TaxNewsFlash

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U.S. Tax Court: Regulation under section 482 relating to consideration of foreign legal restrictions upheld

The U.S. Tax Court today upheld the requirements under Treas. Reg. §1.482-1(h)(2) (2006) that must be met before the IRS "will take into account the effect of a foreign legal restriction" under section 482 and found that Brazilian legal restrictions at issue in the case did not satisfy such requirements.

Today's opinion was joined by seven of the 17 judges of the Tax Court, with one judge writing a separate concurring opinion in which four other judges joined. Two judges concurred in the result only, with one of those judges writing a separate opinion in which three of the judges joined. Eight judges dissented, with one writing a separate opinion in which four judges joined, a second judge writing a separate opinion in which four judges joined, and a third judge writing a separate opinion in which five judges joined.

The case is: *3M Company and Subsidiaries v. Commissioner,* 160 T.C. No. 3 (February 9, 2023). Read the Tax Court's **opinion** [PDF 2.1 MB] (346 pages)

Summary

The taxpayer P is the common parent company of a consolidated group of corporations. P owned the group's trademarks, while other intellectual property (including patents and non-patented technology) was owned by S, a second-tier wholly owned U.S. subsidiary of the taxpayer and member of the consolidated group.

B, a wholly owned Brazilian subsidiary of S, used the trademarks owned by P in its business operations during 2006, pursuant to three trademark licenses. In accordance with the licenses, B paid a royalty to P equal to 1% of its sales of the trademarked products. Some products sold by B were subject to trademarks covered by more than one of the three trademark licenses. For such products, B and P calculated the trademark royalties using a stacking principle under which, for example, if a particular product used trademarks covered by all three trademark licenses, the royalties were 3% of the sales of the product.

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B also used patents and non-patented technology owned by S in its business operations. B paid no patent royalties and made no technology-transfer payments to S. No patent license or technology-transfer agreement was in effect between S and B.

On its 2006 consolidated federal income tax return, the P consolidated group reported as income the trademark royalties that B paid to P in 2006.

In the notice of deficiency, the IRS determined that the income of the P consolidated group must be increased under section 482 to account for an arm's length rate of compensation for B's use of the intellectual property of P and S. P's position was that the section 482 allocation must correspond to the maximum amount that B could have paid for the intellectual property in question under the laws of Brazil, less related expenses. The IRS's section 482 adjustment did not, however, take into account the effect of the Brazilian legal restrictions.

A 1994 regulation, Treas. Reg. §1.482-1(h)(2) (2006), sets forth the requirements that must be met before the IRS "will take into account the effect of a foreign legal restriction" under section 482. P contends that some of the requirements are invalid because they fail either the Chevron step 2 test or the part of the State Farm test that requires the agency to adequately respond to comments. *See Chevron, U.S.A., Inc. v. Nat. Res. Def. Council, Inc.*, 467 U.S. 837, 844 (1984); *Motor Vehicle Mfrs. Ass'n of the U.S., Inc. v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29 (1983); *Altera Corp. & Subs. v. Commissioner*, 145 T.C. 91, 120, 130 (2015), rev'd, 926 F.3d 1061 (9th 2019). P also contends that the entire regulation addressing foreign legal restrictions is invalid under the part of the State Farm test that requires the agency to give a satisfactory explanation for the regulation and the part of the State Farm test that requires the agency to respond to comments. Furthermore, P contends that the entire regulation is invalid under Chevron step 1 because *Commissioner v. First Security Bank of Utah, N.A.*, 405 U.S. 394 (1972), and its progenitor and progeny held that under predecessors to section 482 the IRS cannot make an allocation of income to a taxpayer who did not receive income and could not legally receive the income.

Tax Court decision

The Tax Court held that:

- The requirement of Treas. Reg. §1.482-1(h)(2)(i) (2006) that "a foreign legal restriction will be taken into account only to the extent that it is shown that the restriction affected an uncontrolled taxpayer under comparable circumstances" is not invalid under Chevron step 2.
- The requirement of Treas. Reg. §1.482- 1(h)(2)(ii)(A) (2006) that foreign legal restrictions be taken into account under section 482 only if they are publicly promulgated means that the foreign legal restrictions must be in writing.
- The Brazilian legal restrictions at issue do not meet the publicly promulgated requirement in Treas. Reg. §1.482- 1(h)(2)(ii)(A) (2006).
- The requirement of Treas. Reg. §1.482- 1(h)(2)(ii)(A) (2006) that foreign legal restrictions be taken into account under section 482 only if they are publicly promulgated is not invalid under Chevron step 2.
- The requirement of Treas. Reg. §1.482- 1(h)(2)(ii)(A) (2006) that foreign legal restrictions be taken into account under section 482 only if they are "generally applicable to all similarly situated persons (both controlled and uncontrolled)" is not invalid under Chevron step 2.
- The 1994 regulation Treas. Reg. §1.482-1(h)(2) (2006) is valid under Chevron step 1.
- The 1994 regulation Treas. Reg. §1.482-1(h)(2) (2006) is not invalid under P's State Farm theory.

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