Goodwill Hunting . . . Without a License: The IRS Takes Action

By Ken Brewer

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In this report, Brewer questions the validity of proposed regulations that would eliminate the favorable tax treatment for goodwill and going concern value in outbound transfers.

The views expressed herein are those of the author and do not necessarily reflect the views of Alvarez & Marsal Taxand.

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Undaunted by its recent drubbing (15 to 0) in *Altera*[1] for adopting a rule under section 482 that ignored important facts, the IRS on September 14 boldly released a proposed new rule under section 367[2] that openly defies congressional intent and arguably contradicts statutory language. In keeping with that spirit, the proposed new rule also includes an effective date that would apply retroactively (to September 14, 2015) once the regulations are finalized (presumably sometime after 2015, if at all).

Section 367 is the code section that overrides several nonrecognition rules, like sections 351 and 361, in outbound transfers — that is, situations in which a U.S. person transfers property to a foreign corporation. The proposed new rule would prevent goodwill and going concern value from qualifying for the active trade or business exception in section 367(a)(3), which prevents immediate gain recognition under section 367(a)(1). This would completely reverse the favorable tax treatment that goodwill and going concern value has been given under section 367 ever since that section was enacted in 1976 — treatment that was continued when section 367 was later overhauled by the Deficit Reduction Act of 1984 (DEFRA, P.L. 98-369).

Assuming, for the sake of discussion, that the proposed new rule would be valid if finalized, it will likely become a major new influence on the choice of entity by a U.S. person for start-up operations in foreign countries, and it will likely deter the transfer of existing foreign branch operations to foreign subsidiaries (including deemed transfers as a result of entity classification elections).

So Much for Congressional Intent

The IRS made no bones about admitting that the proposed new rule for goodwill and going concern value defies congressional intent. That admission came in the following language in the preamble to the proposed regulations:

> The favorable treatment of foreign goodwill and going concern value available under existing law is premised on statements in the legislative history of section 367(d). "The committee contemplates that, ordinarily, no gain will be recognized on the transfer of goodwill or going concern value for use in an active trade or business." S. Rep. No. 169, 98th Cong., 2d Sess., at 364; H.R. Rep. No. 432, 98th Cong., 2d Sess., at 1319. The Senate Finance Committee and the House Committee on Ways and Means each noted, without explanation, that it "does not anticipate that the transfer of goodwill or going concern value developed by a foreign branch to a newly organized foreign corporation will result in abuse of the U.S. tax system." S. Rep. No. 169, 98th Cong., 2d Sess., at 362; H.R. Rep. No. 432, 98th Cong., 2d Sess., at 317.

[1] *Altera Corp. v. Commissioner*, 145 T.C. No. 3 (2015).
[2] REG-139483-13.

In spite of that, the IRS justified its action by asserting that "taxpayer positions and interpretations . . . raise significant policy concerns and are inconsistent with the expectation, expressed in legislative history, that the transfer of foreign goodwill and going concern value developed by a foreign branch to a foreign corporation was unlikely to result in abuse of the U.S. tax system." The preamble goes on to explain that Treasury and the IRS actually considered whether a set of rules could be devised that would preserve the tax treatment Congress intended for non-abusive situations and attack only abuses that were not contemplated by Congress. But as for that possibility, the preamble states that "the Treasury Department and the IRS ultimately determined . . . that such an approach would be impractical to administer."

The preamble then explains that as long as goodwill and going concern value is given favorable tax treatment, as compared with other intangibles, taxpayers will be tempted to take aggressive positions regarding the valuation of that value. To sum up the justification for the proposed rule, the preamble states, "The Treasury Department and the IRS have determined that allowing intangible property [including goodwill] to be transferred outbound in a tax-free manner is inconsistent with the policies of Section 367 and sound tax administration."

The preamble's discussion of the legislative history and the justification for the proposed new rule may be distilled down to the following points:

- when it passed DEFRA in 1984, Congress believed that allowing goodwill and going concern value developed by a foreign branch to be transferred to a foreign subsidiary in a tax-free manner was not an abuse of the U.S. tax system and therefore was perfectly consistent with the policies of section 367;
- Congress intended for no gain to be recognized on the outbound transfer of goodwill and going concern value for use in an active trade or business outside the United States;
- Treasury and the IRS believe that experience since DEFRA demonstrates that Congress was incorrect in its belief that the tax-free outbound transfer of goodwill and going concern value developed by a foreign branch was unlikely to result in an abuse of the U.S. tax system;
- Treasury and the IRS believe that allowing goodwill and going concern value to be transferred outbound in a tax-free manner is inconsistent with the policies of section 367; and
- Treasury and the IRS believe that it would be impracticable to design and administer a set of rules that would provide the results intended by Congress without permitting undue abuse of the U.S. tax system.

