April 28, 2022

# District Court Holds Section 245A Temporary Regulations Invalid

## Federal District Court Grants Liberty Global's Motion for Summary Judgment, Holds the Section 245A Temporary Regulations Invalid


## SUMMARY

On April 5, 2022, the United States District Court for the District of Colorado issued an order granting in part Liberty Global Inc.'s ("LGI") motion for summary judgment and held that the temporary Treasury Regulations under Section 245A were invalid because they were promulgated without notice and comment.


## BACKGROUND

### A. SECTION 245A AND GILTI

As part of the 2017 tax reform, legislation was enacted to transition the U.S. towards a participation-exemption system. As part of that legislation, Section 245A and the global intangible low-taxed income ("GILTI") regime under Section 951A were enacted. The GILTI regime was added as a complement to the existing subpart F regime and treats a portion of the income of a controlled foreign corporation ("CFC") as taxable to its 10% U.S. shareholders, regardless of whether such income has been distributed. The GILTI regime applies to income that was generally not subject to immediate inclusion by U.S. shareholders under the subpart F rules. Section 245A acts as the "exemption" portion of the participation-exemption system. Under Section 245A, domestic corporations are generally allowed a dividends-received deduction for dividends received from a 10% or more owned foreign corporation. As a result, Section 245A allows domestic corporations to avoid further incremental U.S. tax when they repatriate certain foreign earnings. The legislative history suggests that Congress intended for the 245A dividends-received deduction to apply only to foreign earnings exempt from GILTI and subpart F.

However, the effective dates of the two provisions did not align in the case of entities with non-calendar year-ends, which includes many CFCs. Specifically, Section 245A was effective for distributions made after December 31, 2017. The GILTI rules, in contrast, were effective for tax years of CFCs beginning after December 31, 2017. Thus, for a CFC with a November 30 year-end, GILTI applied beginning on December 1, 2018. Commentators refer to this misalignment as the "GILTI donut." The result of this misalignment was that a U.S. shareholder of stock in a CFC with a non-calendar year-end could theoretically receive dividends from that CFC during 2018 (prior to the CFC's year-end) that would be eligible for the Section 245A deduction where that dividend was supported by the CFC's earnings that were not subject to the GILTI regime (including amounts that would have been GILTI had GILTI been in effect). The net result of this misalignment would mean that foreign-source income was repatriated from certain CFCs without being subject to any U.S. taxation whatsoever.

### B. SECTION 245A TEMPORARY REGULATIONS

In response to the GILTI donut, in June 2019, Treasury issued temporary regulations under Section 245A to prevent this non-taxation. The temporary regulations applied retroactively to certain transactions intended to take advantage of the GILTI donut that occurred after December 31, 2017.

Specifically, the temporary regulations limited Section 245A's dividends-received deduction where: (1) a related-party "extraordinary" transaction was executed by the CFC on or after January 1, 2018, in a tax year to which GILTI did not apply ("Extraordinary Disposition"); or (2) a transfer or issuance of stock on or after January 1, 2018, resulted in a reduction in a U.S. shareholder's pro rata share of the CFC's subpart F or tested income (an "Extraordinary Reduction").

### C. LGI TRANSACTION

In December 2018, prior to the release of the Section 245A temporary regulations, LGI engaged in a transaction pursuant to which LGI claimed a Section 245A deduction, but which was eventually subject to disallowance under the Section 245A temporary regulations. Accordingly, the IRS denied the deduction. LGI paid its resulting taxes for the 2018 tax year and sued the U.S. government for a refund on the basis that the 245A temporary regulations were invalid.

## THE SUMMARY JUDGMENT DECISION

On April 5, 2022, the court granted in part LGI's motion for summary judgment on the grounds that the Section 245A temporary regulations were invalid. LGI made three arguments for why the Section 245A temporary regulations were invalid: (1) Treasury did not have authority to issue the temporary regulations because they were contrary to the statute; (2) Treasury did not have authority to make the temporary regulations retroactive; and (3) the temporary regulations were invalid because they were promulgated without notice and comment. The court only ruled on the third argument and held the temporary regulations were invalid because Treasury failed to comply with the notice and comment requirements under the Administrative Procedure Act ("APA").

