

United States: Tax Court topples Supreme Court precedent in favor of agency deference

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In brief

In *3M Co. v. Commissioner*,¹ the Tax Court upheld the validity of a regulation—Treas. Reg. § 1.482-1(h)(2) (the “Blocked Income Regulation”)—that effectively taxed income the taxpayer was barred from receiving under foreign law. The result is counterintuitive, and arguably flies in the face of Tax Court, circuit court, and Supreme Court precedents, which previously held that section 482 does not permit the Commissioner to allocate income “that [the taxpayer] did not receive and that he was prohibited from receiving.”² The Tax Court upheld the Blocked Income Regulation by the slimmest of margins: seven judges joined a plurality opinion authored by Judge Richard T. Morrison, two judges concurred in result only, and eight judges dissented. The diversity of opinions reveals deep disagreement among the judges on the proper framework to apply in regulatory-challenge cases and leaves considerable room for a successful appellate challenge.

Background

The facts of *3M* revolve around the international operations of 3M Company (“3M”), the U.S. parent of a consolidated group of corporations engaged in research, development, manufacturing, and sales of products in a range of industries. In Brazil, 3M operated through its Brazilian subsidiary, 3M do Brasil Ltda. (“3M Brazil”).

During 2006, 3M Brazil manufactured and sold products under various trademarks owned by 3M. Its trademark usage in Brazil was governed by a set of intercompany licenses, which were reviewed and recorded by the Brazilian Patent and Trademark Office, and which effectively provided that 3M Brazil would pay 3M 1% of net sales from all trademarked products—the maximum amount allowed under Brazilian law. For 2006, 3M Brazil paid 3M royalties of \$5.1 million under the trademark licenses.

During 2006, 3M Brazil also utilized certain intellectual property (IP) owned by another U.S. affiliate of 3M. This IP was not covered by any intercompany agreement, and 3M Brazil did not pay for using this IP. 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.

Notwithstanding the legal restriction, the IRS proposed to increase 3M's income by \$23.7 million (the equivalent of a 6% royalty applied to 3M Brazil's total net sales for 2006). The IRS's transfer pricing adjustment did not consider the Brazilian legal restriction because it did not meet the requirements of the Blocked Income Regulation. That regulation provides in pertinent part 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.”

¹ 160 T.C. No. 3 (2023).

² *Commissioner v. First Sec. Bank of Utah*, 405 U.S. 394, 403 (1972); see *Procter & Gamble Co. v. Commissioner*, 95 T.C. 323 (1990), *aff'd*, 961 F.2d 1255 (6th Cir. 1992).



The Taxpayer's Challenge

Applying the Blocked Income Regulation meant that 3M would pay tax on income that it indisputably did not, and could not legally, receive. 3M challenged the validity of the regulation on multiple grounds.

- First, 3M argued under *Chevron* step one that section 482 unambiguously precludes the allocation of income that the taxpayer is legally blocked from receiving. 3M cited a line of cases that appeared to hold as much, including the Supreme Court's decision in *First Security Bank*.³ In *First Security*, the Supreme Court held that the Commissioner could not use section 482 to allocate insurance premium income to two banks that were prohibited under U.S. law from soliciting or receiving insurance premiums. In a subsequent decision, *Procter & Gamble*, the Tax Court read *First Security* to mean that "section 482 simply does not apply where restrictions imposed by law, and not the actions of the controlling interest, serve to distort income among the controlled group."⁴ 3M argued that these cases and others (see, e.g., *Exxon Corp. v. Commissioner*)⁵ amounted to a judicial determination (prior to the promulgation of the regulation) that section 482 was unambiguous on the issue of blocked income—thus, Treasury had exceeded its authority.
- Second, 3M argued that even if section 482 was ambiguous on the issue of blocked income, the rule that Treasury promulgated was not a reasonable interpretation of the statute under *Chevron* step two. 3M challenged the reasonableness of several requirements set forth in the Blocked Income Regulation, including that the legal restriction must affect "an uncontrolled taxpayer under comparable circumstances for a comparable period of time" and be "publicly promulgated [and] generally applicable to all similarly situated persons."
- Third, 3M argued that the IRS had failed to promulgate the Blocked Income Regulation according to the required administrative procedures outlined by the Supreme Court in *State Farm*.⁶ In particular, it cited Treasury's failure to respond to comments submitted in response to temporary regulations that were substantively identical to those at issue. Those comments expressed, among other things, concern that certain foreign legal restrictions (like the Brazilian law at issue) do not apply to uncontrolled taxpayers, and many are imposed through informal policies or interpretations that fail to satisfy the public-promulgation test. Yet Treasury did not identify or discuss the relevant comments in its decision implementing the final regulation.