As much as one might agree with the policy reason for the proposed new rule, one might also wonder whether Treasury and the IRS are free to adopt rules that are inconsistent with congressional intent, based purely on their own reasoned judgment that the 1984 Congress got the policy wrong. That would seem to raise the same question in the area of tax law that has been hotly debated recently in the areas of healthcare law and immigration law: the extent to which the executive branch can make or change law by executive action.

With those debates as a backdrop, the purpose of this report is to explore the possibility that this proposed new tax rule might be found invalid on grounds of constitutional separation of powers. Toward that end, it first addresses executive branch powers under the Constitution, then judicial deference to agency interpretations, and finally the policy justification for this particular executive action.

Executive Branch Powers

Opponents to recent executive actions in the areas of healthcare and immigration laws have raised serious questions regarding whether — and if so, the extent to which — the executive branch has the authority to make or change federal statutory law through executive order or regulation.

Tax practitioners know that there is really only one question: "the extent to which" the executive branch has the authority to make or change the law. We witness the IRS regularly adding to and making changes to laws provided by statute,[3] and sometimes even case law.[4] From our perspective, it is a large and important part of the IRS's job.[5] But on rare occasions, we do see courts striking down IRS-made law.

On those rare cases, we may not have seen the IRS error described in the court's opinion as a constitutional violation. Typically, the IRS's action is described as being invalid in light of the authority granted to the agency under a particular code

[3]*See, e.g.*, reg. section 1.894-1(d), which provides rules for the denial of treaty benefits for payments received by some fiscally transparent entities. Those rules are considerably different from the rule enacted by Congress in section 894(c) but appear to be authorized by the grant of regulatory authority in the language of section 894(c)(2).

[4]*See, e.g.*, reg. section 1.956-2(c)(2), in which the IRS adopted a rule for indirect pledges and guarantees by controlled foreign corporations that appears to override the result in then-recent *Ludwig v. Commissioner*, 68 T.C. 979 (1977). *See* Ken Brewer, "Open Questions Regarding Pledges and Guarantees by CFCs," *Tax Notes*, Jan. 21, 2002, p. 359.

[5]And, in my opinion, the IRS does it very well for the most part.

section or sections; or, as in *Altera*, because of failure to comply with the requirements of the Administrative Procedures Act.

Similarly, tax practitioners (with the possible exception of state and local specialists) have a tendency to brush aside the notion that a tax regulation may be found invalid on constitutional grounds.[6] But if we drill down a little further into the underlying legal basis for the analysis applied in the court decisions in which IRS-made law has been overturned, the reason why the validity of the IRS action was judged by reference to a tax code section, the Administrative Procedures Act, a treaty provision, or another court decision is because of limitations imposed on the powers of the executive branch, and hence on the IRS, under the Constitution's separation of powers provisions.

As discussed in more detail below, there appears to be a legitimate question whether the proposed new rule has crossed over into a territory that the Constitution has assigned to Congress and that Congress has not delegated to the executive branch.

Because the IRS is an agency of the executive branch, its authority to make changes in law is confined by the Constitution's boundaries on the powers of the executive branch. The following excerpts from the White House website provide a description of what the current administration believes its constitutional powers are regarding legislation:

> The power of the executive branch is vested in the President of the United States, who also acts as head of state and Commander-in-Chief of the armed forces. The President is responsible for implementing and enforcing the laws written by Congress and, to that end, appoints the heads of the federal agencies, including the Cabinet.
>
> The Cabinet and independent federal agencies are responsible for the day-to-day enforcement and administration of federal laws.
>
> Under Article II of the Constitution, the President is responsible for the execution and enforcement of the laws created by Congress. Fifteen executive departments — each led by an appointed member of the President's Cabinet — carry out the day-to-day administration of the federal government. They are joined in this by other executive agencies such as the CIA and Environmental Protection Agency, the heads of which are not part of the Cabinet, but who are under the full authority of the President. The President also appoints the heads of more than 50 independent federal commissions, such as the Federal Reserve Board or the Securities and Exchange Commission, as well as federal judges, ambassadors, and other federal offices.
>
> The President has the power either to sign legislation into law or to veto bills enacted by Congress, although Congress may override a veto with a two-thirds vote of both houses.
>
> The President can issue executive orders, which direct executive officers or clarify and further existing laws.

