No. 10-2775

IN THE UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

MERCK & CO., INC., Appellant,

v.

UNITED STATES OF AMERICA, Appellee.

Appeal from the United States District Court
for the District of New Jersey
in Case No. 05-2575
Judge Katharine S. Hayden

BRIEF FOR NATIONAL ASSOCIATION OF MANUFACTURERS

IN SUPPORT OF APPELLANT AND REVERSAL

Douglas Hinson (Counsel of Record)
Matthew Stevens
Alston & Bird LLP
950 F Street, NW
Washington, D.C. 20004
(202) 239-3553
Counsel for Amicus Curiae

Of Counsel

Quentin Riegel
National Association of Manufacturers
1331 Pennsylvania Avenue, NW
Washington, DC 20004
(202) 637-3000

September 7, 2010

DISCLOSURE STATEMENT PURSUANT TO RULE 26.1 OF THE FEDERAL RULES OF APPELLATE PROCEDURE

Pursuant to Rule 26.1 of the Federal Rules of Appellate Procedure, counsel for *amicus curiae* hereby states that the association represented on this brief has no parent corporation and has issued no stock.

TABLE OF CONTENTS

TABLE OF AUTHORITIES

Cases

Statutes

Other Authorities

Regulations

QUESTION PRESENTED

In interpreting and applying § 956 of the Internal Revenue Code of 1986, as amended (the "Code"),[1] should a court substitute its own policy views for those of Congress or, conversely, should it apply that section as written?

IDENTITY AND INTEREST OF AMICUS CURIAE AND SOURCE OF AUTHORITY TO FILE

The membership of *Amicus* is comprised of taxpayers engaged in the business of manufacturing, who need to be able to plan their affairs with a reasonable degree of predictability as to the tax consequences thereof. The District Court's holding on the § 956 issue exposes the membership to the threat of unpredictable tax liability arising out of routine business transactions. *Amicus* submits this brief simultaneously with an accompanying Motion for Leave to File.

STATEMENT OF THE CASE

Amicus accepts Appellant's Statement of the Case.

INTRODUCTION

Amicus objects to the District Court's reasoning and conclusion in Part 4 of the "Legal Analysis" section of its opinion, entitled "The Big Picture: Subpart F vs.

---

[1] All "Section" references herein are to the Code, except as otherwise indicated.

Notice 89-21." *See generally* the District Court's opinion (hereinafter "Op.") at 88-90. There, the District Court stated that

> Wholly apart from the Court's economic and legal analysis above [*i.e.*, the sale vs. loan analysis and the analysis of the economic substance doctrine] is the powerful fact that Schering-Plough desired -- from the outset – to bring $690 million of previously untaxed foreign income back to the United States without paying an up-front tax. Subpart F of the Internal Revenue Code was specifically designed to prevent this. . . .

Op. at 88. The District Court then stated that

> . . . The Court concludes that Notice 89-21 was not intended to permit United States shareholders of controlled foreign corporations to repatriate offshore revenues without incurring an immediate repatriation tax. In a clash between the short-lived notice and the enveloping Subpart F regime, the Court is faced with an easy choice, especially where the consequences of elevating the notice over the legislative regime would be to "permit the schemes of taxpayers to supersede legislation in the determination in the time and manner of taxation." [Citations omitted] Notice 89-21 was never intended as a reprieve from Subpart F taxation.

Op. at 90.

In relying on this broad policy argument as an independent ground for decision (apart from the technical issue of whether the assignment of the swap receivables actually constituted a loan and the economic substance issue), the reasoning adopted by the District Court (i) misunderstands the relationship between § 956 and Notice 89-21, 1989-1 C.B. 651; (ii) fundamentally misconstrues the structure and logic of § 956;[2] (iii) casts doubt on the ability of taxpayers to plan their affairs; and (iv) conflicts with other court decisions interpreting not only § 956, but also other complex and highly detailed Code provisions. We explain in greater detail below.[3]

ARGUMENT

I. The District Court Misunderstood the Relationship Between Notice 89-21 and § 956.

Section 956 effectively treats as a dividend certain amounts determined by reference to the "United States property," if any, that are held by a controlled foreign corporation. The relevant question under § 956, then, when a controlled foreign corporation acquires any asset (such as a swap receivable) is whether that asset constitutes "United States property." Notice 89-21 does not contain any definition of U.S. property and has no bearing on whether a swap receivable (or any other asset) is U.S. property. Rather, as the court properly notes earlier in its opinion, Op. at 2-3, that Notice is concerned with establishing a method of accounting to be used by taxpayers who receive lump-sum payments in connection

[2] The District Court repeatedly uses the phrase "Subpart F" when it appears to be referring only to § 956, which is only one section contained in Subpart F. For clarity, we will refer to § 956, as the other provisions of Subpart F are not relevant here.

