2017

Corporate Tax Developments: Tax Reform and Beyond (Power Point)

Lisa M. Zarlenga
Cameron Arterton

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William & Mary Tax Conference

Corporate Tax Developments: Tax Reform and Beyond

Lisa Zarlenga
Steptoe & Johnson LLP

Cameron Arterton
Biotechnology Innovation Organization
Agenda

- Tax Reform
- Extenders?
- Withdrawal of Proposed No Net Value Regulations
- Changes in IRS Private Letter Ruling Program
- Treasury Report on Regulatory Reform
- Priority Guidance Plan
- Administrative Procedure Act Challenges
Tax Reform
Tax Reform – Major Initiatives

- Camp Tax Reform Act of 2014
- Senate Finance Committee bipartisan working group reports 2015
- House Blueprint for Tax Reform (June 2016)
- Hatch Corporate Integration (unreleased)
- Trump Administration one-pager (April 2017)
- Joint Statement of Big Six (July 2017)
- Unified Framework (September 2017)
- Chairman Brady’s Mark (November 2, 2017)
# Tax Reform – Summary of Major Initiatives

<table>
<thead>
<tr>
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<tbody>
<tr>
<td>Tax rates</td>
<td>35% corporate</td>
<td>20% corporate</td>
<td>15% business</td>
<td>25% corporate</td>
<td>20% corporate</td>
<td>20% corporate</td>
</tr>
<tr>
<td>Pass-through tax rates</td>
<td>Taxed at individual owners' rates</td>
<td>25% pass-throughs</td>
<td>15% business</td>
<td>Taxed at individual owners' rates; maximum rate of 25% on domestic mfg income</td>
<td>25% pass-throughs (with unspecified anti-avoidance measures)</td>
<td>25% on “qualified business income” of pass-throughs; alternative formulas to determine capital % (treated as QBI); default capital % for personal services businesses is zero; labor % is subject to self-employment tax; rate N/A to investment income</td>
</tr>
<tr>
<td>Capital gains/dividend tax rates</td>
<td>0%/15%/20% on capital gains and qualified dividends, plus 3.8% net investment income tax for highest earners</td>
<td>50% deduction for capital gains, dividends, and interest income; repeal net investment income tax</td>
<td>Repeal net investment income tax</td>
<td>40% deduction of adjusted net capital gain</td>
<td>No change</td>
<td></td>
</tr>
</tbody>
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*Steptoe & Johnson LLP*
## Tax Reform – Summary of Major Initiatives (cont.)

