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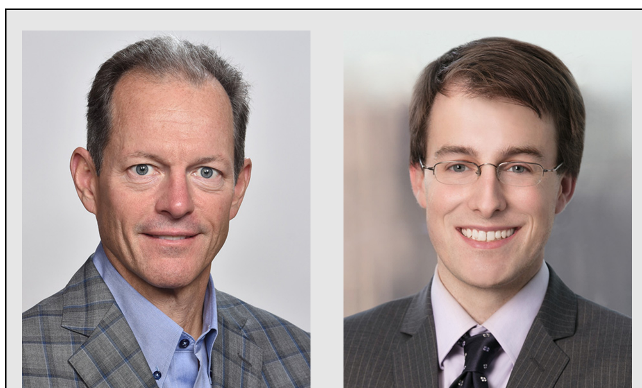

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In this article, the authors analyze the blocked income problem in the 1994 U.S. transfer pricing regulations and how the decision in the *3M* case pending before the U.S. Tax Court might change the landscape.

The U.S. transfer pricing rules revolve around the arm's-length standard, yet taxpayers are not always free to charge an arm's-length price. Transfer pricing rules are only one component of the broader regulatory framework in which multinational enterprises operate, and legal restrictions in the United States and abroad may dictate prices, require or prohibit payments, or otherwise force taxpayers to price transactions in a manner that would not, in the absence of those restrictions, be considered arm's length.

That problem tends to arise when outbound payments from a non-U.S. jurisdiction are limited or prohibited, and is generally referred to as the blocked income problem. Although the blocked income problem has been recognized for decades, recent developments have increased its prominence. A challenge to the IRS's blocked income regulations was recently litigated in *Coca-Cola,*[1] in which the U.S. Tax Court declined to rule on the issue pending the resolution of *3M,*[2] which likewise involves a challenge to the regulations. Given the timing of the *Coca-Cola* decision, an opinion in *3M* — which has been pending since 2013 — is expected shortly.

Case Law

The blocked income issue first appeared in the Tax Court in *L.E. Shunk,*[3] which held that the IRS could not allocate income in excess of what the taxpayers were permitted to charge under World War II price regulations. But the leading case is *First Security,*[4] which has the distinction of being the only IRC section 482 case taken by the U.S. Supreme Court.

First Security concerned U.S. banks that sold insurance policies to their retail customers. The policies were insured by a third-party insurer that performed management services and then were reinsured by Security Life, an affiliate of the banks that recognized the premium income, net of the management fees. Security Life was taxed at a lower rate than the banks, and the IRS made an adjustment allocating 40 percent of the premiums received by Security Life to the banks as sales commissions.

Given that the group had previously used third-party insurers to write the insurance that the banks made available to their customers and had received commissions of between 40 and 55 percent from the insurers, there seems little doubt that — in a market unimpeded by regulation —

[1] *Coca-Cola Co. v. Commissioner*, 155 T.C. No. 10 (2020).

[2] *3M Co. v. Commissioner*, Dkt. No. 5816-13.

[3] *L.E. Shunk Latex Products Inc. v. Commissioner*, 18 T.C. 940 (1952).

[4] *Commissioner v. First Security Bank of Utah*, 405 U.S. 394 (1972).

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the IRS's 40 percent allocation would have represented an arm's-length price. In actuality, there was a regulatory wrinkle: U.S. federal law prohibited banks from receiving insurance premium income. The Supreme Court held in a 6-3 decision that when a legal restriction prohibits the receipt of income by a taxpayer, section 482 and the arm's-length standard do not require the taxpayer to take the prohibited income into account.

The principles of *First Security* were extended to foreign legal restrictions in *Procter & Gamble*.[5] There, the U.S. Court of Appeals for the Sixth Circuit rebuffed the IRS's attempt to allocate royalty income from a Spanish company to its Swiss affiliate (with the aim of increasing U.S. subpart F income), holding that the Spanish rules prohibiting the royalty payment must be respected in the same manner as the federal restriction at issue in *First Security*. The principle was further clarified in *Texaco*,[6] which held that commercial restrictions imposed by the Saudi Arabian government on the resale of Saudi crude oil were foreign legal restrictions that must be respected consistent with *Procter & Gamble* and *First Security*.