The court found Treasury was required to comply with notice and comment procedures in issuing temporary regulations. Treasury argued that Section 7805(e), which allows Treasury to promulgate temporary regulations, is a more specific statute which supersedes the requirements of the APA, but the court rejected this argument. Instead, the court found that Section 7805(e) and the APA could be read consistently, and therefore that Treasury needed to comply with the notice and comment requirements or have good cause to forego such requirements.

The court then found Treasury did not have good cause for failing to comply with the notice and comment requirements. Treasury advanced four arguments for why it had good cause for failing to comply with notice and comment procedures. The court rejected all four arguments. First, Treasury argued that allowing for the time to undergo notice and comment would allow or even encourage taxpayers to engage in the very behavior that these regulations sought to prevent. The court rejected this argument, finding that Treasury discovered the taxpayer behavior that made these regulations necessary in October 2018, which gave Treasury seven months to issue the regulations with the requisite notice and comment period. Given this timeframe, the court reasoned, Treasury could have promulgated the regulations retroactively to prevent abuse while still providing for notice and comment. In particular, the court noted that Treasury could have issued retroactive regulations as late as 2019.

Second, Treasury argued that the delay associated with providing for notice and comment would have left taxpayers with insufficient time to incorporate the ultimate regulations in their initial filing of tax returns, requiring taxpayers instead to file amended tax returns to comply with the temporary regulations, thereby increasing compliance costs. The court rejected this argument, finding that compliance costs to taxpayers was not sufficient justification to override the public interest in having an opportunity to comment on the regulations.

Third, Treasury argued the temporary regulations, by their terms, are only in place for a limited amount of time, and that there is a full opportunity for interested parties to comment on the final regulations. The court rejected this argument, finding that notice and comment for the temporary and final regulations are two separate requirements and are not interchangeable.

Fourth, Treasury argued that the retroactivity provision ensures that the tax regime enacted in 2017 and the interaction between the provisions of the Code will function correctly for all affected periods. The court rejected this argument, finding that it was largely a recast of the previous arguments and that there was sufficient time, given Treasury discovered the taxpayer behavior in October 2018, to implement retroactive temporary regulations and comply with notice and comment in this case.

Finally, Treasury argued that, in any event, the failure to allow for notice and comment was a harmless error because the final regulations did provide for notice and comment. Because the final regulations permitted taxpayers to apply the final regulations to periods when the temporary regulations were in effect, Treasury argued that taxpayers had access to the set of rules reflecting their comments for all periods. The court rejected this argument, as LGI's choice was to either apply the retroactive temporary regulations or apply the final regulations to its 2018 transaction. In both cases, the taxpayer was required to apply the regulations retroactively and the error was, therefore, not harmless.

Summary judgment was granted only in part because the parties agreed at oral argument that there was an issue of fact: whether the transactions and the actions LGI took to attempt to receive the Section 245A deduction complied with the applicable tax laws. The court found that this issue was not material to the validity of the temporary regulations but affects whether LGI is entitled to judgment as a matter of law, at trial, on this issue. As such, litigation is expected to continue.

## IMPLICATIONS OF THE SUMMARY JUDGMENT DECISION

The court only found the temporary regulations invalid based on Treasury's failure to comply with procedure. It did not address LGI's substantive arguments that the regulations were an invalid interpretation of the statute, and it did not consider the validity of the Section 245A final regulations (issued November 2020, but applicable to June 2019). Because the court did not consider LGI's argument that Treasury exceeded its interpretive authority, no conclusion can be drawn regarding whether a court would find the substantially similar final regulations to be an invalid interpretation of the statute.

The government is expected to appeal the order to the Tenth Circuit Court of Appeals, but the timing of such an appeal is an open question.

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