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3M Opinion: The Tax Court's Evolving View of the Administrative Procedure Act

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In a recent trend of regulatory challenge cases, the Tax Court has this time addressed the validity of Treasury Regulation § 1.482-1(h) in *3M Company & Subsidiaries v. Commissioner*, 160 T.C. No. 3 (2023). This regulation interprets Internal Revenue Code § 482, a statute that allows the IRS to "distribute, apportion, or allocate gross income, deductions, credits, or allowances" between organizations or businesses if the IRS "determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of" the organizations or businesses.

One of the goals of section 482 is to ensure that US corporations do not avoid US tax by improperly shifting income and profit to subsidiaries in lower-taxed jurisdictions. But what happens if a foreign law prohibits a parent corporation from receiving profit from an overseas subsidiary?

A few cases answered this question, including *Commissioner v. First Security Bank*, 405 U.S. 394 (1972); *L.E. Shunk Latex Prods. Inc. v Commissioner*, 18 T.C. 940 (1952); *Procter & Gamble Co. v. Commissioner*, 961 F.2d 1255 (6th Cir. 1992); and *Texaco, Inc. v. Commissioner*, 98 F.3d 825 (5th Cir. 1996). All held, with very little variation, that the IRS cannot allocate taxable income to a taxpayer who "'did not receive [the income] and . . . was prohibited from receiving [the income].'" *3M*, 160 T.C. No. 3, slip op. at 138 (citing *First Security Bank*, 405 U.S. at 394-407). All these cases were decided before the regulation at issue was promulgated.

The regulation at issue gives the IRS the right to decide whether a foreign legal restriction exists that affects "the result of transactions at arm's length." Treas. Reg. § 1.482-1(h)(2). If the IRS is not convinced that the foreign legal restriction exists (through several factors listed in § 1.482-1(h)(2)(ii)), the IRS can count as the corporation's income what the overseas subsidiary made whether the corporation actually could receive or received any of that income.

In 3M's case, the Brazilian government prohibited the parent corporation from receiving profit from its subsidiary over and above an amount certain. As a result of this legal restriction, 3M reported that its taxable income was only approximately $4.5 million. *3M*, 160 T.C. No. 3, slip op. at 48. However, the IRS determined that this allocation did not reflect what 3M would receive in an arm's length transaction, and increased 3M's income by $23.6 million. In other words, because of the regulation, the IRS can tax income from corporations whose subsidiaries operate overseas but cannot and have not received any profits from the overseas subsidiary.

The regulation itself is controversial because it is inconsistent with established case law holding that a taxpayer cannot be taxed for income it cannot receive. Accordingly, 3M challenged the regulation under the procedural and substantive arms of the Administrative Procedure Act ("APA"). The Tax Court issued a heavily split decision, with Judge Morrison authoring the opinion on behalf of the majority. Judges Urda, Buch, Jones, Greaves, Weiler, Foley, and Toro dissenting on various grounds. Judges Copeland, Gale, Paris, Ashford, and Kerrigan concurred in result.

In short, the majority ruled that the statute the regulation is interpreting was ambiguous enough to give the Department of Treasury ("Treasury") the discretion to craft a regulation (step 1 of *Chevron*). The majority then ruled that the IRS's interpretation of its regulation was reasonable (step 2 of *Chevron*). Last, the majority held that the "relevant" comments on the regulation were responded to or were not significant enough to require a response (the *State Farm* test, referred to by some as *Chevron* step 0). The majority remained undecided on a couple comments it deemed not relevant.

In light of Supreme Court precedent interpreting section 482, the dissent disagreed with the majority that the statute was sufficiently ambiguous to need Treasury's input with a regulation (*Chevron* step 1). The dissent also disagreed that Treasury adequately responded to comments that expressed serious and substantiated concern over the regulation, thus failing to comply with the procedural requirements of the APA.

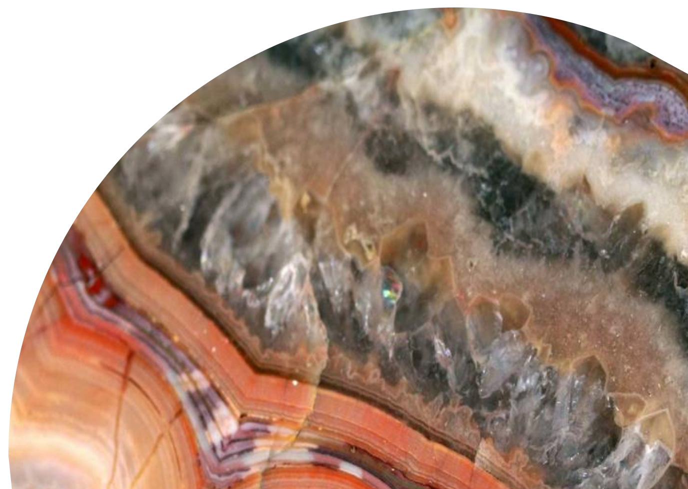
As a result of the decision, Treasury Regulation § 1.482-1(h) remains firmly in place. While reading the case is not entirely for the faint at heart (300 plus pages of largely statutory and regulatory history), it clearly exhibits the difficulties courts are having in determining whether regulations are properly promulgated under the APA before the time that Treasury thought the APA applied to it. The dissent mentions these other legal battles: *Oakbrook Land Holdings, LLC v. Commissioner*, 28 F.4th 700 (6th Cir. 2022); *Hewitt v. Commissioner*, 21 F.4th 1336 (11th Cir. 2021); and *Altera Corp. & Subs. v. Commissioner*, 145 T.C. 91, 119 (2015) (citing *Mayo Foundation*, 562 U.S. at 55), *rev'd on other grounds*, 926 F.3d 1061 (9th Cir. 2019).

The *3M* decision is also a case study in how difficult it is to decipher legislative intent, and most troubling, whether agencies can create regulations (and have them sustained) that override or attempt to override established case law. As the courts give agencies greater leeway in creating

legislative rules, the separation of powers between the legislative, executive, and judicial branches contemplated by our Constitution becomes narrower and narrower.

The link to the full text of the case is below:

3M Co. & Subsidiaries v. Comm'r of Internal Revenue, No. 5816-13 | Casetext Search + Citator



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