1994 Regulations

In the early 1990s, the U.S. government decided to break its losing streak by rewriting the rules. The 1968 regulations had not addressed the effect of legal restrictions but did contain language on control that the Supreme Court had found helpful in *First Security*:

> The interests controlling a group of controlled taxpayers are assumed to have complete power to cause each controlled taxpayer so to conduct its affairs that its transactions and accounting records truly reflect the taxable income from the property and business of each of the controlled taxpayers.[7]

When the IRS released the 1994 final regulations (T.D. 8552) (which were preceded by 1993 proposed regulations on the blocked income issue),[8] the "complete power" language was nowhere to be found.

The 1994 regulations were not so brazen as to go after the Supreme Court's own precedent, but they did effectively abrogate *Procter & Gamble* and *Texaco* in most cases by introducing an intricate and burdensome set of blocked income rules in U.S. Treas. reg. section 1.482-1(h)(2). Those rules identify when foreign legal restrictions will be taken into account for section 482 purposes and when those restrictions will entitle a taxpayer to elect to use a deferred income method of accounting.

As a practical matter, those nuances tend to matter little — the regulations are written in such a way that almost no foreign legal restrictions, apart from less common exchange controls, will be eligible for either option. That is because the rules apply only to foreign restrictions that satisfy several criteria. Restrictions that fail any of the criteria are ignored for section 482 purposes, meaning that affected taxpayers must take items of income or expense into account as if the restrictions did not exist (more on that below). The criteria are:

- the restriction is publicly promulgated;
- the restriction applies to all similarly situated persons, regardless of whether commonly controlled;
- the restriction is not imposed as part of a commercial transaction with the foreign country;[9]
- the taxpayer has exhausted all practical remedies to waive the restriction, without success;
- the restriction expressly prevents the payment or receipt of an arm's-length amount, in any form; and
- the taxpayer has not circumvented or violated the restriction.

[5] *Procter & Gamble Co. v. Commissioner*, 961 F.2d 1255 (6th Cir. 1992).

[6] *Texaco Inc. v. Commissioner*, 98 F.3d 825 (5th Cir. 1996), was litigated before the Tax Court under the name *Exxon Corp. v. Commissioner*, T.C. Memo. 1993-616. While the Fifth Circuit opinion was not issued until 1996, the years at issue predated the 1994 regulations, discussed *infra*.

[7] 405 U.S. at 404 (quoting reg. section 1.482-1(b)(1) (1968)).

[8] 58 F.R. 5310.

[9] That condition appears to be intended to effectively override the result in *Texaco*, which involved commercial transactions between the taxpayer and the Saudi Arabian government.

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If those criteria are satisfied, the taxpayer can elect the deferred income method of accounting, which treats any blocked amount as deferrable until its payment or receipt ceases to be restricted, but deductions and credits chargeable against any blocked income are likewise deferred. If the criteria are satisfied and the taxpayer can also show that the restriction actually affected an uncontrolled taxpayer under comparable circumstances for a comparable period, the restriction will be respected without the need to use deferred accounting. However, meeting those conditions generally is challenging, because many foreign legal restrictions that limit deductible payments are intended to apply exclusively to related-party arrangements.

Another problematic criterion is the requirement that the restriction prohibit payment or receipt in any form. Some common restrictions, such as the Brazilian limitations on royalty payments at issue in both *Coca-Cola* and *3M*, limit deductible payments but do not affect a taxpayer's ability to declare nondeductible dividends in lieu of the blocked payments. Only exchange controls, which restrict a taxpayer's ability to move currency out of a country, are likely to satisfy that requirement. Because few countries today impose exchange controls, the punchline of reg. section 1.482-1(h)(2) is that almost all foreign legal restriction must be ignored.

What's a Taxpayer to Do?