It appears fairly clear from those excerpts that the administration does not believe that the Constitution grants it the power to make, alter, or override legislation, or to overturn the results of court decisions. Rather, when it comes to legislation, the power of the president and the agencies of the executive branch is described on the White House website as being confined to the following types of actions:

- vetoing (the laws enacted by Congress, subject to possible override by Congress);
- implementing (the laws enacted by Congress);
- executing (the laws enacted by Congress);
- enforcing (the laws enacted by Congress);
- clarifying (existing laws); and
- furthering (existing laws).

None of those actions sounds like making, altering, or overriding legislation, or overturning case law.[7]

Article I, section 1 of the Constitution confirms the existence of those limits on the lawmaking powers of the executive branch with the following language:

> All legislative Powers herein granted shall be vested in a Congress of the United States, which shall consist of a Senate and House of Representatives.

That Congress believes (or at least at one time believed) that the above-described limitations apply to the lawmaking powers of the IRS is clearly evident from sections 7801 (defining the Treasury

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[6]*See, e.g.*, New York State Bar Association Tax Section, ''Report on Section 367(d)'' (Oct. 14, 2010). The NYSBA report provides an excellent analysis of the legislative and regulatory history of section 367(d) and suggests, very diplomatically, that an apparent change in the IRS's position regarding the meaning of the term ''goodwill and going concern value'' might be best left for Congress to act on. But nowhere in its 85 pages does the report refer to the Constitution (except on p. 1, in the IRS's Constitution Avenue address).

[7]Although, if we take a page from a prior administration, one might argue that the question of whether the IRS has the unfettered authority to override statutory or judge-made law all depends on what the meaning of the word ''furthering'' is.

secretary's authority) and 7803 (defining the duties and powers of the IRS commissioner).

Despite all the above, any seasoned tax practitioner knows that the IRS routinely makes tax law and changes to tax law. Presumably, that could not occur (at least not as frequently as we all know it does) if it were not permitted by the Constitution. Even though the Constitution does not explicitly grant the executive branch any power to make, alter, or override legislation, Article I, section 8, which enumerates the powers of Congress, concludes with the following congressional power:

> To make all Laws which shall be necessary and proper for carrying into Execution the foregoing Powers, and all other Powers vested by this Constitution in the Government of the United States, or in any Department or Officer thereof.

That language has been interpreted as providing Congress the power to delegate, through legislation, at least some of its legislative powers to the executive branch "to the extent necessary and proper for carrying into Execution" the legislation that Congress enacts. That, in fact, is what Congress did in sections 7801 and 7803 (both described above) and section 7805 (authority to prescribe rules and regulations for the enforcement of the internal revenue title).

So even though the Constitution vests "all legislative powers granted herein" in the Congress and does not directly grant any legislative powers to the executive branch, it has been interpreted to permit the executive branch to exercise the power to make or alter statutory law to the extent that that power has been properly delegated to it through legislation enacted by Congress.

By contrast, the language of the Constitution, on its face, does not appear to vest any power in the executive branch to overturn case law, nor does it appear to vest any power in Congress to delegate any such judicial power to the executive branch. However, if a court decision interprets a statutory provision regarding which the IRS has been delegated, but has not yet exercised, interpretive authority, it is at least conceivable that the IRS may be found to have the authority to override that court decision by regulation.

The extent to which Congress may delegate legislative powers to the executive branch has been the subject of extensive litigation.[8] In short, as tax practitioners know, there can be no question that such delegation is permissible under the Constitution. The only question is the extent to which the executive branch action is authorized. Based on the literal language in the Constitution, that determination would appear to involve three sub-questions:

- whether a federal statute authorized the executive action in question;
- whether that authorization was "necessary and proper"; and
- whether the action by the executive branch was consistent with that authorization.

Judicial Deference: *Chevron v. King*

As much as one might disagree with the policy underlying an agency action, the Supreme Court has made it clear that courts should not substitute their policy preferences for those of the agency to which Congress has delegated policymaking responsibilities when the agency interpretation in question "is a reasonable choice within a gap left open by Congress."[9] The case cited most often as the authority for that principle is *Chevron*[10] — so much so that this principle has come to be known as "*Chevron* deference."

In the *Chevron* decision, the Supreme Court explained that *Chevron* deference involves a two-step process. The first step is to determine whether Congress has spoken on the point in question or has left a gap (for example, an ambiguity in the meaning of a term) within which authority is delegated to the relevant agency of the executive branch. In the former case, no deference is given to the agency interpretation, and the intent of Congress governs. In the latter case, it is necessary to proceed to step two. In step two, *Chevron* deference requires the court to refrain from imposing its own belief regarding the best possible interpretation of the statute and to confine its inquiry to whether the agency interpretation is reasonable in light of the delegation of authority.

