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When Courts Say No: 3M and the Future of Treasury Regulations

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In a win for taxpayers, the Eighth Circuit reversed the Tax Court's sharply divided decision in *3M Co. v Commissioner*. In February 2023, the Tax Court narrowly held for the government, refusing to invalidate Treas. Reg. §1.482-1(h)(2), also known as the "Blocked Income Regulation."

The decision in *3M* demonstrates that the regulatory challenge landscape has shifted significantly post-*Loper Bright*. As the US Court of Appeals for the Eighth Circuit's opinion in *3M v. Commissioner* illustrates, courts have embraced the Supreme Court's mandate to "'fix[] the boundaries of [the IRS's] delegated authority' based on the statute's text." There likely will be more courts rejecting a variety of the Department of Treasury interpretations of the Code in favor of the court's own reading of the statutory language. Not only could this shift signal the demise of certain regulations, but it could also put a break on the IRS's aggressive rulemaking strategy seen in the past several years.

Background to 3M Dispute

Issue. The case relates to the transfer pricing between 3M Company ("3M"), the US parent of a consolidated group of corporations engaged in research, development, manufacturing, and sales of products in a range of industries, and its Brazilian subsidiary, 3M do Brasil Ltda. ("3M Brazil").

Facts. During 2006, 3M Brazil manufactured and sold products under various trademarks that 3M owned. A set of intercompany licenses set the terms and conditions under which 3M Brazil was entitled to use the 3M trademarks. The Brazilian Patent and Trademark Office reviewed and recorded the trademark licenses.

The trademark licenses essentially provided that 3M Brazil would pay 3M a trademark royalty equal to 1% of net sales from all trademarked products. This 1% royalty rate was the maximum amount that Brazilian law in effect at the time would allow. The statutory maximum trademark royalty rate did not align with the arm's-length standard. For 2006, 3M Brazil paid 3M royalties of $5.1 million pursuant to the trademark licenses. 3M Brazil also used certain intellectual property ("IP") that another US affiliate of 3M owned. 3M Brazil and the other affiliate did not enter into a written or formal license that would allow 3M Brazil to use the IP, and 3M Brazil did not pay for using it. But even if 3M Brazil had made such payments, the maximum additional amount that it could have legally paid as royalties to 3M under Brazilian law was $4.3 million.

IRS Proposed Adjustment. Notwithstanding the legal restriction, the IRS proposed to increase 3M's income by $23.7 million, which would reflect a royalty paid to 3M in the amount of 6% of 3M Brazil's total net sales for 2006. The IRS's transfer pricing adjustment did not consider the restriction under Brazilian law—which has since been changed to embrace the arm's-length standard—because the restriction did not meet the requirements of the Blocked Income Regulation. That regulation provides,

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among other things, that a foreign legal restriction will be taken into account "only if the taxpayer establishes that the restriction affected an uncontrolled taxpayer under comparable circumstances for a comparable period of time." This rule allows Treasury to tax certain income even though foreign law prohibits the related party from paying the taxpayer. Treasury issued the Blocked Income Regulation in an attempt to counteract the Supreme Court's holding in *Commissioner v. First Security Bank of Utah, N.A.*, 405 U.S. 394 (1972), which concluded that the IRS could not attribute to taxpayers' income that foreign law prohibited taxpayers from receiving.

Tax Court. By siding with the government, the Tax Court's *3M* decision concluded that the Blocked Income Regulation had effectively reversed the Supreme Court's decision in *First Security*. In particular, the plurality opinion held that the Blocked Income Regulation was valid under both steps of the *Chevron* doctrine, which afforded deference to regulatory agencies. In *Chevron U.S.A. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984), the Supreme Court established a two-step analytical framework for courts to use when reviewing an agency's action:

1. The courts first look to whether Congress had directly addressed the precise issue at hand (i.e., whether the statute was ambiguous).
2. If Congress had not, the courts then consider whether the agency's interpretation of the statute was reasonable. If the agency's interpretation was reasonable, *Chevron* required the court to defer to that interpretation even if it would read the statute differently.

For a more detailed discussion of the Tax Court decision in *3M*, see the article by George Clark and Eric Aberg, and Christine Kim, *Tax Court topples Supreme Court precedent in favor of agency deference* (Apr. 7, 2023).

