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# A Domestic Disturbance: The Seventh Circuit Encroaches on Foreign Related Party Transactions

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## **A DOMESTIC DISTURBANCE: THE SEVENTH CIRCUIT ENCROACHES ON FOREIGN RELATED PARTY TRANSACTIONS**

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Cite as: Erica S. Khalili, *A Domestic Disturbance: The Seventh Circuit Encroaches on Foreign Related Party Transactions*, 2 SEVENTH CIRCUIT REV. 443 (2006), at <http://www.kentlaw.edu/7cr/v2-1/khalili.pdf>.

### INTRODUCTION

When does deference to administrative regulation, that seeks to prevent corporate fraud, cross the line from protecting the investor to adversely impacting capital markets and the US economy? On February 13, 2006, the U.S. Court of Appeals for the Seventh Circuit, in a case of first impression for this circuit, addressed and upheld the validity of a treasury regulation that requires taxpayers to use the cash basis method of accounting when claiming deductions for interest payments made to foreign related parties.<sup>1</sup> The only other circuit court of appeals to address this issue was a similarly-minded Third Circuit.<sup>2</sup> However, the reasoning and rationale of both the Seventh and Third Circuits marks a departure from the interpretation advocated by the lower Tax Court in *Tate & Lyle*.<sup>3</sup> These appellate decisions evidence a continued trend of deference toward administrative regulation; all in

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<sup>1</sup> *Square D Co. v. Comm'r of the Internal Revenue Serv.*, 438 F.3d 739 (7th Cir. 2006).

<sup>2</sup> *Tate & Lyle v. Comm'r of Internal Revenue Serv.*, 87 F.3d 99 (3d Cir. 1996).

<sup>3</sup> *Tate & Lyle v. Comm'r of Internal Revenue Serv.*, 103 T.C. 656 (1994).

an effort for prevention of fraud and deceit in corporate America and protection of U.S. tax revenue.<sup>4</sup>

In *Square D Co. and Subsidiaries v. Commissioner of the Internal Revenue Service*, the Seventh Circuit upheld the validity of Treasury Regulation § 1.267(a)(3) (the “Regulation”) which requires U.S. corporations to utilize the cash basis method of accounting when deducting interest payments made to foreign related parties.<sup>5</sup> This interpretation of the Regulation, given the potential for abuse and manipulation of the underlying transactions, places a necessary burden on U.S. companies who seek to globalize and engage in transactions with foreign parents or subsidiaries.<sup>6</sup> Although the Seventh Circuit’s interpretation is correct, the reasoning supporting its decision is lacking. Practically, the level of deference shown in this decision marks the potential for a descent down a slippery slope in the regulation of U.S. companies with related foreign parties. The broad reach of the power of the Secretary, upheld by the Seventh Circuit, leaves open the question of how far U.S. companies can and should be regulated via administrative regulation. As an extreme example, if the Treasury Secretary can require companies to use cash basis accounting for these transactions, it does not seem to be outside the realm of possibility that the Secretary could issue a regulation disallowing interest deductions when such transactions are with foreign related parties. This wave of regulation is on the cusp of over regulation and, in light of increasing deference by courts, could result in discouraging U.S. participation in global finance leading to an adverse economic impact on the American companies and investors.

The first section of this Note provides background on the differences between cash basis and accrual accounting methods and relevant reasons for utilizing each. The second section of this Note details the context of corporate regulation and its effect on American companies in a global market place. The third section of this Note contains an analysis of rationale for the Seventh Circuit’s

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<sup>4</sup> See, e.g., *Tate & Lyle*, 87 F.3d 99.

<sup>5</sup> *Square D*, 438 F.3d at 747.

<sup>6</sup> See *id.*

interpretation of Treasury Regulation § 1.267(a)-(3) in *Square D Company v. Commissioner of the Internal Revenue Service*, and the relevant arguments against the Seventh Circuit's interpretation. Finally, the last section of this Note concludes that although the Seventh Circuit's decision was correct, based on the language and legislative history of the Code, the decision ignored several compelling arguments and should not be interpreted broadly to indicate that courts need not aim a critical eye toward administrative regulations aimed at preventing fraud.

### I. BACKGROUND

The Internal Revenue Code (the "Code") § 163(a) permits a taxpayer to take a deduction on all interest paid, and in certain circumstances on all interest accrued on indebtedness, within a taxable year.<sup>7</sup> However, other provisions of the Code determine which of these two alternatives is applicable.<sup>8</sup> Special rules govern deductions taken based on transactions with related parties.<sup>9</sup> There are certain types of payments to related parties, for example interest payments, where a taxpayer can claim a deduction.<sup>10</sup> The Code grants the Secretary of the Treasury the power to enact regulations regarding payments to foreign related parties and generally requires the cash basis method of accounting to be utilized when claiming a deduction based on a transaction with a foreign related party.<sup>11</sup> Yet, there are a limited number of exceptions for certain types of payments to foreign related parties that do not have to utilize the cash basis method of accounting.<sup>12</sup>

<sup>7</sup> I.R.C. § 163(a) (2006).

<sup>8</sup> I.R.C. § 448 (a), (b)(3) (2002).

<sup>9</sup> I.R.C. § 267 (2004) (noting in § 267 (a)(1) that generally, a taxpayer cannot take a deduction for a loss from a sale or exchange of property with a related person).

<sup>10</sup> I.R.C. § 267.

<sup>11</sup> *See, e.g.*, I.R.C. § 267(a)(3).

<sup>12</sup> *See, e.g.*, Treas. Reg. § 1.267(a)-3(c)(2) (2006) (noting items exempt from taxation by treaty).

The accrual method of accounting differs from the cash basis method in many notable respects.<sup>13</sup> For example, under the “all events test” of the accrual method, a corporation must include “income and deductions in the taxable year in which the income or liability is fixed and can be determined with ‘reasonable accuracy.’”<sup>14</sup> This differs from the cash basis method, which requires a corporation to include all income and deductions for the year in which the expenses are actually paid or received.<sup>15</sup> In other words, cash basis and accrual accounting use different standards and criteria to determine when revenues and expenses must be recognized and recorded.<sup>16</sup> Under the cash basis method, income and expenses are never counted until money comes in or goes out.<sup>17</sup> Under the accrual method because transactions are counted when the event occurs, a company does not have to wait until the money is actually paid or received to record the transaction.<sup>18</sup> The only meaningful difference between these two methods of accounting is in the timing of when transactions are accounted for or recorded.<sup>19</sup>

A number of factors often determine the decision of whether a company will utilize the cash basis or accrual method of accounting. Initially, some corporations are required by the Code to utilize a

<sup>13</sup> See *Square D v. Comm’r of the Internal Revenue Serv.*, 438 F.3d 739, 741-42 (7th Cir. 2006).

<sup>14</sup> *Id.* (citing Treas. Reg. § 1.446-1(c)(ii) (2006)).

<sup>15</sup> I.R.C. § 446(c)(1), (2) (2006); Treas. Reg. § 1.446-1(c)(i).

<sup>16</sup> See *Tate & Lyle, Inc. v. Comm’r of Internal Revenue*, 103 T.C. 656, 668-69 (1994).