In the recent Supreme Court decision in *Mayo*,[11] the taxpayer argued that the scope of *Chevron* deference should be more restricted for tax regulations than for regulations of other agencies. But the Supreme Court, in affirming the decision below by the Eighth Circuit, rejected that argument with the following statement:

> We see no reason why our review of tax regulations should not be guided by agency

[8] *See, e.g.*, *Loving v. United States*, 517 U.S. 748 (1996); *Touby v. United States*, 500 U.S. 160 (1991); *Mistretta v. United States*, 488 U.S. 361 (1989); *J.W. Hampton Jr. & Co. v. United States*, 276 U.S. 394 (1928); and *Field v. Clark*, 143 U.S. 649 (1892).

[9] *Chevron U.S.A. Inc. v. Natural Resources Defense Council Inc.*, 467 U.S. 837 (1984).

[10] *Id.*

[11] *Mayo Foundation for Medical Education and Research v. United States*, 562 U.S. 44 (2011).

expertise pursuant to *Chevron* to the same extent as our review of other regulations.

Two more recent district court decisions, *King*[12] and *Halbig*,[13] both dealing with the IRS's interpretation of a term used in the Affordable Care Act, appeared to have expanded the scope of *Chevron* deference. The statutory language in question reads as follows: "An Exchange established by the State." Both district courts cited *Chevron* as authority for sustaining the IRS's interpretation of that statutory language to mean "an Exchange established by the State or by the Secretary of Health and Human Services in the absence of a State Exchange." However, the district court's judgment in *Halbig* was overturned by the D.C. Circuit.[14] And about one hour later, the district court judgment in *King* was upheld by the Fourth Circuit.[15]

The Fourth Circuit's decision in *King* appeared to expand *Chevron* deference beyond what the Supreme Court described as "reasonable choices within a gap left by Congress" to cover situations in which the agency to which Congress has delegated policymaking responsibilities has made a determination that an unambiguous statutory term chosen by Congress must not be what Congress really intended, and that the term should therefore be interpreted to mean something different from its plain meaning.

In contrast, the D.C. Circuit would have left *Chevron* deference as it was before the ACA cases. Under that view, *Chevron* deference would probably not have been available to save the ACA.

In anticipation of the Supreme Court's decision in *King*,[16] some legal scholars speculated that the validity of an IRS regulation that arguably lacks constitutional authority might be insulated from challenge by the doctrine of *Chevron* deference. Some have argued that the Supreme Court majority's legal analysis in *King* is technically flawed or intellectually dishonest.[17] Even those detractors should credit the majority for at least not taking what appeared to be an easier (but even more intellectually dishonest) way out to reach the result they wanted in *King* by simply applying *Chevron* deference to uphold the regulation in question, without getting to whether the IRS exceeded its constitutional authority in enacting the regulation.

Had the majority relied on *Chevron* deference to support its decision in *King*, this report might have ended here. The question whether the proposed new rule under section 367 might be determined to be invalid on constitutional grounds would be purely academic. The path for a taxpayer to challenge a tax regulation on constitutional grounds might have been effectively blocked when the IRS could demonstrate at least some resemblance in the regulation to a policy that the agency believed Congress would have adopted if it knew everything the IRS knew.

As with *King*, the decision in *Altera* appears to diminish the IRS's ability to use *Chevron* deference as a shield against taxpayer challenges to regulations that fail to properly take into account relevant facts, statutory language, or congressional intent. Nonetheless, it is still important to understand that regardless of how much one may disagree with the policies that guided the IRS in drafting a regulation, the regulation may be insulated from challenge, at least to some extent, by *Chevron* deference.

Policy Considerations

There seems to be a fairly widely held belief (a widely held misconception, I would argue) that the outbound transfer of any property with unrealized appreciation on a tax-free (that is, tax-deferred) basis is an abuse of the U.S. tax system per se and is therefore inconsistent with policies of section 367. Under that view, the proposed new rule would have to be a welcome, if not long-overdue, change (putting aside its constitutional shortcomings).

By way of background, there is absolutely no question that Congress has always believed that there are important policy reasons to permit a general rule of nonrecognition to apply to realized gains and losses for asset transfers that merely represent a change in the legal form through which an ongoing trade or business is conducted under the same continuing ultimate ownership. It is obvious that the original version of section 367, enacted in 1976, was not intended to completely eliminate the possibility of nonrecognition in the case of outbound transfers. The statutory language of the 1976 version of section 367 makes quite clear that it was intended to prevent nonrecognition only when a principal purpose for the transfer was the avoidance of U.S. taxes.

