice 200216022 (Jan. 8, 2002) had observed that applying Reg. §1.956-2(c)(1) to multiple guaranties could produce "strange results."

Suppose that a U.S. shareholder borrows $1 million, secured by guaranties by five of its CFCs. If the regulations are applied literally, *each* of the five CFCs will be treated as if it had lent the full principal amount of the obligation ($1 million). Assuming sufficient E&P, this will trigger a $5 million inclusion to the U.S. shareholder.

In the preamble to a notice of proposed rulemaking [80 FR 53062 (Sept. 2, 2015)], the Treasury floated the idea of issuing new regulations to allocate the amount of the obligation among the relevant CFCs "so as to eliminate the potential for multiple inclusions and, instead, limit the aggregate inclusions to the unpaid principal amount of the obligation."

Limiting total inclusions to the principal amount of the guaranteed obligation would not have made any difference in *SIH Partners*, because the $1.485 billion loan dwarfed the $375 million that the U.S. partnership was required to include. But that wasn't the point. What mattered was the fact that the regulations had been issued without addressing, much less resolving, a substantive issue that even the Treasury recognized—eventually.

The Tax Court acknowledged that it might make sense for the Credit Support Regulations to include more nuanced rules to deal with multiple guaranties or pledges. But, as the court pointed out, "an agency is not required to take account of and make special accommodation for every scenario in which its rules may apply." After all, the courts "do not sit as a committee of revision to perfect the administration of the tax laws." [*H.O. Correll*, SCt, 68-1 USTC ¶9101, 389 US 299, 306–307, 88 SCt 445.]

The government also invoked *Chevron* deference to defend the regulations. Courts should defer to an agency's substantive construction of a statute when: (1) Congress has delegated authority to the agency to make legislative rules; and (2) the agency's position is based on a permissible reading of the statute. [*See Mayo Found. for Med. Educ. & Research*, SCt, 562 US 44, 57 (2011).]

Code Sec. 956(d) directs the Treasury to prescribe rules for determining whether a CFC's pledge or guaranty should be treated as an investment in U.S. property. Congress did not *require* that obligations secured by multiple guaranties be treated differently from single-guarantor obligations—but it did not *prohibit* special treatment, either. The matter was left to the Treasury to decide.

This delegation satisfied the first leg of the *Chevron* test. The second question was whether Reg. §1.956-2(c)(1) represented a "permissible construction" of the statute. The fact that the regulations simply rephrase Code Sec. 956(d) seems like a pretty big point in their favor.

Nevertheless, the Tax Court performed a detailed review of the language and history of Code Sec. 956(d). It concluded that Congress had instructed the Treasury to issue implementing regulations, but it declined to infer from this that the regulations had to include special rules for multiple-guarantor cases. Reg. §1.9562(c)(1) may be a blunt instrument, but the Tax Court could not conclude that its one-size-clubs-all approach was contrary to Congressional intent.

Third Circuit: Timing Is Everything

Like the Tax Court, the Third Circuit rejected the U.S. partnership's challenge to the Credit Support Regulations. The appeals court began by saying that it "appreciate[d] and agree[d] with the Tax Court's masterful analysis." But it concluded that the regulations should be upheld on somewhat different grounds.

The Tax Court and the litigants had failed to address what the Third Circuit called "the hindsight issue." The U.S. partnership had asserted that the regulations are invalid because they are arbitrary and capricious. To make its case, the partnership had relied on events that occurred *after* the regulations were adopted.

The U.S. partnership argued that the IRS's post-adoption practice showed that the regulations were unreasonable. But challenges to a regulation must be based on "the full administrative record that was before the agency at the time" it took the action under review. [*Citizens to Preserve Overton Park v. Volpe*, SCt, 401 US 402, 420 (1971).]

The Third Circuit added a *pro forma* invocation of *Chevron*, which would require deference to the Treasury's interpretation Code Sec. 956(d). But the appeals court made it pretty clear that the Treasury's interpretation was reasonable enough to sustain the Credit Support Regulations even without *Chevron*. When regulations simply restate the statute, challenging an agency's interpretation as unreasonable is no easy task.