Pat Smith Quoted in Tax Notes on Third Circuit Case on CFC Loan Guarantees

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Ivins attorney Pat Smith was quoted in *Tax Notes* on the Third Circuit appeal in *SIH Partners*, involving a challenge to a regulation treating CFC loan guarantees as investments in U.S. property under section 956. *CFC Loan Guarantee Appeal Approaches Fully Briefed Deadline*.

> Patrick J. Smith of Ivins, Phillips & Barker Chtd. had previously voiced discontent at the Tax Court's comparison [between the facts in this case and the facts in the Supreme Court's *State Farm* decision], but shifting his focus to the merits of the arguments, he told *Tax Notes* that the government is correct to reject SIH's argument that section 956 needs a facts-and-circumstances inquiry every time.
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> > "The government is clearly correct that all the statutory rules in section 956 are extremely mechanical, and that, as a result, the appropriate inquiry under section 956 is clearly not whether there has been an actual repatriation of earnings to the U.S. before section 956 can require an income inclusion," Smith said, adding that the mechanical nature of the statute makes it appropriate for the regs to likewise be mechanical. "The fact that the taxpayer can point to revenue rulings that departed from a mechanical application of the rules in very extreme factual circumstances clearly does not translate into a general principle that every application of section 956 requires a facts-and-circumstances inquiry."

Smith argued that the government was correct to differentiate *SIH* from *Good Fortune Shipping* since nothing in the statute at issue in the latter provided a basis for regs that would exclude a

type of stock from being considered in determining ownership of a corporation that issued bearer stock.

But the taxpayer also put forth a persuasive argument when asserting that the regs were arbitrary and unreasonable in failing to avoid double income inclusions when multiple CFCs guarantee the same loan, Smith continued. The failure to provide any explanation for this part of the rules at the time the regs were issued does open the rules to challenge under the reasoned decision-making [standard], Smith said.

> "The government's assertion that this aspect of the regulations is reasonable and does not result in double counting even where the resulting total income inclusions exceed the amount of the loan that is guaranteed is extremely unpersuasive. This position is so completely untenable that it risks undercutting the government's entire case," Smith argued. "The fact that no commenter on the proposed regulations commented on this aspect of the regulations is not relevant, since this weakness in the regulations is so obvious."

But this failure of the regs to limit total income inclusion is "not really a fundamental flaw," Smith added, because the limitation could be easily superimposed on the operation of the rules. Either the IRS or a court could require the limitation, he surmised.

> "The government is on much stronger ground in pointing out that the factual situation in this case simply does not involve income inclusions that exceeded the amount of the loan that was guaranteed. On balance, I think that because of this factor and [the aforementioned others] . . . the government should probably prevail in this case," Smith said.