[3] *Amicus* also believes the District Court erred in its conclusions that the swap receivables were loans, and that, even if they were not loans, the economic substance doctrine required them to be treated as loans. However, we focus our attention on the so-called "Big Picture," because that issue has particularly wide application to *Amicus*' members.

with notional principal contracts. There is no argument that the Notice trumps § 956.

To see this, consider what the analysis would have been from the taxpayer's perspective had the Notice never been promulgated. The taxpayer still would have had to determine whether the swap receivables constituted U.S. property within the meaning of § 956(c). If the taxpayer determined that the swap receivables did not constitute U.S. property, the taxpayer would then be required to determine over what period the proceeds from the sale of the swap receivables had to be included in its income. In the absence of the Notice, authorities such as *Schlude v. Commissioner*, 372 U.S. 128 (1963), *affg. in part and revg. in part* 8 AFTR2d 5966, *affg*. 32 T.C. 1271, *and American Automobile Ass'n v. United States*, 367 U.S. 687 (1961), *affg*. 181 F.Supp. 255 (Ct. Cl. 1960), might have suggested that the entire payment for the swap receivable would be includable in income in the year of receipt. The Notice, by mandating that such income must be included in income over the life of the contract using a reasonable method of amortization, obviously made the transaction more attractive from a tax perspective. However, to reiterate, the Notice had no bearing whatsoever on the determination of whether the swap receivables constituted U.S. property under § 956(c).

II. The District Court's "Big Picture" Argument Fundamentally Misconstrues § 956.

The Court held that the broad policies underlying the enactment of § 956 required the purchase of the swap receivables to be treated as currently taxable to Schering-Plough, notwithstanding that no provision of § 956 required this result. By so holding, the District Court substituted its own policy judgment about what should constitute U.S. property for purposes of § 956 for the judgment of Congress. The District Court's fundamental error here is seen in the language quoted above in the "Introduction" to this Brief, in which the District Court held that "Subpart F of the Internal Revenue Code was specifically designed to prevent" a taxpayer from bringing "previously untaxed foreign income back to the United States without paying an up-front tax." Op. at 88. The District Court apparently believed that Congress enacted into law a general policy that imposed a tax on income that was "repatriated" or "brought back" in some ill-defined way, giving neither taxpayers nor the IRS any guidance as to what might be considered to constitute a "repatriation." As next shown, however, Congress did not enact a general policy against "repatriation," but instead enacted a specific detailed statutory scheme reflecting its judgment about which types of assets had sufficient nexus to the United States to merit taxing the U.S. shareholders of the controlled foreign corporations that owned such assets. It is this nexus to the United States, rather than any notion of dividend equivalence, that animates the basic definition of U.S. property.

Section 956(c)(1) defines four general classes of "United States property": (A) tangible property located in the United States; (B) stock of a domestic corporation; (C) an obligation of a United States person; and (D) any right to the use in the United States of (i) a patent or copyright; (ii) an invention, model or design; (iii) a secret formula or process or (iv) any other similar property right that is acquired or developed by the controlled foreign corporation for use in the United States. Section 956(c)(3) further includes certain trade or service receivables in the definition of U.S. property, if purchased from a related U.S. person. This definition focuses on the connection between the property acquired and the United States, not on the connection between the seller of the property and the United States. Thus, it cannot be said that the basic definition of U.S. property embodies a "deemed dividend" concept.[4]

---

[4] Having set forth this precise list of types of property that constitutes "United States property," the Code then goes on to carve out twelve different exceptions to the definition of United States property. These exceptions do not adhere to any uniform pattern, reflecting a single unitary purpose in enacting § 956. Rather, they appear to be motivated by many different policies, including facilitating the borrowing of funds by U.S. borrowers from unrelated controlled foreign corporations, *see § 956(c)(2)(F)* and *§ 956(c)(2)(L)*, improving the competitiveness of the U.S. banking industry, *see § 956(c)(2)(A)*, facilitating exports of tangible goods from the United States, *see § 956(c)(2)(B)*, and facilitating transactions done in the ordinary course of business by controlled foreign corporations that are engaged in business as securities dealers, *see § 956(c)(2)(K)*, among many others. The length and complexity of these carve-outs (encompassing approximately 790 words in total) further rebuts any suggestion that Congress intended to enact into law so simple a concept as a tax on a "repatriation."