<sup>17</sup> *Id.*

<sup>18</sup> *Id.* For example, if a corporation makes a purchase on credit, and takes the purchase in 2006, but does not pay for it until 2007 the way in which the expense is recorded varies between the cash basis and accrual methods of accounting. Using the cash basis method, you would record the expense in the 2007, the year when you actually paid for the purchase. However, under the accrual method, you would record the expense in 2006, when you take the purchase and incur the obligation to pay for it.

<sup>19</sup> The substance of this Note deals only with recording and reporting of transactions for purposes of taxation. It should be noted that many large companies record transactions, depreciation, etc. differently for purposes of management and make adjustments for purposes of taxation.

specific method of accounting.<sup>20</sup> Businesses are required to use the accrual method in several instances: if the business has inventory; if the business is a C corporation; or if gross annual sales exceed five million dollars, with certain exceptions for personal service companies, sole proprietorships, farming business, and a few others.<sup>21</sup>

However, accrual accounting can be more costly to maintain, because it requires the recording of more transactions.<sup>22</sup> Cash basis accounting is easier for smaller, simpler companies that do not have a great deal of transactions or credit involved in their business models.<sup>23</sup> In deciding which method to utilize, corporations should consider the opinions and interests of their creditors, shareholders, and the reporting authorities including the Internal Revenue Service (“IRS”).<sup>24</sup> Generally, for large corporations and complex entities, cash basis may be inadequate because it not only fails to project future cash flows anticipated in the subsequent years by the corporation, but it also does not provide a proper analysis of the economics of the organization, thus hindering management decision making.<sup>25</sup>

Critics of allowing accrual accounting for tax purposes cite the ease of manipulation in order to justify the imposition of a mandatory cash basis method.<sup>26</sup> Because under the accrual method, cash basis is not tracked, it is easier for related parties to concoct situations where transactions are made strictly to avoid tax liability.<sup>27</sup> For example, a parent corporation could make a loan to its subsidiary. The subsidiary could then deduct its interest payments every year as they accrue, but never actually pay that interest to the related party. This scenario is of

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<sup>20</sup> See, e.g., I.R.C. §§ 446, 448.

<sup>21</sup> See, e.g., I.R.C. § 448.

<sup>22</sup> See 26 C.F.R. § 1.446-1

<sup>23</sup> *Id.*

<sup>24</sup> *Id.*

<sup>25</sup> See I.R.C. § 448

<sup>26</sup> Karl S. Coplan, *Protecting the Public Fisc: Fighting Accrual Abuse with Section 446 Discretion*, 83 Colum. L. Rev. 378 (March, 1983) (discussing the various ways that accrual accounting can be manipulated).

<sup>27</sup> *Id.*

all the more concern when the parent corporation is foreign because the IRS has no way to substantiate or confirm the eventual payment of the interest expense.<sup>28</sup> Because the interest income is never taxed by the United States, as it would have been had the parent been a domestic corporation, it is difficult for the IRS to confirm that these transactions are anything more than shams to avoid tax liability.<sup>29</sup>

In light of the concerns regarding manipulation and fraud based upon the difference between accrual and cash basis accounting methods, special rules and regulations have been promulgated to govern situations involving deductions based on transactions with a “related person or corporation.”<sup>30</sup> Generally, a taxpayer is not

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<sup>28</sup> *Tate & Lyle, Inc. v. Comm’r of Internal Revenue*, 103 T.C. 656, 660 (1994) (citing *Metzger Trust v. Comm’r*, 76 T.C. 75-76 (1981), affd. 693 F.2d 459 (5th Cir. 1982)).

<sup>29</sup> *Tate & Lyle*, 103 T.C. at 660.

<sup>30</sup> The Code § 267(b) sets forth those relationships that qualify taxpayers as related parties.

The relevant relationships include: (1) Members of a family; (2) An individual and a corporation more than 50 percent in value of the outstanding stock of which is owned, directly or indirectly, by or for such individual; (3) Two corporations which are members of the same controlled group (as defined in subsection (f)); (4) A grantor and a fiduciary of any trust; (5) a fiduciary of a trust and a fiduciary of another trust, if the same person is a grantor of both trusts; (6) a fiduciary of a trust and a beneficiary of such trust; (7) a fiduciary of a trust and a beneficiary of another trust, if the same person is a grantor of both trusts; (8) A fiduciary of a trust and a corporation more than 50 percent in value of the outstanding stock of which is owned, directly or indirectly, by or for the trust or by or for a person who is a grantor of the trust; (9) A person and an organization to which section 501 (relating to certain educational and charitable organizations which are exempt from tax) applies and which is controlled directly or indirectly by such person or (if such person is an individual) by members of the family of such individual; (10) A corporation and a partnership if the same persons own – (A) more than 50 percent in value of the outstanding stock of the corporation; and (B) more than 50 percent of the capital interest, or the profits interest, in the partnership; (11) An S corporation and another S corporation if the same

permitted to take a deduction from its tax liability based on a loss from a sale of property when the parties are related.<sup>31</sup> This provision does not stand as a bright-line rule barring all deductions on transactions with related parties.<sup>32</sup> Code § 267(a)(2) permits deductions for payments made to related parties, but qualifies the deductions when the parties calculate tax liability based on different accounting systems.<sup>33</sup> If the parties use different systems of accounting, the party seeking to utilize the deduction may only apply the deduction to its tax liability in the same year that the related party recognizes the income.<sup>34</sup> Practically, this code provision requires the related parties to “[m]atch[]” one another’s systems of accounting.<sup>35</sup> For example, if the related payee is on the cash basis, the taxpayer will only be able to claim the deduction when the money is actually paid, irrespective of whether or not the taxpayer generally reports on an accrual.<sup>36</sup> Conversely, if the related payee reports on an accrual, the taxpayer can only claim the deduction when the deduction accrues even if generally a cash basis reporter.<sup>37</sup>

When one of the related parties is a foreign entity, the Code includes additional regulations to govern this relationship.<sup>38</sup> In this field of regulation, the Secretary of the Treasury (the “Secretary”) is charged with promulgating and enacting regulations.<sup>39</sup> Specifically, the Secretary shall be charged with disseminating regulations to apply the

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persons own more than 50 percent in value of the outstanding stock in each corporation; or (12) An S corporation and a C corporation, if the same persons own more than 50 percent in value of the outstanding stock in each corporation. I.R.C. § 267(b).

<sup>31</sup> I.R.C. § 267(a)(1).

<sup>32</sup> See I.R.C. § 267 (a)(2).

<sup>33</sup> *Id.*

<sup>34</sup> *Id.*

<sup>35</sup> *Id.*

<sup>36</sup> *Square D v. Comm’r of the Internal Revenue Serv.*, 438 F.3d 739, 741-42 (7th Cir. 2006).

<sup>37</sup> *Id.* at 741.

<sup>38</sup> See, e.g., I.R.C §§ 163(e)(3); 267.

<sup>39</sup> I.R.C. § 267(a)(3).