The Plurality Opinion

As noted, seven judges joined Judge Morrison's plurality opinion, which held that the Blocked Income Regulation was valid under both steps of *Chevron* and *State Farm*. In addressing 3M's *Chevron* step one argument, Judge Morrison opined that the decisions 3M relied on—including *First Security* and *Procter & Gamble*—were decided on the basis of the "complete power" language set forth in regulations no longer in effect, rather than a reading of what the statute permitted. He also opined that the seemingly conclusive language set forth in those decisions emanated from the courts' interpretation of section 61 rather than section 482. Moreover, he observed that these earlier decisions were decided before the commensurate-with-income standard was added to section 482 in 1986. Judge Morrison wrote that by introducing the commensurate-with-income language Congress intended to add a new and additional standard for determining allocations for intangible property that was not at issue in earlier cases.

In its *Chevron* step 2 analysis, the plurality opinion primarily discussed the regulation's requirement that a legal restriction have "comparable effect on uncontrolled taxpayers." Judge Morrison concluded that this requirement was a reasonable interpretation of section 482 because it promoted the goals of tax parity and the arm's length principle.⁷ The plurality

³ *Commissioner v. First Security Bank of Utah, N.A.*, 405 U.S. 394 (1972).

⁴ *Procter & Gamble Co. v. Commissioner*, 95 T.C. 323, 335-36 (1990), *aff'd*, 961 F.2d 1255 (6th Cir. 1992).

⁵ *Exxon Corp. v. Commissioner*, T.C. Memo. 1993-616, *aff'd sub nom. Texaco, Inc. v. Commissioner*, 98 F.3d 825 (5th Cir. 1996).

⁶ *Motor Vehicle Mfrs. Ass'n of the U.S., Inc. v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29 (1983).

⁷ Judge Morrison did not accept 3M's argument that, because the Brazilian law only applied to controlled taxpayers, the regulation imposed a tax *not* on par with uncontrolled entities.



opinion also concluded, with minimal discussion, that the regulation's public-promulgation and general-applicability requirements were reasonable.

Finally, the plurality opinion held that Treasury complied with *State Farm* in promulgating the Blocked Income Regulation. With respect to *State Farm*'s reasoned-explanation requirement, Judge Morrison disagreed with 3M that Treasury was required to explicitly state a rationale for its decision, which, in his view, could be discerned from the text of the regulation itself. Judge Morrison also concluded that the agency was not required to respond to the comments challenging the validity of the regulation because they were "not significant."

Concurrences

Chief Judge Kathleen Kerrigan and Judge Elizabeth Copeland authored two concurrences that upheld the result reached by the plurality. The Chief Judge's opinion expressed general agreement with Judge Morrison's decision, but advanced several additional arguments to bolster his conclusion that the Blocked Income Regulation is valid. Among other things, the Chief Judge emphasized her belief that Treasury was not required to affirmatively respond to public comments regarding the temporary regulations; she opined that the parties' stipulation that Treasury "considered all comments to the 1994 regulations" was sufficient evidence that Treasury complied with *State Farm*. She also expressed concern that the approach advocated by certain judges in dissent—which would consider whether Treasury provided sufficiently substantive responses to comments—was a "slippery slope" that could lead to "undoing of years of regulatory promulgation."

In Judge Copeland's view, "the result of [3M's] case is dictated by the plain text of section 482[.]" Specifically, she opined that the commensurate-with-income standard "require[s] [the allocation]...with or without the clarifications of Treasury Regulation § 1.482-1(h)(2)."

Dissenting Opinions

Eight judges dissented and joined at least one of the three dissenting opinions authored by Judges Ronald Buch, Cary Douglas Pugh, and Emin Toro. In Judge Buch's view, "Congress has not amended Section 482 in any way that would materially alter the Supreme Court's holding in *First Security Bank*." *First Security* holds that "blocked income cannot be taxed" and even though it does not use the "magic word" for purposes of the *Chevron* analysis (i.e., "unambiguous"), *First Security* and its progeny preclude the Commissioner from allocating and taxing income that the taxpayer did not, and cannot, receive. Judge Buch explained that the commensurate-with-income standard, which serves a different policy goal, does not alter "the longstanding precedent that blocked income cannot be allocated and taxed."