The overhaul of section 367 by DEFRA was not the result of a change in policy intended to greatly reduce the potential for nonrecognition. On the contrary, it is clear from the legislative history to DEFRA, which is quoted in the preamble to the proposed section 367 regulations, that Congress

[12] *King v. Sebelius*, 997 F. Supp.2d 415 (E.D. Va. 2014), *aff'd sub nom King v. Burwell*, 759 F.3d 358 (4th Cir. 2014), *aff'd*, 135 S. Ct. 2480 (2015).

[13] *Halbig v. Sebelius*, 27 F. Supp.3d 1 (D.D.C. 2014), *rev'd sub nom Halbig v. Burwell*, 758 F.3d 390 (D.C. Cir. 2014).

[14] 758 F.3d 390.

[15] 759 F.3d 358.

[16] 135 S. Ct. 2480.

[17] *See, e.g.*, *King*, 135 S. Ct. at 2500 (Scalia, J., dissenting) (referring to "the Court's . . . interpretive jiggery-pokery").

continued to believe nonrecognition should be available under the new and improved section 367 for outbound transfers that did not involve a principal purpose of tax avoidance.

The impetus for the 1984 changes to section 367 was a desire on the part of Congress to eliminate the need to obtain an IRS ruling at the time of the transfer in order to avoid recognition under section 367, and to eliminate the highly subjective determination of whether the transfer was motivated by a principal purpose of tax avoidance. To accomplish those legislative objectives, Congress removed the requirement to obtain an advance ruling, and it replaced the subjective tax avoidance language in the 1976 version of the statute with the objective factors used by the IRS in its pre-1984 ruling practices, which were intended to guide the agency's determinations of when tax avoidance was a principal purpose.

To replace the subjective tax avoidance determination with an objective standard, Congress modified section 367 to include a fairly broad exception from the requirement of gain recognition for property that would be used in the active conduct of a trade or business outside the United States (without the need for a subjective finding that there was no tax avoidance purpose). As the IRS explained in the preamble, that exception was intended to apply to goodwill and going concern value created by a foreign branch and then transferred to a foreign corporation in an otherwise tax-free transaction.

To understand why an outbound transfer of property should not be viewed as an abuse of the tax system when the property continues to be used in the conduct of a trade or business by the same ultimate owners, it is useful to compare the consequences of beginning foreign operations through a foreign corporation from their inception versus commencing foreign operations through a foreign branch and then later transferring the branch operations to a foreign corporation.

Applying the underlying policies of a tax system that permits deferral of U.S. tax on active foreign earnings, there is simply nothing abusive about capitalizing a foreign corporation with cash and then allowing the foreign corporation to use that cash to finance the startup of an active trade or business conducted outside the United States. If foreign operations are started through a foreign corporation from their inception, there would be no event resulting in the realization of gain on the appreciation in value of any goodwill and going concern value created within the foreign corporation (or, for that matter, on the appreciation in value of any assets acquired or developed by the foreign corporation).

By comparison, if those same foreign operations were commenced through a foreign branch of a U.S. corporation, there would be no more tax avoidance involved in the transfer of the goodwill and going concern value of the branch on its subsequent conversion to a foreign corporation than there would have been in conducting those same operations from inception through the foreign corporation. Any U.S. tax benefit that might have been obtained from branch losses before conversion would be recaptured under the recapture rules that apply to foreign loss branches, the recapture rules for dual consolidated losses, or the recapture rules for overall foreign losses. So by converting the foreign branch into a foreign corporation, the tax position of the owner of the foreign corporation would be transformed to virtually the same position as if it had opted to use a foreign corporation from inception (which would not have been an abuse of the U.S. tax system).

On reflection, it appears that the policies guiding Treasury and the IRS to eliminate the active trade or business exception for goodwill and going concern value are *not* the policies that guided Congress when it enacted the original or the current version of section 367. Rather, they are the policies of those who believe that the U.S. tax system should not permit deferral of U.S. tax on foreign earnings of foreign subsidiaries. That is not to say that it is wrong to believe in those policies. Undoubtedly, there are many in Congress today who believe strongly in them. However, it would seem more appropriate for such a dramatic policy change to be within the province of Congress, through legislation — not the executive branch, through an executive action.

Conflict With Statutory Language?

An important point that the preamble touches on, but only indirectly, concerns whether the proposed rule conflicts with the language of the statute (as well as with congressional intent). The preamble explains that taxpayers have taken positions on both sides of the question of whether the definition in section 936(h)(3)(B) includes goodwill and going concern value. The answer to that question would determine whether the proposed rule conflicts with statutory language.