“‘matching principle of [ § 267 (a)(2)] in cases in which the person to whom the payment is made is not a United States person.’”<sup>40</sup> Under this delegation of authority, the Secretary set forth a directive (the Regulation) that requires the use of the cash basis method of accounting, with certain carve-out exemptions, when a party seeks to claim deductions to a related foreign person.<sup>41</sup> For example, the aforementioned regulation exemption “ ‘applies to any amount that is income of a related foreign person with respect to which the related foreign person is exempt from United States taxation on the amount owed pursuant to a treaty obligation of the United states,’ *except* for interest.”<sup>42</sup> When a related foreign person accrues interest not effectively connected with the income generated<sup>43</sup> by the foreign party, that interest is not exempt and is governed by the Regulations and thus, the cash basis method.<sup>44</sup>

## II. CONTEXT OF OTHER LAWS AND REGULATIONS

U.S. corporations with foreign parent companies or foreign companies with substantial U.S. operations are a highly regulated group.<sup>45</sup> Within the tax context, the early 1990’s began a wave of regulations applying to these foreign related parties, with a strict eye

<sup>40</sup> *Square D v. Comm’r of the Internal Revenue Serv.*, 438 F.3d 739, 742 (7th Cir. 2006) (quoting I.R.C. § 267(a)(3)) (alteration in original).

<sup>41</sup> Treas. Reg. § 1.267(a)-3(b)-(c)(2) (2006).

<sup>42</sup> *Square D*, 438 F.3d at 742 (quoting Treas. Reg. § 1.267(a)-3(c)(2)).

<sup>43</sup> *See, e.g.*, J.C. Lewenhaupt, 20 TC 151 (1953); A foreign corporation generally will not be subject to direct U.S. taxation unless it is “engaged in a trade or business in the United States.” Although the Code does not explicitly define the phrase “trade or business” the case law has been interpreted to suggest that activity will not constitute a “trade or business” unless it is “considerable, continuous, and regular.” Gregg D. Lemein, John D. McDonald, and Stewart R. Lipeles, *Twists and Turns in the U.S. – Source Rules*, Sep. 12, 2005, available at <http://vcexperts.com/vce/news/buzz/archive>.

<sup>44</sup> Treas. Reg. § 1.267(a)-3(b); Gregg D. Lemein, John D. McDonald, and Stewart R. Lipeles, *Twists and Turns in the U.S. – Source Rules*, Sep. 12, 2005, available at <http://vcexperts.com/vce/news/buzz/archive>.

<sup>45</sup> *See, e.g.*, I.R.C §§ 163; 237.

toward their purported tax liability.<sup>46</sup> Several studies, commissioned by the IRS have indicated that foreign owned businesses operating in the U.S. have manipulated the tax structure to their advantage, to the tune of several billion dollars.<sup>47</sup> Many legislators are advocates of stricter regulatory provisions on this subject because in terms of the American economy, specifically the tax structure, these corporations represent a giant “potential cash cow.”<sup>48</sup> For example, where an interest payment is never taxed as income, the IRS is essentially losing whatever interest expense is deducted, because there is no corresponding tax liability from an increase in the payee’s gross income.<sup>49</sup>

The regulations governing transfer pricing are perhaps the greatest examples of regulations that are aimed at preventing abuse and fraud by foreign related parties. Transfer pricing refers to the pricing of goods and services within a single organization.<sup>50</sup> Serious tax issues arise when cross-border transactions are involved.<sup>51</sup> For example, goods may be sold from one division to another, from one subsidiary to another, or from a parent to a subsidiary where the decisions as to the price affect the distribution of profits and losses amongst the different legal entities within the same organization.<sup>52</sup> Although the use of transfer pricing in global corporations often has an honest and important purpose, it is particularly subject to abuse.<sup>53</sup> Often it is in the best interest of the organization to arbitrarily select a price where the

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<sup>46</sup> Angus McDowell, *The Chartered Minefield of U.S. Company Tax*, June 27, 1998, available at [http://www.mcdowell.com/mcgeneral/a\\_misc/articles/art\\_uscomtax.htm](http://www.mcdowell.com/mcgeneral/a_misc/articles/art_uscomtax.htm) (noting that Angus McDowell is the past president of the Association of Chartered Accountants in the United States).

<sup>47</sup> *Id.*

<sup>48</sup> *Id.*

<sup>49</sup> *See id.*

<sup>50</sup> *See* I.R.C. § 482 (2006); *Boeing Co v. United States*, 537 U.S. 437, 440-48 (2003); [http://en.wikipedia.org/wiki/Transfer\\_pricing](http://en.wikipedia.org/wiki/Transfer_pricing).

<sup>51</sup> *See* I.R.C. § 482.

<sup>52</sup> *Id.*

<sup>53</sup> *Id.*

highest profit margin occurs in a country with the most favorable tax structure.<sup>54</sup> These types of transactions have led to the rise of transfer pricing regulations because governments seek to stem the flow of taxation revenue overseas.<sup>55</sup>

For the purposes of U.S. tax liability, § 482 of the Code governs transfer pricing.<sup>56</sup> Section 482 provides<sup>57</sup>:

In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, *the Secretary may distribute, apportion, or allocate gross income, deductions, credits or allowances between or among such organizations, trades or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly reflect the income of any such organizations, trades, or businesses.*

In certain cases, such as between special related parties “no deduction shall be allowed in respect of any loss from the sale or exchange of property, directly or indirectly, between persons” when the transactions occur between parties with certain relationships.<sup>58</sup> These relationships include, among other, those between family members,

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<sup>54</sup> See I.R.C. § 482; *E.I. Du Pont de Nemours and Co. v. U.S.*, 608 F.2d 445, 449-52 (Cl. Ct. 1979).

<sup>55</sup> See generally I.R.C. § 482.

<sup>56</sup> Section 482 of the Code authorizes the IRS to adjust the income, deductions, credits, or allowances of commonly controlled taxpayers to prevent evasion of taxes or to clearly reflect their income. The regulations under § 482 generally provide that prices charged by one affiliate to another, in an inter-company transaction involving the transfer of goods, services, or intangibles, yield results that are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances.

<sup>57</sup> I.R.C. § 482 (emphasis added).

<sup>58</sup> I.R.C. § 267.

individuals and the corporations they control, the grantors or beneficiaries of a trust and its fiduciaries, and *two corporations which are members of the same controlled group*.<sup>59</sup> The basis for these regulations stems from the ease of manipulation and the possibility for fraudulent transfers that would cause the financials of a company to look more favorable than they are.<sup>60</sup> For example, if one wants to generate a loss to offset tax liability, by selling to one's parent company for \$80 stock purchased for \$100, § 267(a)(1) will preclude the deduction of the loss because of the nature of the relationship.<sup>61</sup> This limitation on deductions for transfers between related parties protects against "sham transactions" and manipulations without economic substance.<sup>62</sup> However, it should be noted that "there are often honest and important non-tax reasons for sales between related parties, so it [is] important to fairness to preserve [these transactions and] the pre-sale basis where loss on the sale itself is [not] recognized for tax purposes."<sup>63</sup> "A variant of this scheme applies to 'controlled groups,' that is, corporations with interlocking ownership as specified by statute.<sup>64</sup> Instead of being disallowed under § 267(a)(1), the loss is 'deferred' under § 267(f)(2) until one of two conditions pertains either: (1) until the property is transferred outside such controlled group and there would be recognition of loss under consolidated return principles; or (2) until such other time as may be prescribed in regulations."<sup>65</sup> These regulations, although preventing fraud and abuse, place a burden on American companies that are attempting to use related party transactions to compete in a global marketplace.