Judge Pugh similarly pointed out that *First Security* remains a controlling precedent because the 1986 change to section 482 did not alter the definition of "income." Because the *First Security* holding did not rest on the defunct "complete power" regulation, but rather on the definition of "income," Judge Pugh reasoned that the statutory amendment does not vitiate the precedential value of the decision and does not authorize Treasury to issue regulations that conflict with the Supreme Court and Sixth Circuit decisions of *First Security Bank* and *Procter & Gamble*, respectively.

In the third and final dissent, Judge Toro focused on the procedural defects of the Blocked Income Regulation. Under the Administrative Procedure Act (APA), Treasury was required to provide adequate reasons for its actions and address significant comments to the regulations. Comments that expressed the view that the Blocked Income Regulation "contradicted the Supreme Court's decision" are significant, according to Judge Toro. Yet, the record is devoid of any explanation as to the basis for the rules and the issues raised in the comments. In fact, as Judge Toro pointed out, "[i]n promulgating Treasury Regulation § 1.482-1(h)(2) (and the entire regulation package of which it was a part), Treasury repeatedly expressed the view that it did not have to follow the APA's notice and comment procedures."

Future of the Blocked Income Regulation and the 3M Decision

The Tax Court took almost a decade after 3M filed its petition in March 2013 to resolve the long-running dispute regarding the effect of foreign legal restrictions on section 482 adjustments. While at a first glance the Tax Court seems



to have handed the IRS a significant victory, *the court's nine-to-eight split decision likely will not be the last word on this issue*. So narrow was the victory for the IRS that if the court had rendered its decision a mere seven months later, the taxpayer would have prevailed. Two of the judges who signed onto Judge Morrison's opinion have either assumed senior status since the decision (Judge David Gustafson) or will assume senior status in August 2023 (Judge Joseph Gale).

The stark contrast between the plurality's holding and Judge Toro's dissent (joined by five judges) demonstrates the deep divide between the judges on how to deal with procedural failings of Treasury regulations, and the uncertainty for taxpayers challenging the validity of regulations on those bases in the Tax Court. It is worth noting that many of the recent appointees to the bench⁸ would set a higher bar for Treasury in issuing a procedurally valid regulation, a standard that appears to be more consistent with other recent cases that address agency decisionmaking. Viewed through another lens, the plurality strained to explain why a Supreme Court opinion doesn't mean what it said. The principal opinion spans more than 150 pages while Judge Pugh's pithy dissent takes up less than a page. As litigators are often reminded by judges, short is not only sweet, but also it has more tendency to be correct.

At bottom, the multitude of competing opinions indicates that 3M has strong grounds to challenge the Tax Court's decision if it pursues an appeal. Coca-Cola, whose transfer pricing case was decided in 2020 except for the similar blocked income issue upon which the Tax Court declined to rule pending the outcome of 3M, has already signaled its intention to appeal.⁹ On appeal, circuit courts tasked with reviewing the Tax Court decisions (the Eleventh Circuit in *Coca Cola* and the Eighth Circuit in 3M) will grapple with the question of whether *First Security* and related cases no longer control as a result of the statutory amendment that added the commensurate-with-income standard to section 482. The courts will also likely examine in-depth the role of the commensurate-with-income requirement within the broader statute and its relationship with the arm's-length principle. Alternatively, it is also possible that the courts will simply choose to focus on whether Treasury fulfilled its responsibility under the APA in promulgating the Blocked Income Regulation. In recent years, federal courts at all levels have demonstrated a willingness to subject Treasury Regulations to a more searching administrative review than the Tax Court arguably performed. In either case, any circuit split could lead to a Supreme Court review. Review is possible even if both circuit courts affirm, because the Tax Court decision effectively overturns the Supreme Court precedent of *First Security*.

While the substantive issues arising from the Brazilian legal restrictions may have limited relevance in the future as a result of new transfer pricing legislation in Brazil that adopts the arm's-length principle, the import of the 3M case is far more extensive for taxpayers. At its heart, the case concerns the Commissioner's authority under section 482, the purpose and principles of section 482, and even more broadly, the concept of taxable income, issues that are fundamental to many transfer pricing disputes.

⁸ Judges Ronald Buch, Patrick Urda, Courtney Jones, Travis Greaves, and Christian Weiler joined Judge Toro's dissent. Judge Urda joined the Tax Court in 2018, Judges Toro and Jones in 2019, and Judges Greaves and Weiler in 2020.

⁹ *Coca-Cola Co. & Subs. v Commissioner*, 155 T.C. 145 (2020).

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