The existing regulations under section 367 do not directly resolve whether goodwill and going concern value is covered by the section 936(h)(3)(B) definition. But in defining the category of intangibles covered by section 367(d), those regulations purport to carve out an exception for foreign goodwill and going concern value. Therefore, under the existing regulations, if a taxpayer maintains that goodwill and going concern value is included in the section 936(h)(3)(B) definition, that taxpayer would also be maintaining that foreign goodwill and going concern value is carved out of section 367(d) coverage and that it is not covered at all by section 367(a), which by its terms excludes all intangible property.

For a taxpayer that takes the position under the existing regulations that goodwill and going concern value is *not* included in the section 936(h)(3)(B) definition, the carveout of foreign goodwill by the regulations is mere surplusage. Under that view, all goodwill (foreign and domestic) is covered by the statutory language of section 367(a), which allows it to qualify for the active trade or business exception provided by section 367(a)(3) if it is to be used in the active conduct of a trade or business outside the United States.

It is not entirely clear from the legislative history to DEFRA whether Congress believed foreign goodwill and going concern value is outside the scope of section 367(d) because (1) goodwill and going concern value (regardless of whether foreign or domestic) does not fall within the definition of intangible property in section 936(h)(3)(B); or (2) even though goodwill and going concern value does fall within that definition, Congress intended for it to be carved out of the section 936(h)(3)(B) definition to arrive at the category of intangibles that Congress intended to be subject to section 367(d). Before the release of the proposed new rule for goodwill and going concern value under section 367, it seemed fairly clear that both the IRS and the current administration would argue that goodwill and going concern value is included in the section 936(h)(3)(B) definition.[18] By way of contrast, the New York State Bar Association Tax Section report makes a convincing argument to the contrary.[19]

Interestingly, the IRS did not purport to resolve this definitional question in the proposed regulations or in the preamble. Rather, it acknowledged that taxpayers have taken both positions. For a taxpayer that maintains that section 936(h)(3)(B) *does* include goodwill and going concern value, the proposed new rule (by eliminating the carveout in the section 367(d) regulations) causes that value to automatically be covered by the rules in section 367(d) for intangible property.

For a taxpayer that maintains that section 936(h)(3)(B) does *not* include goodwill and going concern value, the proposed regulations would permit two different options. Under the default option, the taxpayer is required to treat the outbound transfer of goodwill and going concern value as being subject to immediate and full gain recognition under section 367(a)(1). Alternatively, the proposed regulations permit that taxpayer to elect to have goodwill and going concern value covered by the deferred recognition rules in section 367(d) that apply to section 936(h)(3)(B) intangibles.

At first blush, choosing to make this election allowed by the proposed regulations might appear to be a no-brainer. Note, however, that the default treatment of immediate and full gain recognition may represent a new planning opportunity for taxpayers with expiring tax credits.

Which of the two interpretations of the section 936(h)(3)(B) definition has an important impact on the constitutional analysis? If goodwill and going concern value does not fall within the section 936(h)(3)(B) definition, based on the statutory language of section 367, goodwill and going concern value is not covered by section 367(d); it *is* covered by section 367(a), including the active trade or business exception in section 367(a)(3). Under that interpretation of the statutory language of sections 936(h)(3)(B) and 367, the proposed rule excluding all intangibles from the active trade or business exception of section 367(a)(1)(3) would directly contradict the language of the statute.

Perhaps by sidestepping the question of whether the section 936 definition includes goodwill and going concern value, the IRS hopes to retain the ability to argue either side under the existing regulations, depending on which position is asserted by the taxpayer. Also, perhaps by not affirmatively taking the position that goodwill and going concern value *is* included in the section 936(h)(3)(B) definition, the hope may be to postpone when a court will decide that question and thereby preserve, until then, the room to argue that the proposed rule is *not* in direct conflict with statutory language.

Section 936(h)(3)(B) Intangibles

The NYSBA report asserts that ''other similar assets,'' as used in section 936(h)(3)(B), should be interpreted to describe assets that share common characteristics with the listed assets. The report explains that the listed items, including a customer list, have two prominent common characteristics that should inform whether property is within the ''other similar assets'' category of section 936(h)(3)(B): (1) that the property may be separately valued; and (2) that, at least theoretically, the property may be transferred separately from the business to which it relates. The NYSBA report takes the view that because goodwill and going concern value cannot be transferred separately from the business to which it relates, it is not ''intangible property,'' as that term is defined in section 936(h)(3)(B).