Another example of the strict regulation of foreign related party transactions is the stringent requirements that corporations must

<sup>59</sup> I.R.C. 267(a)(1), (b).

<sup>60</sup> *See id.*; *McWilliams v. C.I.R.*, 331 U.S. 694, 700-701 (1947).

<sup>61</sup> *Unionbanca Corp. v. Comm'r of Internal Revenue*, 305 F.3d 976, 978 (9th Cir. 2002).

<sup>62</sup> *See McWilliams*, 331 U.S. at 700-701.

<sup>63</sup> *Unionbanca*, 305 F.3d at 978-79.

<sup>64</sup> *Id.* at 979 (citing I.R.C §§ 267(b)(3), 267(f)(1), 1563).

<sup>65</sup> *Unionbanca*, 305 F.3d at 978-79.

adhere to if engaged in these types of transactions. Specifically, § 6038(a) governs the reporting requirements on transactions with foreign related parties.<sup>66</sup> This provision was enacted to impose a higher standard of reporting requirements on foreign controlled U.S. corporations and branches of foreign corporations.<sup>67</sup> Section 6038(a) requires domestic corporations that are 25% foreign owned to furnish records to the IRS to justify transactions with foreign shareholders.<sup>68</sup> The penalties associated with non-compliance are extremely harsh, such that a corporation has no option but to comply with the requirements, even if in order to substantiate the transaction the company must produce books from all over the world.<sup>69</sup> Companies are then forced to justify the expenses and transactions under the IRS' "profitability" standard which determines the amount of tax that should be imposed based on a number of questions including: "would the financial and commercial arrangements have been the same"; if the entities had not been related, would the transaction have occurred; etc.<sup>70</sup> This Code provision essentially grants the Secretary the broad authority to seek any information, even that tangentially related to a transaction, under the justification of preventing fraud and deceit. The ultimate purpose of the legislation is to provide the IRS with sufficient information to compute accurate transfer prices based on its economic model. However, the IRS can then replace the recorded book figures for transactions between related parties with the amounts that it chooses and in the case of insufficient records, it can choose almost any figure.<sup>71</sup>

<sup>66</sup> I.R.C § 6038 (1998).

<sup>67</sup> ASAT, Inc. v. Comm'r of Internal Revenue, 108 T.C. 147 (1997).

<sup>68</sup> Nissei Sangyo America Ltd. v. United States, 1995 WL 263473, at \*2 (N.D. Ill. 1995) (citing H.R. Rep. No. 247, at 1296-97 (1989), *reprinted* in 1989 U.S.C.C.A.N. 1906, 2766-67)).

<sup>69</sup> Angus McDowell, *The Chartered Minefield of U.S. Company Tax*, June 27, 1998, available at [http://www.mcdowell.com/mcgeneral/a\\_misc/articles/art\\_uscomtax.htm](http://www.mcdowell.com/mcgeneral/a_misc/articles/art_uscomtax.htm).

<sup>70</sup> *Id.*

<sup>71</sup> *Id.*

There are several legitimate reasons to use interrelated transactions, such as accounting for time spent from the home office consulting with other divisions, transfers of materials, and services such as research and development.<sup>72</sup> This level of regulation is a great burden on corporations, and requires extreme diligence (and expense) to fully comply.<sup>73</sup> Foreign companies may see this regulation, in the context of the other regulations that impact corporate conduct as a deterrent to U.S. market entry or current U.S. market position. This amount of discretion and broad authority granted to the Secretary could have unforeseen consequences as corporations looking to streamline, decrease costs, and improve efficiency may take a close look or have a second thought before they enter or remain in the U.S. marketplace.

### III. THE VALIDITY OF REGULATION 1.267(A)-3.

In *Square D*, the Seventh Circuit upheld the validity of Reg. 1.267(a)-3, which requires a taxpayer to use the cash basis method of accounting with respect to the deduction of interest owed to a related foreign party.<sup>74</sup> This issue was a matter of first impression for the Seventh Circuit. In both its reasoning and decision, the Seventh Circuit relied heavily on the analysis presented by the Third Circuit, which decided a factually analogous case.<sup>75</sup> The Seventh Circuit has reasoned that as a general matter, “[r]espect for the decisions of other circuit courts is especially important in tax cases due to the importance of uniformity, and the decision of the Court of Appeals of another circuit

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<sup>72</sup> *Id.*

<sup>73</sup> *Id.* (noting that this new tax regime will have several costs associated with it including: the costs of the disruptions by IRS investigations; time spent reviewing records and obtaining additional information from old or international records; and costs of professional, legal and accounting advice will likely be significant as there may be a lot of transactions that could be characterized in many different ways).

<sup>74</sup> *Square D Co. v. Comm’r of the Internal Revenue Serv.*, 438 F.3d 739 (7th Cir. 2006).

<sup>75</sup> *Tate & Lyle, Inc. v. Comm’r of the Internal Revenue Serv.*, 87 F.3d 99 (3d Cir. 1996)

should be followed unless it is shown to be incorrect.”<sup>76</sup> “Although we are not bound by them, we ‘carefully and respectfully consider’ the opinions of our sister circuits.”<sup>77</sup>

#### A. *Square D*

Square D, an accrual taxpayer, was acquired by Schneider S.A., a French Corporation, in 1991.<sup>78</sup> As a result of the acquisition, Square D borrowed additional funds and ended up with a four hundred million dollar debt to Schneider.<sup>79</sup> It accrued interest to Schneider in 1991 and 1992 but it did not deduct these amounts in its tax returns for those years.<sup>80</sup> Square D paid the accrued interest on these loans in 1995 and 1996.<sup>81</sup> Since Schneider was a resident of France, the interest paid to it by Square D was exempt from U.S. tax under the United States-France income tax treaty.<sup>82</sup> However, after an audit of Square D’s financials, the Internal Revenue Service charged Square D for the deficiencies evidenced in its 1991 and 1992 tax returns.<sup>83</sup> Square D informally requested that it be permitted to deduct the accrued amounts in order to offset the deficiency.<sup>84</sup> The Tax Court denied the allowance of a deduction based on the interest expense accrued and upheld the

<sup>76</sup> Bell Fed. Sav. & Loan Ass’n v. Comm’r of the Internal Revenue Serv., 40 F.3d 224, 226-27 (7th Cir. 1994) (quoting Fed. Life Ins. Co. v. United States, 527 F.2d 1096, 1098-99 (7th Cir. 1975)).

<sup>77</sup> 330 W. Hubbard Rest. Corp. v. United States, 203 F.3d 990, 994 (7th Cir. 2000).

<sup>78</sup> *Id.* (noting that Schneider acquired Square D by means of a hostile takeover, initially acquiring Square D through a special purpose entity that was later merged into the Schneider corporation).

<sup>79</sup> *Id.*

<sup>80</sup> *Id.*

<sup>81</sup> *Id.*

<sup>82</sup> 1967 Double Taxation Convention, U.S.-Fr., Article 10(1), Oct. 27, 1979, RIA TAXT 2168.