The 1994 regulations put taxpayers in a position in which they may be required to include amounts of income or expense for section 482 purposes that cannot legally be paid or received because of foreign legal restrictions. The regulations provide a partial solution, in that they do not require taxpayers to choose between ignoring those amounts (thereby inviting IRS adjustment, with the potential addition of penalties) and violating foreign law to pay them.

Along with the blocked income rules, the 1994 regulations introduced the taxpayer-initiated adjustment rules of reg. section 1.482-1(a)(3), which provide taxpayers a limited right to report the results of controlled transactions based on prices other than those actually charged if necessary to reflect an arm's-length result. Downward adjustments to U.S. income may be made only on original, timely returns.

Making a taxpayer-initiated adjustment does not remedy the fact that the restriction has prevented the movement of funds. To address that problem, an additional step is needed. Taxpayer-initiated adjustments trigger several correlative consequences, including secondary adjustments, and one mechanism for implementing those secondary adjustments is to elect repatriation treatment under Rev. Proc. 99-32, 1999-2 C.B. 296.

Absent an effective election under Rev. Proc. 99-32, the default secondary adjustment treatment under the regulations will infer at least one deemed transaction to align the taxpayer's tax position with its books. For a taxpayer-initiated adjustment increasing the income of the U.S. parent of a Brazilian subsidiary, that deemed transaction would be a deemed capital contribution from the parent to the subsidiary. Under that option, the funds would remain in Brazil and would be included in U.S. income when repatriated to the United States as a dividend. Before the Tax Cuts and Jobs Act, that effectively resulted in taxing the primary adjustment twice (once at the time of the taxpayer-initiated adjustment, and once when the dividend was paid). Post-TCJA, that is a much smaller problem because dividends generally are paid out of previously taxed earnings and profits or qualify for the 100 percent dividends received deduction under section 245A.

Under Rev. Proc. 99-32, if the taxpayer makes an election, sets up an interest-bearing intercompany account in the amount of the primary taxpayer-initiated adjustment, and satisfies the account within 90 days, the default secondary adjustment treatment and the associated tax consequences are avoided. Accordingly, because of the effective double taxation under the default treatment, taxpayers historically have tended to opt for Rev. Proc. 99-32 treatment when making taxpayer-initiated adjustments to increase U.S. income.

Taxpayers that have paid a dividend and do not want to make a second payment under Rev. Proc. 99-32 may be able to elect a dividend offset. The revenue procedure allows for an intercompany account payable to be satisfied by

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offsetting a dividend paid in the current year or in the year for which the taxpayer-initiated adjustment was made on an original return. Some legal restrictions that preclude deductible payments do not preclude the payment or receipt of funds as dividends. If the entity subject to the restriction pays a dividend in the same amount during the year it would (but for the restriction) have paid the blocked income, and dividend offset treatment is elected, the lag can be eliminated.

Coca-Cola and *3M*

If you think the journey through the regulatory and procedural framework sounds like a lot of hassle just to arrive at a result that runs contrary to the arm's-length standard as interpreted by the Supreme Court, you are not alone. The issue was raised in *Coca-Cola* and is pending in *3M*.

Coca-Cola has been widely analyzed since the Tax Court released its opinion last November, but relatively scant attention has been given to the blocked income question it raises, largely because the court was content with a cliffhanger: It acknowledged the issue, but reserved ruling on it pending the issuance of an opinion in *3M*.

The issue relates to Coca-Cola's Brazilian supply point, which the company's petition notes was subject to restrictions on currency remittances without Central Bank approval, as well as legal restrictions on the remittance of royalties. Together, those restrictions limited the royalties the Brazilian supply point could pay to Coca-Cola in the United States. Coca-Cola argued that reg. section 1.482-1(h)(2) did not apply and that the regulatory requirements for respecting the legal restrictions were satisfied. Alternatively, it argued that the regulations are invalid under the Administrative Procedure Act (APA) and the *Chevron* framework for the review of Treasury regulations.[10]

The Brazilian supply point paid dividends in lieu of the royalties (as did some other supply points), and Coca-Cola sought dividend offset treatment consistent with the terms of its 1996 closing agreement with the IRS. However, Coca-Cola did not file the necessary election statement under Rev. Proc. 99-32, and the IRS challenged the dividend offset claim. On the facts of the case, and given that the IRS was aware that Coca-Cola intended to seek that treatment, the Tax Court concluded that the absence of a formal election was harmless error, saving Coca-Cola $1.8 billion in additional adjustments. Despite Coca-Cola's victory on that point, the fact that the Tax Court took care to limit its holding to the "peculiar circumstances of this case" indicates that other taxpayers with Rev. Proc. 99-32 foot faults may be less fortunate.