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<tr>
<td>Cost recovery of capital investments</td>
<td>Depreciation deductions over time</td>
<td>100% expensing</td>
<td></td>
<td>Extends cost recovery periods; maximum $250K on expensing of business property (reduced on investment above $800K)</td>
<td>New investment after 9/27/2017 eligible for full expensing for at least five years</td>
<td>New investment after 9/27/2017 and before 1/1/2023 eligible for full expensing; section 179 expensing increased to $5M through 2023</td>
</tr>
<tr>
<td>Deductions and credits</td>
<td>Numerous deductions and credits</td>
<td>Eliminate all except R&amp;D credit</td>
<td></td>
<td>“Eliminate tax breaks for special interests”</td>
<td>Domestic production deduction (section 199) repealed; other unspecified tax benefits also repealed; R&amp;D credit, LIHTC repealed; R&amp;D credit, LIHTC remain</td>
<td>Repeal section 199, deduction for transp., entertainment, rehab. credit, WOTC; carryover of general business credit repealed; R&amp;D credit, LIHTC remain</td>
</tr>
<tr>
<td>Interest expense</td>
<td>Deductible</td>
<td>Disallow deduction for net interest expense</td>
<td></td>
<td>Limits interest deduction of US shareholder of a CFC part of the same worldwide affiliated group</td>
<td>Net interest expense deductions limited for C corporations; treatment for non-corporate entities unspecified</td>
<td>Net interest expense deduction limited to 30% of business’s adjusted taxable income; Limitation on interest expense deduction of certain U.S. corp based on share of group EBITDA</td>
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<tr>
<td>NOLs</td>
<td>NOLs carried back 2 years and forward 20 years</td>
<td>NOLs carried forward indefinitely with interest factor, limited to 90% of net taxable amount; no NOL carrybacks</td>
<td>NOLs limited to 90% of taxable income; repeals special carryback rules</td>
<td></td>
<td></td>
<td>NOLs limited to 90% of taxable income; repeals carryback rules (except permits 1-year carryback for small businesses and farms in case of casualty losses; allows interest factor on carryforwards)</td>
</tr>
<tr>
<td>Deemed repatriation</td>
<td>No current provision (voluntary holiday in 2004)</td>
<td>Mandatory tax on previously untaxed foreign earnings - 8.75% cash; 3.5% other assets – payable over 8 years</td>
<td>“One-time tax on trillions of dollars held overseas”</td>
<td>Mandatory tax on previously untaxed foreign earnings – 8.75% cash; 3.5% other assets, less proportional foreign tax credit – payable over 8 years</td>
<td>Mandatory tax on previously untaxed foreign earnings at unspecified bifurcated rate</td>
<td>Mandatory tax on previously untaxed earnings determined as of 11/2/2017 or 12/31/2017 (whichever is higher) – 12% cash; 5% other assets – payable over 8 years</td>
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<tr>
<td>International</td>
<td>Tax worldwide profits (tax deferred on active foreign earnings until repatriated to US)</td>
<td>Tax only US sales, services, and intangibles (based on destination); 100% exemption for dividends</td>
<td>Territorial tax system</td>
<td>95% exemption for dividends from 10% subsidiaries</td>
<td>Territorial system with 100% dividend exemption; global minimum tax; other unspecified anti-base erosion measures</td>
<td>Territorial system with 100% dividend exemption; largely retains subpart F (except repeals foreign based company oil related income); inventory income from within/without US sourced based on activities; current US tax on 50% of US parent’s “foreign high returns” (excess of foreign income over routine return)</td>
</tr>
<tr>
<td>operations</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Imports/exports</td>
<td>Included in corporate tax base if company is subject to US tax</td>
<td>Border adjustments: Imports are taxed; exports are exempt</td>
<td></td>
<td>No border adjustments</td>
<td></td>
<td>20% excise tax on deductible payments to related foreign corporations, unless elect to treat as effectively connected income</td>
</tr>
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Steptoe & Johnson LLP
Senate Finance Committee Background

Senate Finance Committee Working Groups

- Five bipartisan tax reform working groups
  - Business income
  - Community development & infrastructure
  - Individual tax
  - International tax
  - Savings & investment

- Reports released July 2015
Senate Finance Committee Background

Senate Finance Committee Working Groups (cont’d)

Business income tax working group report

- Support for lower corporate rate
- Must find ways to help passthroughs too
  - Options to ensure equitable treatment:
    - Business equivalency rate
    - Targeted tax benefits for passthroughs
    - New deduction for active passthrough business income
- Further consideration of corporate integration recommended
- Ways to promote savings and investment through moving to a consumption tax base examined
Senate Finance Committee Background

Senate Finance Committee Working Groups (cont’d)

International tax working group report

- Recommended overhaul of current system
- Recommended dividend exemption regime with base erosion rules
- Recommended net interest limitations and one-time tax on previously untaxed foreign income
- Minimum tax on foreign earnings also examined
Senate Finance Committee Background

Corporate Integration: Finance Chairman Hatch proposal to partially integrate the corporate and individual tax systems (not formally released)

- Proposal understood to reduce or eliminate double taxation through establishment of a corporate dividends-paid deduction (DPD)
  - Corporation withholds [35]% tax on gross amount of all dividends
  - Withheld amount would be a “nonrefundable credit” for the shareholder
- 20% preferential rate for qualified dividends would be repealed
- Corporation withholds [35]% tax on the gross amount of interest paid to creditors

Policy rationale
- Narrow tax treatment gap between C corps and pass-throughs
- Create some incentive to repatriate foreign earnings
- Eliminate tax code bias in favor of debt
- Withholding tax on interest viewed as curbing “earnings stripping”
Extenders?
Extenders?

