

Tax Court upholds validity of ‘blocked income regulation’ in long-awaited 3M decision

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In brief

In *3M*, a sharply divided US Tax Court on February 9 issued a long-awaited decision ([Docket Number 5816-13](#)) that upheld the 1994 blocked income regulation under Section 482. The majority opinion, written by Judge Richard Morrison, was accompanied by a number of concurring and dissenting opinions, reflecting a 9-8 split among the judges. Two of the nine judges who held for the IRS concurred only in the result. The varying opinions, running for a total of 346 pages, show the division of the court and perhaps partially explain the long history of this case, which was first docketed in 2013.

Why it is relevant: In upholding the validity of the 1994 blocked income regulation, the Tax Court majority opinion directly impacts the evaluation of related-party transactions that are subject to legal restrictions preventing the payment or receipt of arm’s-length amounts. The 1994 regulation allows taxpayers to avoid the imputation of arm’s-length income that is subject to such legal restrictions only if certain strict requirements are met. Because it found that 3M did not meet the regulatory requirements, the Tax Court majority opinion held that 3M had to recognize arm’s-length royalty income on its license to a Brazilian subsidiary regardless of the legal restrictions on royalty payments imposed under Brazilian laws and policies. Companies facing similar blocked income issues should carefully consider how each of the specific regulatory requirements might apply under their facts and circumstances.

The reasoning of the Tax Court also relates more broadly to the evaluation of the validity of income tax regulations in general. The Tax Court majority held that the 1994 blocked income regulation was entitled to deference under the principles of *Chevron* and was procedurally valid under the Administrative Procedure Act. In contrast, dissenting judges believed that the regulation exceeded the Treasury Department’s authority under Section 482 as interpreted by prior case law, and that the regulation was procedurally defective because the Treasury Department failed adequately to explain the reasons for its adoption of the 1994 blocked income regulation and to respond to relevant public comments submitted during the rulemaking process. The sharp division among the Tax Court judges on this issue leaves uncertainty as to how these factors might be applied in future cases in which the validity of income tax regulations is challenged.

Once it is finalized, the 3M decision could be appealed to the US Circuit Court of Appeals for the Eighth Circuit.

In detail

Facts

3M, the US-based industrial and consumer products company, had a Brazilian subsidiary (3M Brazil) that used 3M trademarks and other intellectual property in 2006. The case related to the royalty income allocable from 3M Brazil to 3M's US consolidated return group, consisting of the group's ultimate US parent company, "P," and P's wholly owned US subsidiary, "S."

During 2006, 3M Brazil used various trademarks owned by P under three separate trademark licenses. Each license concerned a separate set of trademarks. In accordance with the licenses, 3M Brazil paid a royalty to P equal to 1% of its sales of the trademarked products.

For products sold by 3M Brazil under more than one set of trademarks, 3M Brazil and P applied a "stacking" principle under which each set of trademarks generated a separate 1% royalty. Under this stacking principle, if a particular product used trademarks covered by all three trademark licenses, the royalties would be 3% of the sales of the product. Under an unwritten policy of the Brazilian Patent and Trademark Office, however, the maximum trademark royalty that could be paid on the sale of a product was 1% of net sales, regardless of how many licensed trademarks were identified on the product.

3M Brazil also used patents and non-patented technology owned by S. 3M Brazil paid no patent royalties and made no technology-transfer payments to S. Additionally, no patent license and no technology-transfer agreement was in effect between S and 3M Brazil. Rules and policies of the Brazilian Patent and Trademark Office also limited the amount of technology royalties that could be paid.

Procedural history and positions of the parties

The IRS asserted that 3M's US income should be increased under Section 482 to reflect the full arm's-length compensation for the intellectual property used by 3M Brazil. 3M argued that the Section 482 allocation should only correspond to the maximum amount that 3M Brazil could have paid for the intellectual property in question under the laws of Brazil, less related expenses.

Relying on the blocked income rules contained in Reg. 1.482-1(h)(2), the IRS argued that the Brazilian legal restrictions should not be taken into account. Those regulations which were revised in 1994 as part of a major overhaul of the transfer pricing regulations, set forth a number of requirements that must be met before the IRS will take into account the effect of a foreign legal restriction when making a Section 482 allocation.

While 3M argued that some of those requirements were invalid under administrative procedure law precedents, including tests for regulatory validity under *Chevron* and *State Farm*, 3M's principal contention essentially was that the entire regulation was invalid under step one of the *Chevron* test because of the Supreme Court's holding in *Commissioner v. First Security Bank of Utah, N.A.*, 405 U.S. 394 (1972). *First Security Bank* held that the IRS cannot make a Section 482 allocation of income to a taxpayer who did not receive the income and could not legally receive the income. 3M argued that under "step one" of *Chevron*, a prior judicial precedent that interprets a statute controls over a subsequent agency interpretation that is inconsistent with the judicial precedent.

Some important history underlies the current blocked income rules, which is discussed below.

History of the blocked income issue and general principles

One of the essential premises of Section 482 is that there is common control of the entities in question, which presumably provides the controlling interests with the ability to cause each controlled entity to conduct its affairs in a manner that clearly reflects its income. Accordingly, if such control does not exist, then Section 482 should be inapplicable.