Loper Bright. After the Tax Court issued its decision in *3M,* the Supreme Court issued its landmark ruling in *Loper Bright Enters. v. Raimondo,* 603 U.S. 369 (2024), which abrogated *Chevron* deference. Under *Loper Bright*, courts may no longer defer to agency interpretations. Instead, courts must independently determine the best interpretation of the statute at issue, including whether an agency acted within its statutory authority. This approach accords with the Administrative Procedure Act (the "APA"), which requires that courts, not agencies, decide questions of law and affords no deference to agency interpretations. Although Treasury and the IRS had frequently asserted that the APA does not apply to Treasury, the Supreme Court firmly rejected this notion in *Mayo Foundation for Medical Education and Research v. United States,* 562 U.S. 44 (2011), explaining that it was "not inclined to carve out an approach to administrative review good for tax law only."

Eighth Circuit's Holding

The departure from the *Chevron* doctrine was a seismic shift in paradigm, which the Eighth Circuit in *3M* fully embraced by giving no weight to the agency's interpretation of the statute, namely, §482. Instead, the Eighth Circuit determined that the best reading of the statute prohibits the IRS from reallocating income in cases where foreign law bars the related party from paying the taxpayer. Therefore, the IRS could not make transfer pricing adjustments to increase the 3M's income by the amount of royalties that Brazilian law barred 3M Brazil from remitting to 3M.

Textual Approach. Parsing the text of §482, the Eighth Circuit focused on the limits on the government's authority to reallocate income Congress incorporated into the statute. One such limit is the necessity of reallocation to "clearly to reflect the income." Courts have interpreted this language, which appears in the first sentence of §482, as embodying the "arm's length standard." *See, e.g.*, *First Security*, 405 U.S. at 400; *Barclays Bank PLC v. Franchise Tax Bd. of Cal.*, 512 U.S. 298, 305 (1994). Relying heavily on the Supreme Court precedent in *First Security*, the Eighth Circuit confirmed that for the IRS to

reallocate "income," the taxpayer must have complete dominion over the income. The taxpayer cannot have complete control over the income if it cannot legally receive the income in the first place. In this case, Brazilian law did not allow 3M Brazil to transfer to 3M the royalties at issue. Given this prohibition, attributing these royalties to 3M would not clearly reflect income under §482.

Although the IRS directed the court's attention to the "commensurate with the income" ("CWI") standard in the second sentence of §482, this standard could not salvage the government's case. Congress added the CWI standard to the statute after the Supreme Court's decision in *First Security*. The IRS argued that this change to the statute superseded *First Security* and required royalties paid with respect to IP to be commensurate with income attributable to such IP, regardless of whether such amount could be legally paid. Consulting grammatical rules to discern "the statute's true meaning," the Eighth Circuit found that the term "income," which Congress used twice in the second sentence, necessarily relates back to the "gross income" in the first sentence. The Eighth Circuit found that the term "income" was limited to the amount over which the taxpayer has dominion or control. Because the "commensurate with income" standard must be construed in the context of §482's first sentence, the requirement that the taxpayer has dominion or control over an amount for it to be income to that taxpayer still applies in the context of IP licenses.

The IRS's reading of the CWI standard as redefining what can be allocated under §482 does not comport with the purpose of the CWI standard. Congress enacted the CWI standard to address the difficulties in applying an arm's length approach to transactions without comparable transactions, particularly in the context of intangibles with a high profit potential. H.R. Rep. No 99-426,1st Sess. 423 (1985). The Eighth Circuit's reading of §482 reflects such congressional intent: The first sentence grants the IRS the authority to allocate income, and the second sentence governs how to allocate income in certain situations when the transaction involves intangible property.

Delegation of Discretionary Authority Rejected. The Eighth Circuit was equally unmoved by the IRS's theories in its post-*Loper Bright* supplemental briefing. The IRS argued that the broad language of §482 "delegate[d] discretionary authority" to Treasury and that Treasury had acted within the bounds of its authority when it issued the Blocked Income Regulation. In response, the Eighth Circuit made clear that the court's job was to "'fix[] the boundaries of [that] delegated authority' based on the statute's text." The Eighth Circuit explicitly declined to defer to the agency's interpretation when the agency "recently invented" its interpretation, and the court was able to identify a "better reading" of the statute.