[18]*See, e.g.*, Treasury, ''General Explanations of the Administration's Fiscal Year 2010 Revenue Proposals,'' at 32 (May 2009).

[19]NYSBA, *supra* note 6.

Additional support for that view can be inferred from the legislative history and the circumstances surrounding the enactment of the definition in section 936(h)(3)(B). Section 936 was enacted back in the 1970s as an incentive for investment by U.S. companies in business activities in Puerto Rico and other U.S. possessions. The incentive took the form of a notional tax credit for domestic corporations that satisfied specified conditions regarding the relative amount and nature of their activities in the possession (so-called possessions corporations). The credit was a function of the U.S. taxable income of the possessions corporation. As a result, the amount of the section 936 credit could be increased by shifting taxable income from a U.S. corporation to a U.S. subsidiary that satisfied the conditions for a section 936 credit.

Section 936(h) was added to section 936 in 1982 because of a concern that taxpayers were transferring some types of intangible property to possessions corporations, thereby creating an inappropriate shifting of taxable income. Because possessions corporations were domestic corporations, the transfer of intangible property to them did not give rise to a tax under section 367. To eliminate the perceived abuse, Congress enacted section 936(h) to require U.S. shareholders of possessions corporations to include the intangible property income of their possessions corporation subsidiaries in their gross income. Section 936(h)(3)(B) was enacted to define the term ''intangible property'' for that purpose.

It is clear from the legislative history of section 936(h) that Congress understood that the ''intangibles-intensive industries'' that were partaking of the perceived abuse did not have customers or suppliers in the possession. Rather, they would simply set up a manufacturing operation in the possession to produce products from raw materials procured outside the possession for sale to the customers of the parent corporation or other subsidiaries, which were also located outside the possession. Thus, there was no concern that possessions corporations were earning excessive profits because of their ownership of goodwill and going concern value. In almost all cases, possessions corporations had no significant goodwill and going concern value. But the intangibles that Congress did perceive them to have were patents and trademarks and other similar intangibles of a type that would have been developed outside the possession and that could be legally transferred to the possessions corporation separately from the business of the U.S. transferor to which the intangibles related.

Thus, it seems highly likely that when Congress drafted the definition of the type of intangible property that would be subject to the deemed income inclusion of section 936(h), it did not have goodwill and going concern value in mind. That would explain why Congress did not specifically mention goodwill and going concern value — a common and often very valuable intangible — in section 936(h)(3)(B). The following quote from the blue book to the 1982 Tax Equity and Fiscal Responsibility Act supports that view:

> The Act is intended to lessen the abuse caused by taxpayers claiming tax-free income generated by intangibles *developed outside Puerto Rico*.[20] [Emphasis added.]

Goodwill and going concern value associated with a business in Puerto Rico would be developed in Puerto Rico. The types of intangibles that might be developed outside Puerto Rico and then transferred to a possessions corporation would be things other than goodwill and going concern value, such as patents and trademarks and similar items that can be transferred separately from the business of the U.S. transferor to which they relate — that is, the kinds of intangibles enumerated in section 936(h)(3)(B).

IRS Rationale

Although the IRS did not directly address this question in the proposed regulations, it has previously gone on record as stating that its position does not contradict statutory language. For example, the IRS asserted in TAM 200907024 that Congress did not specifically direct the agency (in the statutory language of section 367(d) or its legislative history) to exclude goodwill and going concern value from the scope of section 367(d). Under that view, if goodwill and going concern value is included in the section 936 definition, short of a discretionary carveout by the IRS, the language of the statute requires goodwill and going concern value to be covered by section 367(d) and not to be covered by section 367(a) (including the active trade or business exception).

If the IRS was authorized, but not specifically directed, to carve out goodwill and going concern value from the section 367(d) definition, it is arguably within the agency's discretion to not adopt a regulatory carveout and thereby allow the language of the statute to exclude all intangible property, including goodwill and going concern value, from the active trade or business exception in section 367(a). Under that view, the scope of the goodwill

[20]Joint Committee on Taxation, ''General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982,'' at 83 (1983).

and going concern value carveout (in the existing section 367(d) regulations) would arguably be a matter of broad executive branch discretion, subject to the possibility of elimination at any time at the discretion of the executive branch.

Prognosis on the Validity of the Proposed Rule

There are several factors (including those discussed above) that may affect the likelihood that this proposed rule will be stricken down by a court as invalid on constitutional grounds. Certainly at the top of the list is the determination of whether the proposed rule is inconsistent only with legislative intent or also with the legislation itself.