- Protecting Americans for Tax Hikes Act of 2015 (PATH Act) permanently extended some provisions, but extended others only temporarily.
- Current plan to address expiring provisions in tax reform.
  - If tax reform does not happen this year, possible end of the year extenders package.
- Tax reform plan may create new extenders by adopting temporary provisions.
Extenders? (cont.)

PATH Act: Tax Extenders 2015

- Permanent provisions include
  - R&D credit
  - Election to deduct State and local general sales taxes
  - 15-year recovery period for qualified leasehold improvements, property, and qualified retail improvement property
  - Exception from subpart F income for active financing income
  - Various charitable and S corporation provisions

- 5-year extensions
  - CFC look-thru rule
  - Work opportunity tax credit
  - New markets tax credit
  - Bonus depreciation: phased down -- 50% for property placed in service during 2015, 2016 and 2017; 40% for 2018; and 30% for 2019
Extenders? (cont.)

PATH Act: Tax Extenders 2015

- Many provisions extended for two years (2015 and 2016)
  - Credit for nonbusiness energy property (extended and modified)
  - Credit for alternative fuel vehicle refueling property
  - Credit for two-wheeled plug-in electric vehicles
  - Second generation biofuel producer credit
  - Biodiesel and renewable diesel incentives
  - Credits with respect to facilities producing energy from certain renewable resources
  - Credit for energy-efficient new homes
  - Special allowance for second generation biofuel plant property
  - Energy efficient commercial buildings deduction
  - Excise tax credits relating to alternative fuels
  - Credit for new qualified fuel cell motor vehicles
  - Exclusion from gross income of discharge of qualified principal residence indebtedness
  - Treatment of mortgage interest premiums as qualified residence interest
  - Classification of certain race horses as three-year property
  - Seven-year recovery period for motorsports entertainment complexes
  - Special expensing rules for certain film and television productions
Extenders? (cont.)

Additional Energy Provisions?

- "Orphans" (energy technologies left out of investment tax credit extension, including fuel cells, small wind, geothermal heat pumps)
- Amendments to 45J (nuclear production tax credit)
- Amendments to 45Q (carbon capture and sequestration tax credit)
Extenders? (cont.)

"Reverse Extenders" may increase pressure to act in 2017 outside tax reform

- Delayed the 40% "Cadillac tax" on high-cost health plans until 2020
  - Cadillac tax delayed until the beginning of 2020
- Suspended medical device excise tax for calendar years 2016 and 2017
- Suspended annual fee on health insurance providers for one year, during 2017
Withdrawal of Proposed No Net Value Regulations
No Net Value Proposed Regulations

- On March 10, 2005, Treasury and the IRS issued proposed regulations regarding corporate formations, reorganizations, and liquidations of insolvent corporations (the “Proposed Net-Value Regulations”).

- The Proposed Net-Value Regulations generally:
  - Required the exchange (or, in the case of a section 332 liquidation, the distribution) of net value for the nonrecognition rules of sections 332, 351, and 368 to apply;
  - Required the recipient corporation of a section 332 liquidation receive some payment for each class of stock it owns in the liquidating corporation; and
  - Clarified the extent to which creditors are proprietors of the corporation in determining whether continuity of interest is preserved in a potential reorganization (“Creditor Continuity of Interest”).
No Net Value Proposed Regulations (cont.)

- Regulations Adopted as Final:
  - On December 12, 2008, Treasury and the IRS adopted the Creditor Continuity of Interest provisions as final regulations.
  - On March 28, 2016, minor portions of the proposed regulations that reflected statutory changes to sections 332 and 351 were also adopted as final regulations as part of a Treasury decision adopting final regulations under sections 334(b)(1)(B) and 362(e)(1).

- On July 12, 2017, the IRS and Treasury withdrew the remaining 12-year-old proposed regulations under the view that:
  1) Current law is sufficient to ensure that the reorganization provisions and section 351 are used to accomplish readjustments of continuing interests in property held in modified corporate form; and
  2) Certain authorities and legislative history continue to reflect the position of the Treasury Department and the IRS with respect to section 332 liquidations.
No Net Value Proposed Regulations (cont.)