"Shifting Sands of Administrative Law"

Rectifying the Consequences of *Chevron*. The Eighth Circuit's decision in *3M* reflects the changing landscape in regulatory challenges in the wake of *Loper Bright*. In recent years (particularly after Congress enacted the Tax Cuts and Jobs Act in 2017), Treasury has increasingly issued regulations that effectively override or rewrite clear statutory text, without regard to whether Treasury claimed to be acting pursuant to a specific grant of rulemaking authority or the more general grant under §7805. Although many taxpayers and industry groups have informed Treasury that some of their regulations are contrary to statutes and exceed the agencies' rulemaking authority, the government has refused to correct its course.

The *Chevron* decision, likely unintentionally, eased the way for Treasury to issue regulations that overrode or rewrote statutes by requiring courts to defer to agency interpretations. Taxpayers often loath litigating tax cases, as they view litigation to be expensive and time consuming. Because of *Chevron* deference, taxpayers viewed cases involving challenges to Treasury regulations to also be uphill battles. Accordingly, for many years, taxpayers were reluctant to challenge potentially invalid Treasury regulations, which may have emboldened Treasury to believe that it had far more license to

create law in regulations than it actually had. *Loper Bright*'s mandate will help dispel any such mistaken perception. As the opening of the Eighth Circuit's opinion in *3M* illustrates, *Loper Bright* has ushered in a new era: "Statutes trump regulations…. The IRS [] authorized by regulation what a statute had not. That strategy might have worked before…but not now."

Although *Loper Bright* represents a significant shift in administrative law, courts have grown increasingly skeptical of regulations even before the Supreme Court handed down that decision. The district court in *FedEx Corporation v. United States*, No. 2:20-cv-02794 (W.D.Tenn. Mar. 31, 2023), the US Court of Appeals for the Sixth Circuit's decision in *Whirlpool Financial Corporation v. Commissioner*, 19 F.4th 944, 952-53 (6th Cir. 2021), and the US Court of Appeals for the First Circuit's decision in *TBL Licensing LLC v. Commissioner*, 82 F.4th 12 (1st Cir. 2023), all of which predate *Loper Bright*, illustrate courts' increasing tendency to closely scrutinize Treasury regulations after the decision in *Mayo Foundation*.

Effective Date Cases. Nowhere has the government's overreach been more apparent or *Loper Bright* been more impactful than in the context of effective dates. Last year, in *Varian Medical v. Commissioner*, 163 T.C. 76 (2024), the Tax Court applied *Loper Bright* for the first time to reject the government's argument that that the §78 regulations provided an earlier effective date provision for newly enacted §78.

In 2017, Congress enacted §245A as part of the Tax Cuts and Jobs Act. Section 245A allows a deduction for certain dividends domestic corporations receive from foreign subsidiaries for distributions made "after December 31, 2017."

Section 78 has long required a "gross-up" for foreign taxes deemed paid where a taxpayer claims a foreign tax credit. Congress amended §78 in the TCJA to prevent taxpayers from taking a §245A deduction for their §78 dividends. Amended §78 applied to the tax years of foreign corporations that began after December 31, 2017. The difference in effective dates between §245A and amended §78 meant that for certain foreign subsidiaries using fiscal years, there was a window in which §245A was in effect, but the amended version of §78 was not in effect. This discrepancy meant that for a limited period of time, some taxpayers were able to take a §245A deduction for their §78 dividends.

Seeking to prevent what it perceived to be an unintended result, in 2019, Treasury amended the §78 regulations to provide that §78 dividends are not treated as dividends for the purpose of §245A and specifically applied this revision to "section 78 dividends that are received after December 31, 2017, by reason of taxes deemed paid under section 960(a) with respect to a taxable year of a foreign corporation beginning before January 1, 2018." Treas. Reg. §1.78-1(c). This rule gave §78 an earlier effective date than the plain language of the statute provided for. To be specific, this rule purported to change §78's effective date from "the first taxable year beginning after December 31, 2017," to "January 1, 2018."