3M likewise involves a challenge to Brazilian restrictions on the payment of royalties. In 2006, 3M's Brazilian subsidiary paid $5.1 million in royalties (3M and the IRS have stipulated that the maximum possible royalty payable under Brazilian law was $9.4 million). In the IRS's view, an arm's-length royalty would have been much higher — the IRS made a $23.7 million adjustment after taking into account a setoff for unreimbursed research and development expenses. 3M filed its Tax Court petition in March 2013, and the case was submitted fully stipulated. Oral arguments were held in November 2016.

As in *Coca-Cola*, 3M's subsidiary paid dividends in lieu of the blocked royalty, and 3M does not argue that it satisfied the requirements of reg. section 1.482-1(h)(2). Rather, it takes issue with the blocked income rules. Like Coca-Cola, it asserts that the rules are invalid under the APA and *Chevron*. 3M also points to the inconsistency between the regulations and prior case law (*First Security*, *Procter & Gamble*, *Texaco*, and *L.E. Shunk*) as grounds for invalidating the regulations under the Supreme Court's decisions in *Brand X* and *Home Concrete*,[11] which held that an agency cannot issue regulations that conflict with an earlier judicial precedent if the case determined the underlying statute was unambiguous.

What Now?

The 1994 regulations are difficult to square with the arm's-length standard because they force

[10] *Chevron U.S.A. Inc. v. Natural Resources Defense Council Inc.*, 467 U.S. 837 (1984).

[11] *National Cable & Telecommunications Association v. Brand X Internet Services*, 545 U.S. 967 (2005); and *United States v. Home Concrete & Supply LLC*, 566 U.S. 478 (2012).

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taxpayers to posit an alternative reality in which they are not subject to very real foreign legal restrictions. The arm's-length standard refers to "the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances," not to the results that would have been realized had the taxpayer itself been subject to a separate set of circumstances. The regulations were a direct assault on *Procter & Gamble* and *Texaco*, and given the strength and unanimity of the case law on the issue, it is somewhat surprising that it took almost 20 years for a case to surface challenging the regulations. Perhaps 3M was spurred by the end to tax exceptionalism heralded in *Mayo Foundation*,[12] which served to remind the tax community that Treasury is generally beholden to the same administrative legal framework as other agencies.

Just as surprising is that despite having been submitted fully stipulated with no need for a trial, the Tax Court has yet to decide *3M*. That the court reserved ruling on the issue in *Coca-Cola* suggests that the opinion in *3M* may soon see the light of day.

Whatever the outcome, *3M* — which turns entirely on legal questions — seems ripe for appeal, meaning it could still be many years before we have a final resolution. Coca-Cola has announced that it will appeal the Tax Court decision, and given the conviction with which it is pursuing its case and the amount of money at stake, one can expect that it would appeal an adverse ruling on the blocked income component as well. With the morass of the APA, *Chevron*, and *Home Concrete* issues surrounding the regulations, one can even imagine a universe in which the Supreme Court might be persuaded to accept another blocked income case. But speculation is futile — for now, the result in *3M* is eagerly anticipated.[13] ■

[12] *Mayo Foundation for Medical Education & Research v. United States*, 562 U.S. 44 (2011).

[13] The information in this article is not intended to be "written advice concerning one or more Federal tax matters" subject to the requirements of section 10.37(a)(2) of Treasury Department Circular 230. The information contained herein is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser. This article represents the views of the authors only and does not necessarily represent the views or professional advice of KPMG LLP. While companies mentioned in this article may receive other services as clients of KPMG, KPMG is not representing any company in the matters discussed herein.

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