III. If the "Big Picture" Aspect of the District Court's Decision is Upheld, the Tax Consequences of Many Routine Transactions Will Be Thrown Into Doubt.

Notwithstanding the clear language of the statute, the District Court appears to believe that the purchase by a controlled foreign corporation of an obligation of an unrelated foreign person (*i.e.,* ABN) from a U.S. shareholder of that controlled foreign corporation constitutes an investment in U.S. property. If this is true, then there is no reason to exclude from the definition of U.S. property the purchase of other property from related U.S. persons, as well. For example, suppose a U.S. parent corporation owns an office building in London, England that is net leased to a third party. If the U.S. parent sells the building to its wholly-owned U.K. controlled foreign corporation, is that an "investment in U.S. property by the controlled foreign corporation?" Congress limited the definition of U.S. property as it relates to tangible property to property "within the United States," and the office building is by assumption in London. Under the District Court's "repatriation" theory, however, the sale by the parent of an office building in London is just as much of a repatriation as selling an office building in the United States. In both cases, the parent would have cash instead of an illiquid payment stream, and the controlled foreign corporation would no longer have the cash but would have an asset that would produce a steady stream of cash over time.[5] Yet to adopt the District Court's view would be to ignore the plain language of the statute based on its own policy preferences. This is impermissible.

IV. The District Court's Conclusion Under the Big Picture Analysis is Inconsistent with the Way in Which Other Courts Have Construed § 956 and Other Complex Code Provisions.

A. Other Courts Have Declined the Government's Invitation to Construe § 956 in Accordance with Its Perceived Overarching Purpose.

For example, in *The Limited Inc. v. Commissioner*, 113 T.C. 169 (1999), *revd.* 286 F.3d 324 (6th Cir. 2002), a controlled foreign corporation deposited funds with a member of its U.S. parent's consolidated group that was a credit card bank. The taxpayer took the position that such deposit did not constitute an investment in U.S. property under the exception for deposits made with "persons carrying on the banking business" within the meaning of § 956(b)(2)(A) (as then in effect). The Tax Court held that a credit card bank was not a person "carrying on the banking business," and that, even if it were such a person, "[a] related party prohibition is implicit in the exception for § 956 deposits. Such a prohibition is

5 To be sure, in the case of the office building, the parent was assumed to own the office building free and clear, and so would not have any obligation to make payments over time in the same manner as Schering-Plough did. One could account for this by changing the example so that the parent borrowed funds to buy the office building and then when the building was sold retained the obligation to make payments under the loan. This tweak, however, would not affect the general principle, which is that Congress did not intend to treat as investments in United States property the acquisition by the controlled foreign corporation of property located outside the United States, regardless of whether such acquisition provided liquidity to the parent.

necessary to give effect to the dividend equivalence theory that underlies the repatriation provision. [citations omitted]." *Id*. 189-190. On appeal, the Court of Appeals for the Sixth Circuit flatly rejected the Tax Court's conclusion, holding that

> the Tax Court abandoned the plain language of § 956(b)(2)(A). Section 956(b)(2)(A) has no related-party prohibition. In fact, the statutory text of § 956 contains a related-party prohibition only in § 956(b)(2)(C) and (F) and (b)(3). If it had intended to impose a related-party prohibition on transfers under § 956(b)(2)(A), Congress could have easily made that prohibition more general or applied it beyond solely those subsections. Congress did not do either. Regardless of its reasons for not doing so, the plain language of § 956(b)(2)(A) has no related-party prohibition, and thus, there is no need to examine legislative history here.
>
> The Tax Court examined legislative history because it found that the Competitive Equality Banking Act made reading § 956(b)(2)(A) without implying a related- party exception unreasonable. The Tax Court explained that had Congress known that banks could constitute related parties when it enacted § 956(b)(2)(A), it would have added a related-party exception to § 956(b)(2)(A). *As a matter of policy that argument makes sense, but it is not the Tax Court's role to inject its own policy determinations into the plain language of statutes.* (emphasis added). . . . While obviously not the policy that the Tax Court would promote were it an über-legislature, interpreting § 956(b)(2)(A) without a related-party prohibition hardly rises to a level of unreasonableness that merits ignoring the plain text of the statute.

The Limited Inc. v. Commissioner, 286 F.3d 324, 336 (6^{th} Cir. 2002).