<sup>83</sup> *Square D v. Comm’r of the Internal Revenue Serv.*, 118 T.C. 299, 300-03 (2002)

<sup>84</sup> *Id.*

validity of the Regulation.<sup>85</sup> It is these deficiencies that are the subject of this analysis as Square D challenged the deficiencies and argued that it should be allowed to deduct the interest accrued to Schneider in 1991 and 1992, thus eliminating any deficiency.<sup>86</sup>

The first challenge that Square D presented was to the validity of Regulation 1.267(a)-3, arguing that this regulation was unreasonable given the clear meaning of the language of § 267(a)(2)-(3).<sup>87</sup> Square D argued that the language of § 267(a)(3) limited the power of the Secretary to only promulgate a regulation that applied the “matching principle” articulated in § 267(a)(2) in the context of foreign related parties.<sup>88</sup> Square D’s French parent company, Schneider, was not subject to U.S. tax liability and had no U.S. tax liability or method of accounting for tax liability to match against.<sup>89</sup> Square D argued that the Secretary’s regulation, mandating use of the cash basis method of accounting, was beyond the scope of authority granted to the Secretary under the plain language of the Code.<sup>90</sup>

The issue presented involved the Seventh Circuit’s determination of the validity of a regulation; hence, the analysis of the court was governed by a two-step *Chevron U.S.A, Inc. v. Natural Resources Defense Council, Inc.* inquiry.<sup>91</sup> First, a determination whether the

<sup>85</sup> *Id.*

<sup>86</sup> *Square D v. Comm’r of the Internal Revenue Serv.*, 438 F.3d 739, 742-43 (7th Cir. 2006)

<sup>87</sup> *Id.*

<sup>88</sup> *Id.* (noting that section 267(a)(2) generally provides that in the case of certain related parties, if the person to whom the amount is owed, as a result of that person’s method of accounting, is not required to include that item in income (unless actually paid), then the person who owed the amount cannot deduct it from their income tax liability until it is includable by the recipient of the income).

<sup>89</sup> *See id.*

<sup>90</sup> *Id.* at 743.

<sup>91</sup> 467 U.S. 837, 842-43 (1984). A *Chevron* analysis requires a court to first ask “whether Congress has directly spoken to the precise question at issue” and if Congress’ intent is clear from the plain language of the statute the inquiry must cease. However, if the court concludes that Congress has not directly addressed the issue or that the statute is ambiguous, then the court must determine whether the agency’s interpretation “is based on a permissible construction of the statute.” *Id.*



plain meaning of the relevant Code provisions clearly support or oppose the validity of the regulation; and second, if the plain meaning is either silent or unclear the Court must evaluate the reasonableness of the regulation in light of the language, overall structure, intent and purpose of the statute.<sup>92</sup> However, under *Chevron*, “when reviewing an agency’s regulatory implementation of a statute, [the court] look[s] first to the intent of Congress” and only if that intent is unclear is it the duty of the court to determine if the regulation is a reasonable interpretation, while giving deference to the Commissioner’s interpretation.<sup>93</sup>

### 1. Plain Language of the Statute

The Seventh Circuit, acting under a *Chevron* analysis, determined that the Code supported the Regulation.<sup>94</sup> The court declined to look at the Code provisions in a vacuum, rather reading the provisions together in order to ascertain the plain meaning.<sup>95</sup> One of the fundamental canons of statutory construction is that a statute should be construed to give meaning to all provisions and that on the whole no clause or word should be rendered void, insignificant or redundant.<sup>96</sup> Under *Chevron*, all words should be read in context.<sup>97</sup> Therefore, if, § 267(a)(3) merely authorized the Secretary to mechanically implement, with no modifications or alterations, the provisions of § 267(a)(2) to foreign related parties it would be redundant given that

<sup>92</sup> *See id.* at 843.

<sup>93</sup> *Square D*, 118 T.C. at 307 (citing *Chevron*, 467 U.S. at 842-43).

<sup>94</sup> *Square D*, 438 F.3d at 745

<sup>95</sup> *Id.* When ascertaining the plain meaning of a statute, the court must look to the statutory language at issue, as well as the language and design of the statute as a whole. *See, e.g.*, *Food & Drug Admin. v. Brown and Williamson Tobacco Corp.*, 529 U.S. 120, 132-33 (2000); *K-Mart Corp. v. Cartier, Inc.*, 486 U.S. 281, 291 (1988).

<sup>96</sup> *Alaska Dep’t of Env’tl. Conservation v. EPA*, 540 U.S. 461, 489 n.13 (2004); *Cole v. U.S. Capital Inc.*, 389 F.3d 719, 725 (7th Cir. 2004).

<sup>97</sup> *FDA v. Brown & Williamson Tobacco Corp.*, 529 U.S. 120, 133 (2000) (citations omitted).

§ 267(a)(2) plainly does not distinguish between domestic and foreign related parties and thus logically applies to both.<sup>98</sup> Section 267(a)(2) already applied to both foreign and domestic parties, rendering § 267(a)(3) “surplusage” unless it extends the meaning articulated in § 267(a)(2).<sup>99</sup> Moreover, § 267(a)(2) was enacted two years before § 267(a)(3), which can be interpreted as shaping the provisions already included in the Code.<sup>100</sup> The inclusion of the provision, given the statutory scheme as a whole, suggests that § 267(a)(3) has a distinct meaning which is ambiguous and dictates a further analysis.<sup>101</sup>

## 2. Legislative History

In *Square D*, because the provisions were ambiguous, in order to determine the validity of the regulation the Court looked to whether the interpretation set forth by the Secretary was a reasonable one.<sup>102</sup> With regard to the legislative history surrounding § 267(a)(2) the Court noted that the Congressional climate was focused on attempting to restrain fraud and abuse in related party transactions as these types of transactions were easily manipulated by parties to shield profits and avoid tax liability.<sup>103</sup> Under the precursor to I.R.C. § 267(a)(2), Congress imposed an extremely strict limitation on interest

<sup>98</sup> *Square D*, 438 F.3d at 745 (explaining that § 267(a)(3) grants the Secretary the discretion to issue regulations to apply the matching principle in cases where the person to whom the payment is made is not a United States person).

<sup>99</sup> *Id.*

<sup>100</sup> *See id.* at 746.

<sup>101</sup> *Id.* at 745.

<sup>102</sup> In cases where “Congress has made an express delegation of authority to enact regulations, ‘[s]uch legislative regulations are given controlling weight unless they are arbitrary, capricious, or manifestly contrary to the statute.’” *Id.* (citing *Chevron*, 467 U.S. at 844).