It is one thing to say that a regulation conflicts with congressional intent. That alone *might* lead to a finding by a court that the regulation in question is invalid. It is an entirely different thing to say that a regulation conflicts with the language of a federal statute. In that case, the Constitution should compel a court to find the regulation invalid as a matter of constitutional law.[21]

Even if it is correct to say that Congress did not specifically direct the IRS to exclude goodwill and going concern value from the scope of section 367(d), it is possible that Congress did not do so because it believed that the statute itself caused goodwill and going concern value to be subject to section 367(a) and not section 367(d). If a court found that to be the case, it would appear to be compelled by the Constitution to invalidate the proposed new rule.[22]

In contrast, if a court found that the definition in section 936(h)(3)(B) actually does include goodwill and going concern value, the proposed rule would not appear to conflict with the statute. In that case, its vulnerability under the Constitution would be less clear. As the IRS asserted in TAM 200907024, if section 936(h)(3)(B) includes goodwill and going concern value, the agency would not appear to be compelled by the statute to issue regulations carving out goodwill and going concern value from the definition of section 367(d) intangibles. And although it was clearly *authorized* by the legislative history to issue those regulations, the IRS may be correct to say that it was not compelled to do so. One potential weakness in that argument concerns the fact that the IRS did act, shortly after DEFRA, to create (or perhaps merely acknowledge) a carveout for goodwill and going concern value consistent with congressional intent. That would seem to raise a question of whether it is now authorized to act contrary to legislative intent by amending the regulations to eliminate that carveout.

Regardless of whether one agrees with the Fourth Circuit's apparent expansion of the scope of *Chevron* deference in *King*, the IRS might argue that the *Chevron* decision itself requires judicial deference to the proposed new rule's change in the scope of the active trade or business exception.[23] Note that *Chevron* dealt with a situation in which the executive branch agency (the Environmental Protection Agency) sought to redefine a term used in a statute to mean something different than what that same agency had previously defined that term to mean, based on policies of a newly incumbent administration (the Reagan administration). That would seem to provide the IRS with a strong argument that even though its proposed new treatment of goodwill and going concern value is different from its interpretation back in 1986, the proposed new rule is still entitled to *Chevron* deference if that interpretation is consistent with the policies of the Obama administration (which is clearly the case here[24]).

But that argument seems to overlook what might be viewed as a critical aspect of the holding in *Chevron*: Specifically, *Chevron* involved a situation whereby Congress had not provided *any* guidance in the statute or its legislative history regarding the meaning of the term in question. Under those circumstances, the Supreme Court determined that "an agency to which Congress has delegated policymaking responsibilities may, *within the limits of that delegation*, properly rely upon the incumbent administration's views of wise policy to inform its judgments" (emphasis added). But are those the same circumstances surrounding the proposed restriction of the active trade or business exception to cover only tangible property?

Unlike the fact pattern in *Chevron*, we seem to have a situation here in which Congress, when it revised section 367 back in 1984, provided some fairly clear guidance in the legislative history, to the effect that Congress believed that goodwill and going concern value should qualify for the active trade or business exception. It would seem a bit of a stretch to interpret *Chevron* to require deference to

[21]*But see King*, 135 S. Ct. 2480, in which the Supreme Court determined that the allowance by regulation of tax credits for insurance coverage purchased on "an Exchange established . . . by the Secretary of Health and Human Services" satisfied the statutory requirement that the coverage must be purchased on "an Exchange established by the State." In light of that finding, Justice Antonin Scalia observed in his dissenting opinion that "words no longer have meaning." *Id.* at 2497.

[22]*See* discussion of *King*, *supra* note 21.

[23]This argument assumes that goodwill and going concern value is included in the definition of intangible property in section 936(h)(3)(B).

[24]*See* Treasury, "General Explanations of the Administration's Fiscal Year 2013 Revenue Proposals," at 90 (Feb. 2012).

a change in the IRS's position away from one that was largely consistent with congressional intent to one that is clearly inconsistent with congressional intent. That would not seem to be within the limits of Congress's delegation of policymaking responsibilities to Treasury and the IRS in DEFRA.

It is interesting to note that when the IRS ran into similar problems with tax-motivated valuations of goodwill and going concern value and other intangibles in the rules for depreciation and amortization, it was Congress that had to step in to resolve the problem through legislation (with the enactment of section 197 as part of the Omnibus Budget Reconciliation Act of 1993). Constitutional separation of powers principles would seem to make that the more appropriate resolution here.

It may be that Congress is unwilling or unable to amend section 367 to bring it in line with the tax policies that the current administration deems important. But as the debates in the healthcare and immigration areas have demonstrated, there is a real question under the Constitution of whether a lack of action by Congress gives the administration license to change the law on its own.