The government asserted that the rule was a permissible interpretation of the statute because this interpretation resolved the interaction between §245A and §78. The Tax Court was unpersuaded, explaining that "[n]o matter what the revised regulation intended to interpret, it cannot contradict the clear effective date provided for in the statutory text."

Less than a month after its decision in *Varian*, the Tax Court addressed the same issue in *Sysco v. Commissioner*, No. 5728-23 (Sept. 13, 2024), similarly holding that the taxpayer was entitled to a §245A deduction for its §78 dividend for its 2018 tax year. This interaction between the effective dates in §245A and §78 has also been taken up by a district court in a series of suits involving the taxpayer Kyocera. *Kyocera AVX Components Corp. v. Commissioner*, No. 22-cv-02440 (D.S.C.); *United States v. Kyocera AVX Components Corp.*, No. 6:25-cv-01704 (D.S.C.).

Courts' Review of Agency Interpretations in Other Contexts. *Loper Bright* has had, and will continue to have, significant and wide-ranging implications for many cases involving regulatory challenges and agency interpretations. This year, relying in part on its holding in *Varian*, the Tax Court in *JM Assets, LP v. Commissioner*, No. 2531-24 (2025) found that Treas. Reg. §301.6235-1(b)(2)(A) was invalid because it extended the period of limitations for issuing a notice of final partnership adjustment past the time prescribed in the statute and was accordingly invalid. The Tax Court reiterated that "where Congress expressly delegates broad rulemaking authority, that authority does not extend to contradicting statutory text." For a more detailed discussion of *JM Assets*, see Vivek Patel and Uchenna Abakwue, *United States: Tax Court Holds That Regulations Do Not Extend the BBA Modification Period* (Nov. 18, 2025).

The fact that courts have been refusing to defer to agency interpretations is also evident outside of the regulatory invalidity context. For example, in the recent Tenth Circuit decision in *Liberty Global v. Commissioner*, No. 24-9004 (10th Cir. 2025), the court applied a similar plain-language analysis of statutory text, albeit in favor of the government. Specifically, the US Court of Appeals for the Tenth Circuit declined to accept Liberty Global's argument that the regulations (i.e., the IRS's interpretation of the statute) allowed for a broader reading of the statute at issue. In doing so, the court noted that the taxpayer's interpretation would broaden the provision "well beyond the statutory language" and create a conflict with other provisions in the Code. For a more detailed analysis of *Liberty Global* and the diminishing influence of regulations, see Sam Pollack, *Liberty Global Reflects the Continuing Decline of Regulatory Weight*, Tax Mgmt. Int'l J. (Nov. 3, 2025).

3M and Varian Are Just the Beginning. This change in landscape with regard to regulatory challenges may bode well for a number of other pending cases in which a regulation's validity is at stake. For example, the validity of the Blocked Income Regulation is also at issue in *Coca-Cola Co. & Subs. v. Commissioner*, 155 T.C. 145 (2020), another Tax Court decision, which upheld the regulation following its prior ruling in *3M* and is currently on appeal before the Eleventh Circuit.

The taxpayer in *Abbott Laboratories v. Commissioner*, No. 20227-23, has challenged several regulations on the basis that they conflict with a statute. The taxpayer is challenging the rules in Treas. Reg. §1.482-7(d), which require taxpayer to include stock-based compensation in cost sharing arrangements, on the basis that they conflict with the arm's length standard of §482. The taxpayer also argues that Treas. Reg. §1.951A-2(c)(5), which disallows certain deductions for the purpose of determining tested income or losses under §951A, is invalid because this regulation conflicts with the plain language of §951A.
The taxpayer in *McKesson Corp. v. United States*, No. 3:25-cv-01102 (N.D. Tex.) has also challenged the rules requiring taxpayer to include stock-based compensation in cost sharing arrangements on the basis that they conflict with §482.

In *Siemens Medical Solutions USA, Inc. v. Commissioner*, No. 11432-25, the taxpayer has challenged the validity of the §245A temporary regulations, arguing in part that §245A does not impose any limit on the §245A deduction and therefore the "extraordinary dispositions" limitation the temporary regulations created conflicts with the plain language of the statute and accordingly is invalid.

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