<sup>103</sup> *Square D*, 438 F.3d at 746 (citing I.R.C § 267(a)(2) (previously Revenue Act of 1937, Pub. L. No. 75-377 §301(c) which became § 267(a)(2) in 1954)).

transactions between related parties.<sup>104</sup> The initial enactment of § 267(a)(2) “permanently disallowed deductions for . . . interest accrued during the taxable year but not paid within two and one-half months after the close of the year if the payee was related to the taxpayer and, because of the payee’s method of accounting, the payee did not include the accrued interest in its income.”<sup>105</sup> However, Congress amended § 267(a)(2) to include the “matching principle” to remedy the unduly harsh results that occurred as a result of the permanent disallowance of deduction.<sup>106</sup> When related taxpayers attempt to deduct interest, especially under different accounting methods, it is nearly impossible to monitor when payments are actually made if the interest is accrued and the actual payments are not made until several years later.<sup>107</sup> This makes the job of the IRS practically impossible and allows for companies to deduct for interest payments that potentially are never paid.<sup>108</sup>

The legislative history also indicates that not only was Congress concerned with the monitoring and compliance nightmare that could easily ensue, but also with the ease with which taxpayers could engage in “phantom transactions” that led to deductions for payments that were either never made or manipulated in order to minimize liability in a high tax year.<sup>109</sup> The general purpose of the present § 267(a)(2) was clear: it was intended “to prevent the allowance of a deduction

<sup>104</sup> Under the 1937 law, Congress refused to allow a deduction for accruing an interest obligation to a related party; rather in order to apply the deduction, the payor had to actually pay the interest within approximately the same year as the accrual. *Id.*

<sup>105</sup> *Id.*; Brief for the Appellant at 3, *Tate & Lyle, Inc. v. Comm’r of Internal Revenue Serv.*, No. 95-7523 (3d Cir. Sep. 1995)) (citing H. Rep. No. 75-1546, reprinted in 1939-1 C.B. (Pt. 2) 704, 724-25) (noting that “the rule was adopted because Congress found that some accrual taxpayers were claiming deductions for amounts owed to related parties as accrued, but thereafter never paid the amounts so accrued).

<sup>106</sup> Brief for the Appellant at 18-19, *Tate & Lyle, Inc. v. Comm’r of Internal Revenue Serv.*, No. 95-7523 (3d Cir. Sep. 1995).

<sup>107</sup> H.R. Rep. No. 75-1546 (1937), reprinted in 1939-1 C.B. (Pt. 2) 704, 724-25.

<sup>108</sup> *See id.*

<sup>109</sup> *Id.*

without the corresponding inclusion in income.”<sup>110</sup> When Congress revisited this subject two years later it promulgated § 267(a)(3) which requires the Secretary to “apply the matching principle of [I.R.C. § 267(a)(2)] in cases in which the person to whom the payment is made is not a United States person.”<sup>111</sup>

In its decision, the Seventh Circuit followed the reasoning articulated by the Third Circuit in *Tate & Lyle*, indicating that Congress envisioned this provision to cover circumstances beyond an accounting method mismatch, and to cover circumstances where the foreign related party was not subject to U.S. tax liability.<sup>112</sup> The Seventh Circuit was persuaded by the Committee Reports that Congress clearly intended and anticipated that the Code would cover situations in which the cash basis accounting method would govern even when there was no mismatch in accounting systems because the foreign related party is not subject to U.S. tax liability.<sup>113</sup> In light of the legislative history, the Seventh Circuit’s determination was based on whether the Regulation was reasonable in light of the overall structure and purpose of the Code.<sup>114</sup> Based on the Committee notes, and in light of the overall fraud-prevention purpose of the provisions, the Seventh Circuit held that the Commissioner’s decision to enact the Regulation was reasonable despite the fact that it extended beyond situations involving an accounting mismatch and included transactions

<sup>110</sup> H.R. Rep. No. 98-432 (II) at 1025 (1984) *reprinted in* 1984 (vol. 3) U.S.C.C.A.N 697, 1205 (widening the scope of the provision to address all payments, not just interest payments, between related parties with different accounting methods).

<sup>111</sup> I.R.C. § 267(a)(3).

<sup>112</sup> *Tate & Lyle v. Comm’r of the Internal Revenue Serv.*, 87 F.3d 99, 105 (3d Cir. 1996); *see also* H.R. Rep. 99-426 at 939 (1985) *reprinted in* 1986-3 C.B. (Vol. 2) at 959; S. Rep. No. 99-313 at 959 (1986), *reprinted in* 1986-3 (Vol. 3) at 959 (articulating a situation where the foreign parent was not subject to U.S. tax liability but provided services to a U.S. company and thus the U.S. company was required to use cash basis accounting).

<sup>113</sup> *Square D Co. v. Comm’r of the Internal Revenue Serv.*, 438 F.3d 739, 747 (7th Cir. 2006) (citing *Tate & Lyle*, 87 F.3d at 105; H. Rep. 99-426, at 940, 1986-3 C.B. (Vol. 2) at 940; S. Rep. 99-313, at 960, 1986-3 C.B. (Vol.3) at 960).

<sup>114</sup> *Square D*, 438 F.3d at 747.

where the foreign related party was not subject to U.S. tax liability.<sup>115</sup> Further, given the history of manipulation of interest payments between related parties, the Seventh Circuit determined that the Commissioner's decision to treat interest differently was well within his purview and consistent with congressional intent.<sup>116</sup>

*B. Tate & Lyle and the Tax Court's Holding of the Invalidity of Treasury Regulation 1.267(a)-(3)*

Although the only circuits to address this issue have subscribed to the interpretation articulated by the Seventh Circuit, the Tax Court in *Tate & Lyle* held that the Regulation was an invalid exercise of the authority granted by § 267(a)(3) of the Code.<sup>117</sup> The foundation for this holding is based in the plain language of the Code.<sup>118</sup>

The Tax Court recognized that it must “ordinarily defer to the regulation if it implements the congressional mandate in some reasonable manner.”<sup>119</sup> Section 267(a)(2) of the Code provides generally that a taxpayer may not deduct any amount owed to a related party until it is includible in the payee's gross income *if the mismatching occurs because the parties use different methods of accounting*.<sup>120</sup> Although the Code does not explicitly define the term “method of accounting” that term has the common usage to indicate the cash basis method, the accrual method, or some combination of the methods.<sup>121</sup> Following this logic, a method of accounting is only applicable to determine when an item is includable in gross income; consequently, if the item is excluded from the entity's gross income

<sup>115</sup> *Id.*

<sup>116</sup> *Id.*

<sup>117</sup> *Tate & Lyle v. Comm'r of the Internal Revenue Serv.*, 103 T.C. 656, 666 (1994).

<sup>118</sup> *Id.*

<sup>119</sup> *Id.* (citing *United States v. Correll*, 389 U.S. 299, 307 (1967)).

<sup>120</sup> *Tate & Lyle*, 103 T.C. at 666. (emphasis added).

<sup>121</sup> *Id.*

altogether, there is no method of accounting of which to speak.<sup>122</sup> When the interest owed is not includable in gross income because, for example, it was excluded from tax liability, such as in the case of a treaty, then there is no method of accounting and the regulations are not applicable to it.<sup>123</sup> The plain language of the code is clear; the statutory mandate in § 267(a)(3) is that it “applies the matching principle of paragraph (2).”<sup>124</sup> There is no reason to go beyond the language of the statute and engage in an exploration of the legislative history because the language clearly does not permit the Secretary to promulgate Regulations that exceed the scope of the “matching principle” to accounting methods as is articulated in § 267(a)(2).<sup>125</sup> The Secretary is not permitted to promulgate regulations that would alter the clear statutory scheme of the Code.<sup>126</sup> Rather, the authority of the Secretary is limited in scope to filling gaps in the Code and setting forth regulations that clarify the implementation of the Code.<sup>127</sup> The Regulation as issued, which does not allow a taxpayer to accrue and deduct interest owed to a foreign related party, is beyond the mandate of the statutory authority, and is thus, invalid.<sup>128</sup>

The Tax Court addresses the argument that the Secretary’s justification is based on an attempt to analogize to provisions governing the original issue discount (“OID”).<sup>129</sup> The Court hypothesizes that the goal of the Regulation was to treat interest deduction in the same way that deductions attributable to the original

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<sup>122</sup> *Id.* at 669.