Income that is subject to legal restrictions on payment may constitute one situation where such control is lacking, such as where a payor is legally prohibited from making payment or where a payee is legally prohibited from receiving payment. The essential question raised in *3M* and similar cases is whether and to what extent such legal restrictions on payment or receipt should be taken into account to limit the income that can be imputed between related parties under Section 482.

The US Supreme Court addressed this issue in a domestic law context in *First Security Bank*. In that case, the IRS attempted to impute insurance-related income to a bank in relation to certain transactions with related-party insurance companies.

Because the banks were prohibited by the federal banking laws from receiving insurance-related income, the Supreme Court held that Section 482 was inapplicable. The Supreme Court reasoned that the bank did not have sufficient control to cause the insurance company to pay any portion of its premium income to the bank. The Court cited to general principles of income taxation (such as assignment-of-income principles) and noted the Section 482 regulations in place at the time also recognized these principles.

In particular, the regulation in place at the time stated that Section 482 presumes that controlled entities have “complete power” to cause each entity to reflect its true net income from its business and transactions (Reg. 1.482-1(b)(1) (1971)). The Court held that it is only where such power exists, and has been exercised in such a way that true taxable income has been understated, that the IRS’s authority under Section 482 is operative.

Because the taxpayer in *First Security Bank* had no such power unless it acted in violation of federal banking laws, the Court held it was not within the scope of power contemplated by the regulation. In reaching this conclusion, the Court cited with approval the opinion in *LE Shunk Latex Prod. Inc. v. Commissioner*, 18 T.C. 940 (1952), in which the Tax Court had held that an allocation under Section 482 that would have violated applicable Office of Price Administration regulations during World War II was improper as the IRS had “no authority to attribute to [the taxpayers] income which they could not have received.”

Subsequent case law applied the *First Security Bank* principle to restrictions imposed by foreign law. *Procter & Gamble Co. v. Commissioner*, 95 T.C. 323 (1990), *aff’d*, 961 F.2d 1255 (6th Cir. 1992), held that a Section 482 allocation was improper, based upon *First Security Bank*, due to a restriction on the payment of royalties under applicable Spanish law that could have exposed the taxpayer to criminal prosecution for any unsanctioned transactions. The Tax Court concluded that “Section 482 does not impel the violation of a legal prohibition solely for the sake of matching income and expense.” Courts have reached similar conclusions in other cases involving pricing restrictions imposed by foreign sovereigns. See *Exxon Corp. v. Commissioner*, T.C. Memo. 1993-616, *aff’d sub.nom. Texaco, Inc. v. Commissioner*, 98 F.3d 825 (5th Cir. 1996).

Following the IRS’s court losses on this issue, the blocked income regulations were significantly revised in 1994 to include a number of strict elements that must be satisfied before foreign legal restrictions will be taken into account. See Reg. 1.482-1(h)(2).

Tax Court majority opinion analysis in *3M*

Legal restrictions

The Tax Court’s majority opinion held that the Brazilian legal restrictions at issue did not meet a number of the requirements imposed by Reg. 1.482-1(h)(2). The court found that foreign legal restrictions are to be taken into account under the regulations only if seven requirements are met:

- (1) The restriction affected uncontrolled taxpayers under comparable circumstances for a comparable period of time.
- (2) The restriction was publicly promulgated.
- (3) The restriction was generally applicable to all similarly situated persons (both controlled and uncontrolled).

- (4) The restriction was not imposed as part of a commercial transaction between the taxpayer and the foreign government.
- (5) The taxpayer exhausted all remedies prescribed by foreign law or practice for obtaining a waiver of the restriction (other than remedies that would have a negligible prospect of success).
- (6) The restriction expressly prevented the payment or receipt, in any form, of all or part of the arm's-length amount. A regulatory example indicates that this requirement is not met if payments could be made in the form of dividend distributions.
- (7) The taxpayer and related parties did not engage in any arrangement with controlled or uncontrolled parties that circumvented the restriction, and did not materially violate the restriction.

Observation: This list of seven elements makes it difficult for many taxpayers to avoid the imputation of income under Section 482 when the income is subject to legal restrictions imposed by foreign laws or rules.

***Chevron* test**

3M argued that the blocked income regulation violated both steps of the *Chevron* test for determining whether to defer to an agency regulation. Under *Chevron* step one, the court must determine whether Congress has expressed an unambiguous intent on the issue. If it has not, then *Chevron* step two evaluates whether the agency regulation represents a reasonable interpretation of the statute.

3M argued that the blocked income regulation failed *Chevron* step one because *First Security Bank* and other cases had held that Section 482 does not authorize the IRS to allocate blocked income to a taxpayer. The Tax Court majority stated that *First Security Bank* had relied on the application of a specific regulation (Reg. 1.482-1(b)(1) (1971)), rather than the text of the relevant statute (Section 482 of the Internal Revenue Code of 1954), therefore, the majority did not find that the statute was “unambiguous” as required under *Chevron*. The court further stated that had “it thought the statute to be unambiguous, the Supreme Court would not have had to rely on a regulation.” The other blocked income cases that had held against the IRS also cited this regulation.