- Where does that leave us?
  - Liquidations
    - Proposed no net value regulations did not change this.
    - However, the proposed regulations contained a rule that analyzed separate classes of stock separately. With respect to those classes of stock for which no payment is received, the proposed regulations refer to section 165(g) worthless stock deductions, and with respect to those classes of stock for which payment is received, the proposed regulations refer to section 368(a)(1) regarding a potential reorganization or to section 331 if the distribution does not qualify as a reorganization.
No Net Value Proposed Regulations (cont.)

■ Where does that leave us?
  – Reorganizations
    • For tax-free reorganizations under section 368, the proposed regulations required that there be both a surrender and a receipt of net value. Prop. Treas. Reg. §1.368-1(f)(1).
    • Current law: Sideways merger of an insolvent corporation into a sister corporation is tax free. See Norman Scott, Inc. v. Commissioner, 48 T.C. 598 (1967), acq. in result only, AOD 1967-104 (Dec. 7, 1967); Rev. Rul. 54-610, 1954-2 C.B. 152; see also G.C.M. 33859 (June 25, 1968).
No Net Value Proposed Regulations (cont.)

- Where does that leave us?
  - Section 351 transactions

  - The proposed regulations provided that stock would not be treated as issued for property if either: (i) FMV of the transferred property does not exceed the sum of the liabilities assumed and the amount of money and FMV of any other property received, or (ii) FMV of the assets of the transferee does not exceed the amount of its liabilities immediately after the transfer (i.e., the transferee is insolvent). Prop. Treas. Reg. §1.351-1(a)(1)(iii).

  - Current law is mixed. Some courts have held that section 351 applies to the incorporation of an insolvent corporation, see Focht v. Commissioner, 68 T.C. 223 (1977); Rosen v. Commissioner, 62 T.C. 11 (1974); Sohmer & Co., Inc. v. U.S., 86 F.Supp. 670 (S.D.N.Y. 1949), but others have held that section 351 does not apply, see DeFelice v. Commissioner, 386 F.2d 704 (10th Cir. 1967); Meyer v. U.S., 129 Ct. Cl. 214 (1954)
Changes in IRS Private Letter Rulings Program
Section 355 PLR Pilot – Rev. Proc. 2017-52 (cont.)

- Documents – Must be highlighted or underscored to show the relevant portion or portions and relevant portions summarized.
  - For purposes of section 11.05(1) of Rev. Proc. 2017-1 (conditions under which a letter ruling may be revoked), a determination whether there has been a misstatement or omission of controlling facts is made *solely on the basis of the information in the body of the request and without regard to any documents or other attachments*, including those provided pursuant to section 3.02 of Rev. Proc. 2017-52.

- Representations - Must include a statement that, except as otherwise set forth in the submission, the taxpayer makes all the representations in section 3 of the Appendix to Rev. Proc. 2017-52 in the form set forth therein.
  - If any of the representations does not apply, the taxpayer should so state and explain why the representation does not apply.
  - If the taxpayer cannot make the representation in the form set forth in the Appendix, the taxpayer must explain its inability to make the representation in that form and, if appropriate, make a modified representation.

- Introduces 18-month pilot program expanding the scope of letter rulings available from the IRS to include rulings on the general federal income tax consequences of a Covered Transaction.
  - Covered Transaction means (i) a transaction intended to qualify under sections 368(a)(1)(D) and 355 or (ii) a distribution that is intended to qualify under section 355(a) and 355(c).

- Prior standard – Rev. Proc. 2013-32, the IRS would rule only on significant issues raised in these transactions (Significant Issue Ruling).

- Different ruling standards for Covered Transaction Ruling and Significant Issue Ruling.

- Comfort rulings – The IRS will issue comfort rulings on Covered Transactions, but not on international issues.

- Pilot program expires on March 21, 2019.

- The IRS requests comments on all aspects of this revenue procedure; comments due by December 31, 2017.
IRS Statement on Changes to Certain PLRs

- On October 13, the IRS issued a “statement” to “inform taxpayers and their advisers of changes relating to requests for private letter rulings on certain corporate transactions.”
  - The IRS stated that it was reconsidering its views regarding certain issues studying these issues.