Similarly, in *Ludwig v. Commissioner,* 68 T.C. 979 (1977), the taxpayer was a U.S. citizen who owned all of the stock in Oceanic, a controlled foreign corporation. The taxpayer borrowed funds from a group of banks and pledged his stock in Oceanic as part of the collateral for the loan. Additionally, the taxpayer made negative covenants in the loan agreement, in which he undertook, in his capacity as sole shareholder, to prevent Oceanic from engaging in certain transactions that would impair the value of its stock as collateral. *Id*. at 980. Section 956 treats the pledge or guarantee by a controlled foreign corporation in support of a loan as a loan by the controlled foreign corporation, but neither the Code nor (at that time) the Treasury regulations addressed the treatment of a pledge by a U.S. shareholder of controlled foreign corporation stock.[6] The Service argued that the shareholder's pledge of the stock of a controlled foreign corporation, coupled with the negative covenants, should be treated as a pledge or guarantee by the controlled foreign corporation. The Tax Court rejected this argument, however, holding that

> [W]e can find no basis for respondent's expansive interpretation of that section in the statutory language, its legislative history, or the implementing regulations. If the draftsmen's handiwork fell short of fully accomplishing the objectives sought, it must be left to Congress to repair such shortfall. Accordingly, we hold that petitioner did not realize gross income under § 951 by reason of his pledge of his Oceanic stock as collateral for his loan from the lending banks.

Id. at 991-992.

[6] The Treasury regulations were subsequently amended to address this point. *See* 26 C.F.R. § 1.956-2(c)(2) (treating a controlled foreign corporation as a pledgor or guarantor of an obligation of a United States person "if its assets serve at any time, even though indirectly, as security for the performance" of that obligation).

Just as in *The Limited* and *Ludwig*, it is not the District Court's role to inject its own policy determinations into the plain language of statutes, nor to repair a congressional shortfall in the drafting of Section 956. Statutes must be interpreted in accordance with the purpose of the legislature, as reflected in the language the legislature chose to accomplish that purpose. Adherance to this rule ensures that taxpayers may enter into transactions (even tax-motivated transactions, as was the case in *The Limited*) with confidence that courts will not sit as "über-legislatures" to enact their own policy preferences into law retroactively.

In support of the "Big Picture" portion of its opinion, the District Court cites *Jacobs Engineering Group, Inc. v. United States,* No. 96-2662, 1997 WL 314167 (C.D. Cal. Mar. 5, 1997). During the taxable years at issue in that case, a Treasury regulation provided that the term "obligation" did not include any indebtedness that was collected within one year from the time it was incurred. *See* 26 C.F.R. § 1.956-2(d)(2)(ii)(a) (promulgated as T.D. 6704, 1964-2 C.B. 284). The taxpayer structured a series of twelve loans, each with a term of no longer than a few months, from the controlled foreign corporation to its U.S. shareholder. The District Court ruled that § 956 applied on broad policy grounds. The Ninth Circuit concluded in an unpublished opinion that the

> stipulated facts demonstrate that Jacobs was attempting to borrow a lump sum over a two year period, but that it broke up the lump sum into twelve different loans in order to avoid paying any taxes on the transaction. Jacobs technically complied with Treas. Reg. § 1.956-

> 2(d)(2), but violated the purpose and spirit of that regulation, which was to except true, short term obligations from the imposition of tax under IRC sections 951 and 956. The Commissioner and the district court therefore correctly applied the substance over form doctrine to reach the conclusion that Jacobs owed taxes on these transaction [sic].
>
> Our conclusion is reinforced by that fact that Jacobs has failed to meet its burden because it has not brought forth evidence that would contradict the Commissioner's determination that the series of loans was in essence a two and a half year loan from JILI to Jacobs structured to circumvent IRC sections 951 and 956. [citation omitted]

Jacobs Engineering Group, Inc. v. United States, 168 F.3d 499 (9th Cir. 1999). Thus, the Ninth Circuit in *Jacobs Engineering* accepted the Service's *factual* recharacterization of a series of short-term loans made between related parties into a single longer term loan between those same two parties. It did not, by contrast, suggest that a court should be free to expand the *legal* definition of U.S. property to encompass a controlled foreign corporation's purchase of the obligation of an unrelated non-U.S. person (*i.e.*, ABN).

B. The Supreme Court Has Rejected the Notion That Courts Should Enact Their Own Policy Preferences Into Law Under the Guise of <u>Interpreting a Tax Statute</u>.