<sup>123</sup> *Id.*

<sup>124</sup> *Id.*

<sup>125</sup> *Id.* at 670.

<sup>126</sup> *See, e.g.,* *Chevron U.S.A. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837, 843-44 (1984); *Correll*, 389 U.S. 299, 307 (1967) (noting that the deference given to Treasury Regulation is based in the fact that Congress has delegated the task of administering tax laws to the Secretary and thus the choice among reasonable alternatives is his).

<sup>127</sup> *Id.*

<sup>128</sup> *Tate & Lyle*, 103 T.C. 656, 672 (1994).

<sup>129</sup> *Id.* at 671.

issue discount are treated.<sup>130</sup> However, the Tax Court adheres to the plain language and distinguishes the treatment of OID because there is no language or provision that requires for the expansion of the reach of the regulations beyond the matching principle articulated in § 267(a)(2) interpretation.<sup>131</sup> The administrative authority conferred on the Secretary is only to fill gaps; therefore, the Regulation as issued is beyond the scope of that authority and contrary to the plain language of the Code.

Although not addressed by the Tax Court, the Regulation could be seen to place accrual taxpayers that engage in transactions with related foreign parties at a disadvantage vis-à-vis taxpayers in similar situations but dealing with a domestic related party. The primary justification for the “matching principle” is so that there is a balance between the deduction taken on interest paid and additional tax liability recognized on interest income.<sup>132</sup> However, when the income is not included in payee’s gross income, the concerns from the IRS of balancing tax liability seems to diminish because the income will never generate U.S. tax revenue.<sup>133</sup>

#### IV. THE SEVENTH CIRCUIT DECISION WAS CORRECT AND SHOULD BE FOLLOWED BY OTHER COURTS

The Seventh Circuit’s decision to uphold the validity of the Regulation is correct and should be followed by other jurisdictions. However, from the absence of many key arguments and the limited rationale expounded by the Seventh Circuit, the basis for the decision involved too much deference to the Third Circuit decision and the authority of the Secretary.

<sup>130</sup> *Id.*; I.R.C. § 163(e)(3).

<sup>131</sup> Internal Revenue Code § 163(e)(3) provides that no deduction for original issue discount on a debt instrument held by a related foreign person shall be allowed until paid.

<sup>132</sup> *Tate & Lyle*, 103 T.C. at 660-61.

<sup>133</sup> *See id.*

The tax context is unique, and admittedly has the need for uniformity. Although deference is an important factor to consider, it is not controlling and the Seventh Circuit must reason its decision based on the arguments presented as opposed to merely following a like interpretation from another circuit. Yet, despite the deficiencies in the court's reasoning and rationale, the decision was substantively correct.

The Tax Court in *Tate & Lyle* read the definition of “matching principle” too narrowly. The Tax Court seems to confuse the “matching principle” with the specified reason or cause for a mismatch.<sup>134</sup> Practically, § 267(a)(2) triggers the correction contemplated by § 267.<sup>135</sup> The provision articulated in § 267 is logically read to indicate that mismatches in federal income tax reporting, including accounting for interest expense and income are to be avoided.<sup>136</sup> The language of the provision indicates that it is not aimed at remedying the reason that the mismatch occurred, but rather remedying the effects of the mismatch.<sup>137</sup> In terms of the domestic taxpayers contemplated under § 267(a)(2)(A), given that both taxpayers are domestic related parties it is obvious that the only way that a mismatch could occur is because of different accounting methods, as both parties are subject to the U.S. tax liability and governed by the Code, meaning that they must utilize an approved accounting method.<sup>138</sup> However, the “specified reason or cause for a mismatch (namely, a difference in accounting method) that triggers corrections under § 267(a)(2) is not a part of the ‘matching principle.’”<sup>139</sup> Rather, the mismatch represents the “trigger” for the

<sup>134</sup> *Tate & Lyle v. Comm’r of Internal Revenue Serv.*, 103 T.C. 656, 680-81 (1994) (Swift, J. dissenting).

<sup>135</sup> *Id.*

<sup>136</sup> See I.R.C § 267; *e.g.*, *Albertson’s Inc. v. Comm’r of Internal Revenue*, 42 F.3d 537, 543 (9th Cir. 1994)(noting that generally the point of the “matching principle” as used in § 404 is to prevent one party from taking a deduction for payment until the other party includes the payment in its income, and is therefore taxed on it).

<sup>137</sup> See I.R.C § 267; *Tate & Lyle*, 103 T.C. at 680-81 (Swift, J. dissenting).

<sup>138</sup> See *Tate & Lyle*, 103 T.C. at 680-81 (Swift, J. dissenting).

<sup>139</sup> *Id.*



matching principle that would result in a correction.<sup>140</sup> Congress, in 1986, added § 267(a)(3) in recognition of the fact that when domestic and foreign parties are involved in a transaction, mismatches occur for reasons other than a difference in accounting systems.<sup>141</sup> Congress added § 267(a)(3) to remedy the effects of mismatches that are triggered by circumstances other than a difference in accounting methods.<sup>142</sup> For example, a treaty would be a reason or cause for a mismatch and would be within the authority of the Secretary to determine the appropriate remedy and action.<sup>143</sup> Applications of treaties, such as the U.S.-France tax treaty, were entered into to prevent double taxation (that is taxation on the same transaction by two governments). In this case, the interest income will be taxed by the country of France. In effect, the U.S. has acquiesced to the loss of certain tax revenues in exchange for a more efficient allocation of global resources and the influx of foreign capital. In order to give credence to this treaty, it should be treated as a “trigger” causing a mismatch and therefore, the matching principle should apply to transactions between domestic corporations and foreign corporations existing under a tax treaty.

An argument ignored by the Seventh Circuit is that Congress did not relieve taxpayers from the requirements of § 267 where one of the related parties is tax-exempt, as in the case of a charitable organization, under § 501.<sup>144</sup> It is inequitable that § 267 would apply to domestic parties engaged in transactions with tax exempt parties, but would not apply to domestic parties engaged with foreign tax

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<sup>140</sup> *Id.*

<sup>141</sup> *Id.*

<sup>142</sup> *Id.* (noting that Congress directed in § 267(a)(3) that the Commissioner, by means of legislative regulations, provide other causes of mismatches between domestic and foreign related parties to trigger the provisions of § 267); Brief for the Appellant, *supra* note 106, at 10.

<sup>143</sup> Brief for the Appellant, *supra* note 106, at 10 (stating that Judge Swift considered the treaty-mandated an accounting method in and of itself).

<sup>144</sup> *See* I.R.C. § 267(b)(9).

exempt parties.<sup>145</sup> In both cases the payee will never be including the payment in its gross income, and will never be subject to U.S. tax liability. From a policy perspective, there is no justification that the reason why income is not taxed should make any difference.<sup>146</sup> Whether income is “tax-exempt” as in the case of a charitable organization or is exempt by reason of a tax treaty is irrelevant.<sup>147</sup> The “matching principle” is triggered wherever there is a mismatch, and the reason why the mismatch occurs is irrelevant to the ability of the Secretary to issue regulations. It naturally follows that the same standards should apply to these groups because the scenarios are far more analogous than two domestic corporations with different accounting systems.