- No rule – In connection with a worthless stock loss under section 165(g)(3)(B), IRS will no longer rule on whether the character of gross receipts received by a consolidated group member in an intercompany transaction may be redetermined by reference to the character of the source funds possessed by the counter party to the intercompany transaction.
Substantial scrutiny, but IRS will still rule

- If, in connection with a section 355 distribution, a distribution of stock, securities, or other property to the distributing corporation’s shareholders or creditors is substantially delayed, rulings will no longer be based solely on the length of the delay and will be subject to substantial scrutiny.

- IRS will increase its scrutiny and analysis of “drop-spin-liquidate” and similar transactions, but will continue to rule in accordance with prior practice on such transactions (including “Morris Trust” and “reverse Morris Trust” transactions) if the distributing corporation or the controlled corporation are not related before the acquisition.

For example, a corporation may distribute the stock of a subsidiary in a transaction potentially subject to section 355, and as part of the same plan the distributing corporation or the subsidiary may liquidate into a corporate parent or may merge into or otherwise be acquired by its corporate parent or another related corporation.
IRS Statement on Changes to Certain PLRs (cont.)

- Substantial scrutiny, but IRS will still rule
  - IRS will increase its scrutiny and analysis of potential reorganizations that result in transfers of a portion of a subsidiary's assets to its corporate shareholder, if the transfer does not qualify under section 332 or section 355 but is intended to be tax-free.
    - For example, a corporate subsidiary may convert into a limited liability company that is treated as a disregarded entity owned by its parent. As part of the same plan, the disregarded entity distributes a portion of its assets to the parent and then either elects to be taxed as a corporation or converts back into a corporation (either in the same state as the state of incorporation of the original subsidiary or a different state).

- PLRs issued previously on these matters are not affected.
Treasury Report on Regulatory Reform
Treasury Report on Regulatory Reform

- Required by Executive Order 13789: directed Treasury Secretary to identify significant tax regulations issued on or after January 1, 2016 that:
  - Impose an undue financial burden on US taxpayers;
  - Add undue complexity to the federal tax laws; or
  - Exceed the statutory authority of the IRS.

- Interim Report: June 22, 2017
  - Identified eight regulations for review.
  - Treasury and the IRS received more than 140 comments (plus thousands of “form” comments) on the eight regulations identified in the interim report.

- On October 4, Treasury released “Second Report to the President on Identifying and Reducing Tax Regulatory Burdens” (dated October 2).
  - Contains recommendations for eight regulations identified in interim report.
Treasury Report on Regulatory Reform (cont.)

- **Complete Withdrawal:**
  - Proposed regulations under section 2704 on restrictions on liquidation of an interest for estate, gift, and generation-skipping transfer taxes.
    - No mention of revised regulations.
  - Proposed regulations under section 103 on the definition of a “political subdivision.”
    - May issue “more targeted guidance” in the future.

- **Revoke in Part:**
  - Final and Temporary regulations under section 385 on the treatment of certain interests in corporations as stock or indebtedness.
    - Revoke documentation regulations.
    - Reconsider need for distribution regulations if tax reform does not obviate the need for them.
Treasury Report on Regulatory Reform (cont.)

- **Revoke in Part (cont.):**
  - Regulations under section 707 and section 752 regarding the treatment of partnership liabilities.
    - Proposed and temporary regulations governing how liabilities are allocated for purposes of disguised sale treatment may be revoked while “novel approach” is examined further.
    - Bottom dollar guarantees rules retained.
  - Final regulations under section 7602 on the participation of a person described in section 6103(n) in a summons interview.
    - Prospectively narrow the scope of the regulations by prohibiting the IRS from enlisting outside lawyers to participate in an examination, but would continue to allow outside subject-matter experts to participate in a summons proceedings.

- **Substantially Revise:**
  - Final regulations under section 367 on the treatment of certain transfers of property to foreign corporations.
    - Considering expanding the scope of the active trade or business exception to include relief for outbound transfers of foreign goodwill and going-concern value attributable to a foreign branch under circumstances with limited potential for abuse and administrative difficulties, including those involving valuation.
Treasury Report on Regulatory Reform (cont.)