Looking beyond § 956, the approach taken by the District Court is incompatible with the approach taken by Congress in recent years in crafting the Internal Revenue Code. The modern Code is replete with extremely complicated provisions reflecting a congressional struggle to balance the conflicting goals of, *inter alia*, (i) preventing abusive transactions; (ii) not deterring legitimate transactions; (iii) accommodating non-tax goals (e.g., research and development); and (iv) maintaining some level of administerability. Given this complexity, many courts have recognized that it is not the role of the courts or internal revenue agents to attempt to discern the overarching policy of a particular Code section, and to apply that overarching policy to override the language enacted by Congress.

This modern approach to the strict interpretation of Code provisions is reflected in the recent Supreme Court case of *Gitlitz et al v. Commissioner,* 531 U.S. 206 (2001), *revg.* 182 F.3d 1143 (10th Cir. 1999), *affg, Winn v Commissioner*, T.C. Memo. 1998-71. In *Gitlitz*, the Supreme Court held that shareholders in a Subchapter S corporation were allowed to increase the basis in their stock by the amount of cancellation of indebtedness income, even though such income was excluded from the income of the S corporation (and therefore from the income of the shareholders). While the nonrecognition of cancellation of indebtedness income required the reduction of tax attributes, such as the net operating losses of the S corporation, the Supreme Court held that this reduction did not occur until after the cancellation of indebtedness has already passed through to the shareholders, at which point there was nothing left to reduce. The net effect of this holding was to permit the taxpayers a deduction for the corporation's net operating losses and an exclusion for the corresponding cancellation of indebtedness income (*i.e.*, a double tax benefit).

In reaching this conclusion, the Supreme Court acknowledged the concern that

> if shareholders were permitted to pass through the discharge of indebtedness before reducing any tax attributes, the shareholders would wrongly experience a "double windfall": They would be exempted from paying taxes on the full amount of the discharge of indebtedness, and they would be able to increase basis and deduct their previously suspended losses. [footnote omitted].

Id. at 219-220. The Supreme Court, however, summarily dismissed this tax policy issue, stating that, "[b]ecause the Code's plain text permits the taxpayers here to receive these benefits, we need not address this policy concern." *Id*. at 220. This conclusion is especially noteworthy, because the double benefit at issue in *Gitlitz* would generally be considered to be a more fundamental tax policy concern (and therefore more worthy of overriding the plain language of the statute) than is the mere deferral of income at issue in the case under review. Yet the Supreme Court applied the statute as enacted, and did not substitute its own judgment for that of Congress.

CONCLUSION

For these reasons, this Court should reverse the decision of the District Court.

Respectfully submitted,

/s/ Douglas Hinson
Douglas Hinson (Counsel of Record)
Matthew A. Stevens
Alston & Bird LLP
950 F. Street, NW
Washington, DC 20004
(202 239-3553

Attorneys for Amicus Curiae

Dated: September 7, 2010

COMBINED CERTIFICATIONS

Certificate of Bar Admission in Accordance with Local Rule 46. (e)

I certify that I am a member in good standing of the bar of this Circuit. I was admitted on July 19, 2006.

Certificate of Compliance with Fed. R. App. P. 29(d) and 32(a)

I certify that this brief complies with the typeface requirements of Fed. R. App. P. 32(a)(5) and the type style requirements of Fed. R. App. P. 32(a)(6) because the brief has been prepared in proportionally-spaced typeface using Microsoft Word 2003 in Times New Roman, 14 point.

I also certify that this brief complies with the length requirements of Fed. R. App. P. 29(d) and 32(a)(7)(b) because it contains 3179 words, including footnotes.

Certificate of Compliance with Local Appellate Rule 21.1(c)

I certify that this brief has been scanned for viruses and is reported by Symantec Endpoint Protection 11.0.6005.562 to be virus free.

Certificate of Compliance with Local Appellate Rule 31.1

I certify that the text of the electronic brief being provided to this Court is identical to the text in the paper copies.

Certificate of Service

I certify that on September 7, 2010, a true copy was filed with the Court through the CM/ECF system, which will send notice to all registered users In addition, per Local Rule 25.1 and 31.1, ten bound copies were sent to the Court and two copies were sent to counsel below by first class U.S. Mail postage prepaid:

Judith A. Hagley, Esq.
United States Department of Justice
Tax Division
950 Pennsylvania Avenue, NW
P.O. Box 502
Washington, DC 10044-0000

Counsel for Appellee

Jonathan S. Franklin
Fulbright & Jaworski L.L.P.
801 Pennsylvania Ave. N.W.
Washington, D.C. 20004

Counsel for Appellant

/s/Douglas Hinson
Douglas Hinson

Dated: September 7, 2010