Another issue ignored by the Seventh Circuit, but that argues in favor of its decision, is the parallel interpretation between the Regulation and § 163(e)(3) with respect to original issue discount.<sup>148</sup> Section 163(e)(3) requires a taxpayer to use the cash basis method of accounting for deductions of original issue discount<sup>149</sup> on debt instruments held by foreign related parties.<sup>150</sup> These provisions were enacted to remedy the exact concerns that led Congress to enact § 267.<sup>151</sup> Both provisions were aimed at preventing abuse by taking tax deductions for payments never made.<sup>152</sup> Further, the “definition of foreign related person” in § 163(e)(3) contains a direct reference to

<sup>145</sup> *Tate & Lyle v. Comm’r of Internal Revenue Serv.*, 103 T.C. 656, 679 (1994) (Halpern, J. dissenting) (noting that it is difficult to see any reason why one tax exemption should be treated differently from another).

<sup>146</sup> Brief for the Appellant, *supra* note 106, at 37.

<sup>147</sup> *Id.*

<sup>148</sup> I.R.C. § 163 (e)(3); Treas. Reg. § 1.267(a)-3.

<sup>149</sup> “Original issue discount” is defined as the excess, if any, of the stated redemption price of a debt instrument at maturity over the issue price of the instrument. I.R.C. § 1273 (a)(1).

<sup>150</sup> *Id.* Note: this article will not address the validity of § 163(e)(3) or its accompanying Treasury Regulations. This article will only address this issue in relation to parallels and similarities with § 267.

<sup>151</sup> Brief for the Appellant, *supra* note 106, at 39.

<sup>152</sup> *See id.*

§ 267(b).<sup>153</sup> By defining related parties in this fashion, it can be reasonably inferred that Congress envisioned in § 163(e)(3) and § 267 a natural overlap in application and interpretation between these two provisions.<sup>154</sup> One might argue that the absence of any reference to § 163(e)(3) in the legislative history of § 267 indicated that Congress did not intend the provisions to parallel one another.<sup>155</sup> The absence of a reference in no way indicates that Congress intended to prohibit the Secretary from issuing a similarly aimed regulation; it merely demonstrates that Congress did not intend to require such a rule.<sup>156</sup>

Square D did not raise, and the Seventh Circuit did not address, the impact that the level of deference to administration regulation could have on the future viability of transactions with foreign related parties.<sup>157</sup> Although Square D made a non-discrimination claim, which was quickly dismissed by the Seventh Circuit, it never raised the

<sup>153</sup> *Id.* (citing I.R.C. § 163(e)(3)).

<sup>154</sup> Brief for the Appellant, *supra* note 106, at 39.

<sup>155</sup> *Tate & Lyle v. Comm’r of Internal Revenue Serv.*, 103 T.C. 656, 671 (1994).

<sup>156</sup> Brief for the Appellant, *supra* note 106, at 41.

<sup>157</sup> Square D argued in the alternative that Reg. 1.267(a)-3 conflicted with the Tax Treaty between the United States and France because it requires a U.S. taxpayer, owned by a foreign [French] corporation to use the cash basis method of accounting to deduct interest payment to its parent, rather than the more advantageous accrual method. The Seventh Circuit reasoned that this argument failed because the type of discrimination sought to be prevented was discrimination based solely on the foreign ownership of the foreign-owned person. However, in this case, the regulation did not dictate the use of the cash basis method based on the French ownership of Square D. Rather, the dictate was based upon the fact that the interest payments were rendered to a foreign party. Therefore, had Square D been owned by a domestic corporation, any interest payment to a foreign related party would still be subject to the rule putting Square D’s deduction on the cash basis method. The Seventh Circuit reasoned that in order to violate the nondiscrimination clause in the treaty, the additional burden levied must be directed at a nationality. Hence, since all companies who engaged in transactions with foreign related parties resulting in payment of interest were equally subject to this provision, whether owned by a foreign or domestic parent company, there was no discrimination. Therefore, there was no violation by the Reg. 1.267(a)-3 of the non-discrimination clause of the Treaty. *Square D*, 438 F.3d at 747-48.

question of where the foreseeable scope of these regulations might end.<sup>158</sup> In the Seventh Circuit's holding, it indicated its propensity to defer to administrative regulation, without a full exploration of the arguments, under the justification of prevention of fraud.<sup>159</sup> For example, in an effort to prevent fraud and ease the burden of tracking deductions, the next step might be to eliminate the ability of a taxpayer to take advantage of the interest deduction when the payee is any foreign party. Although this is an extreme example, given the current distrust of corporate America and prevalence of scandal, without an adequate check on administrative regulation, these regulations could easily exceed their intended scope. Reviewing courts are charged with conducting a thorough analysis to ensure that administrative regulation is reasonable. Absent such an analysis it is possible that the Secretary will exceed the scope of its authority and do more harm than good for American Corporations.

However, in light of the much stricter regulations upheld affecting transactions with foreign related parties, the interpretation of the Regulation at issue in *Square D* is consistent with the deference applied to other similarly aimed regulations.<sup>160</sup> Although the subject matter of these laws varies quite broadly over a spectrum of topics, they all share one common goal: to prevent fraud and abuse by corporations.<sup>161</sup> Given the serious nature and consequences of these regulations, courts must hesitate before granting broad deference and latitude to the agencies charged with ensuring compliance. It is a very fine line between reasonable enforcement of these provisions as initially intended and allowing these regulations to be carried to illogical extremes, impairing American corporations by placing them on unequal footing in a global marketplace. Therefore, it is critical that reviewing courts engage in a thorough analysis of any administrative

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<sup>158</sup> *Id.*

<sup>159</sup> *See id.* at 747 (stating that although the use of the cash basis method may seem "counter-intuitive" it is justified by the potential to prevent "fraud and abuse by taxpayers").

<sup>160</sup> *See, e.g.,* *Boeing Co v. United States*, 537 U.S. 437 (2003); *Tate & Lyle v. Comm'r of Internal Revenue Serv.*, 87 F.3d 99 (3d Cir. 1996).

<sup>161</sup> *See, e.g.,* I.R.C. §§ 163, 267, 446

regulation aimed at preventing fraud in taxation before granting deference to an administrative regulation.

#### CONCLUSION

There is no debate that adequate regulation of corporate transactions is important. Proof of this fact has never been more evident than in the past few years when the effects of corporate wrongdoing have been recognized at the greatest level. For the purposes of tax liability, related party transactions are one of the most commonly abused vehicles.

Both the Seventh and Third Circuit have upheld the validity of the Regulation requiring a taxpayer to use the cash basis method of accounting to deduct interest payments to foreign related persons. This decision represents a trend toward greater regulation and discretion for the agencies charged with promulgating these regulations. Although these decisions should be narrowly construed and not used as precedent for sweeping deference to administrative regulation they were correctly decided. The burden that this regulation imposes is both necessary and mild in light of the context of other similarly aimed regulations. As such, the decision of the Seventh Circuit in *Square D* is correct and all other circuits addressing this narrow issue should follow the decision. However, the absence of extensive reasoning by the Seventh Circuit should not be read to indicate that, in the context of administrative regulation under the Code, all regulation is good regulation.