- **Substantially Revise (cont.):**
  - Temporary regulations under section 337(d) on certain transfers of property to regulated investment companies (RICs) and real estate investment trusts (REITs).
    - Considering revisions to limit the potential taxable gain recognized where a small corporation engages in a spin-off and then is acquired by a large company that is or elects to become a REIT.
  - Final regulations under section 987 on income and currency gain or loss with respect to a section 987 qualified business unit.
    - Propose modifications to permit taxpayers to elect to adopt a simplified method of calculating section 987 gain and loss and translating section 987 income and loss, subject to certain limitations on the timing of recognition of section 987 loss.
    - Also considering alternative loss recognition timing limitations that would apply to electing taxpayers, as well as alternatives to the transition rules in the final regulations.
Treasury Report on Regulatory Reform (cont.)

- Additional Comments
  - Treasury continues to analyze all recently issued significant regulations.
  - Considering possible reforms of several regulations not identified in the interim report, including:
    - Regulations under section 871(m) (relating to payments treated as US source dividends); and
    - The Foreign Account Tax Compliance Act (FATCA).
  - Additional comprehensive review of all tax regulations identified more than 200 regulations for potential revocation that are unnecessary, create undue complexity, impose excessive burdens, or fail to provide clarity and useful guidance.
    - Treasury and the IRS expect to begin the rulemaking process for revoking these regulations in the fourth quarter of 2017.
Priority Guidance Plan
2017-2018 Priority Guidance Plan

- On October 20, Treasury and the IRS released their 2017-2018 Priority Guidance Plan.

- Priority Guidance Plan takes into account the burden-reducing policies and reforms described in Executive Orders 13789 and 13777.
  - Part 1 of the plan includes the modifications to the eight regulations identified in Treasury’s Report on Regulatory Reform.
  - Part 2 of the plan includes other burden reducing projects, including section 871(m) and FATCA.
  - Part 3 of the plan includes projects that implementation of the new statutory partnership audit regime.
  - Part 4 of the plan, like past years’ plans, describes specific projects by subject area.
Administrative Procedure Act

Challenges
Altera Corp. v. Commissioner

- In *Altera Corp. v. Commissioner*, 145 T.C. 91 (2015), the Tax Court held that a 2003 final Treasury regulation that requires participants in qualified cost-sharing arrangements to share stock-based compensation costs to achieve an arm's-length result is arbitrary and capricious and therefore invalid.

- The Tax Court held that the regulation was a legislative rule, not an interpretive rule, because it has the force of law.
  - The court relied on section 7805(a), concluding that Congress had delegated legislative power to Treasury, and Treasury intended to exercise that power when it issued the final rule.

- The Tax Court found that the final regulation lacked a basis in fact; that Treasury failed to rationally connect the choice it made in drafting the regulation with the facts found and to respond to significant comments when it issued the final regulation; and that Treasury's conclusion that the final regulation is consistent with the arm's-length standard is contrary to all the evidence before it.
  - Thus, the Tax Court held that the final regulation was invalid, explaining that Treasury failed to satisfy the reasoned decision-making standard in *Motor Vehicle Mfrs. Ass'n of the U.S. v. State Farm Mut. Auto Ins. Co.*, 463 U.S. 29 (1983).

- The case is on appeal before the 9th Circuit Court of Appeals.
Chamber of Commerce v. IRS

- In *Chamber of Commerce v. IRS*, 2017-2 USTC ¶50,361 (W.D. Tx 2017), the district court held that the 2016 temporary anti-inversion regulations governing so-called serial acquisitions were unlawfully issued because they did not adhere to the Administrative Procedure Act’s notice and comment requirements.
  - The temporary regulation was effective immediately and was simultaneously issued as a proposed regulation subject to notice and comment.
- The court concluded that the temporary regulation was within the IRS’s statutory authority and was not arbitrary and capricious.
- However, the court held that the temporary regulation did not meet the required 30-day minimum notice and comment period.
  - The court concluded that the statute does not expressly exempt temporary regulations from the APA’s notice and comment requirement.
  - The court also concluded that the regulation did not satisfy the interpretive rule exception, because it provided a substantive or legislative rule by changing the computation for determining whether a corporation would be treated as a surrogate foreign corporation by directing that certain stock that would otherwise be included in the calculation is excluded.