The Tax Court also reasoned that *First Security Bank* and the other authorities relied upon by 3M all dealt with Section 482 prior its amendment in 1986 to add the commensurate with income (CWI) provision, which was contained in the new, second sentence of Section 482. The court reasoned that the proposed allocation under review was consistent with the 1986 CWI language, which requires that income from a license of intangibles (such as the intangibles licensed to 3M Brazil) be commensurate with the income attributable to the intangible.

3M argued that the CWI provision was not designed to address blocked income, but rather was adopted because of certain other specific concerns regarding the transfer pricing of intangible transactions. The majority opinion concluded, however, that the CWI provision did not have a limited scope. Indeed, the majority opinion believed that the CWI provision had a broad scope that provided the foundation for many key elements of the entire set of transfer pricing regulations issued in 1994. The concurring opinions of Chief Judge Kathleen Kerrigan and Judge Elizabeth Copeland also emphasized the CWI provision.

Observation: The majority opinion’s suggestion that key elements of the 1994 regulations (including the regulations specifying the comparable profits method and the profit split method) were tied to the enactment of the CWI provision seems open to question. Those methods — as well as many other aspects of the new regulatory regime introduced in 1994 (such as the best method rule, comparability considerations, and other provisions) — apply generally to all related-party transactions, including tangible goods and services transactions, not solely to intangible transactions that are subject to the CWI provision.

The Tax Court then proceeded to the second step of the *Chevron* test and held that Reg. 1.482-1(h)(2) reflects a reasonable interpretation of the statute and its purpose of ensuring tax parity between controlled and uncontrolled taxpayers and ensuring arm's-length results. Particularly in light of the 1986 statutory addition of the CWI standard

for intangible property transactions, the court reasoned that the conditions imposed by the blocked income regulations were consistent with the IRS's statutory authority.

State Farm test

Finally, the court addressed 3M's argument that the blocked income regulation failed the so-called *State Farm* test requiring that agencies provide a satisfactory explanation for their regulations and respond to comments submitted during the rulemaking process, under the standards of the Administrative Procedure Act. The majority opinion concluded that the regulations complied with the Administrative Procedure Act because Treasury and the IRS adequately explained the reason for the blocked income regulations. The court also found that relevant public comments submitted during the rulemaking process were not "significant comments" requiring a response.

Tax Court dissenting opinions in 3M

Judge Ronald Buch penned a dissent (joined by four other judges) that viewed the Supreme Court's *First Security Bank* opinion as resting on basic principles of income tax law rather than an application of a specific regulation. His dissent noted that the Supreme Court (and other courts) had cited the old regulatory provision solely to show that the IRS's regulations also recognized this principle of income tax (i.e., a taxpayer cannot be charged with income that the taxpayer did not receive and did not have a legal right to receive). Similarly, Judge Cary Pugh's concise dissent pointed out that the 1986 CWI amendment to Section 482 did not modify the meaning of "income" in that section, so it could not open the door for Treasury to issue a regulation that contravenes *First Security Bank* and *Procter & Gamble*.

Judge Buch's dissent posed a key question at the core of the case — can an agency promulgate a regulation that is contrary to existing case law? His dissent reviewed other Supreme Court precedents holding that a prior judicial construction of a statute trumps an agency construction otherwise entitled to *Chevron* deference only if the prior court decision holds that its construction follows from the unambiguous terms of the statute and thus leaves no room for agency discretion. Under this standard, the dissenters said, *First Security Bank* foreclosed the allocation, and thus the taxation, of blocked income. The dissent noted that every other court to have considered the Supreme Court's *First Security Bank* ruling in the context of a blocked income issue has understood it as describing a limit on the IRS's power to allocate income and thus as an unambiguous interpretation of Section 482.

Judge Emin Toro also issued a dissenting opinion (joined by five other judges, some of whom also joined the other dissenting opinions) addressing 3M's argument that the blocked income regulation was invalid because Treasury violated the Administrative Procedure Act. This dissent argued that the 1994 blocked income regulations were procedurally defective because the Treasury was obligated to, but did not, specifically respond to significant comments relating to the blocked income provisions submitted during the rulemaking process.

The takeaway

If the Tax Court's blocked income decision is appealed to the relevant US Circuit Court of Appeals, the varying opinions of the majority and dissenting Tax Court judges would appear to provide ample analysis to assist the appellate court judges in considering alternative thinking and outcomes on the issue presented.

More broadly, the majority and dissenting judges expressed differing views on the import of the CWI provision and on how Administrative Procedure Act requirements should be applied to the income tax regulatory process in general. Similar issues regarding the Administrative Procedure Act's application to income tax regulations were also addressed by the court in *Altera* (see [PwC's Tax Insight dated June 17, 2019](#)). Given the close divide among the 3M judges, it remains unclear how the varying views expressed in the 3M majority and dissenting opinions might be applied in subsequent cases raising these types of broader issues.

Let's talk

For a deeper discussion of how the recent *3M* decision might impact your business, please contact:

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