US OUTBOUND

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Tax Court to decide on foreign taxpayer's right to deductions in *Adams Challenge*

In January 2020, the US Tax Court issued a decision on the US taxability of the foreign taxpayer's Outer Continental Shelf (OCS) income in *Adams Challenge (UK) Ltd. v. Commissioner*, which we addressed in a previous column. The Internal Revenue Service (IRS) victory on that issue was just the first stage of a larger fight. As the Tax Court has determined that the taxpayer's OCS charter income was taxable in the US, it must now decide whether the taxpayer is entitled to take deductions against that income, an issue on which the parties recently submitted competing motions for summary judgment. The taxpayer filed its motion on April 10, while the IRS filed both a response and its own motion on June 9.

At issue in *Adams Challenge* are the years 2009 through to 2011. The taxpayer did not file US income tax returns for 2009 or 2010 within the time limit specified in Treas. Reg. § 1.882-4(a)(3), but did file a timely return for 2011. The IRS's position is that, under section 882(c)(2) of the Internal Revenue Code and Treas. Reg. § 1.882-4, the taxpayer's failure to file timely US tax returns for 2009 and 2010 deprives it of the ability to receive the benefit of deductions and credits for those years. While the IRS initially denied deductions for 2011, as well on the basis that its 'doomsday notice' under Treas. Reg. § 1.882-4(a)(3)(i) overrode the taxpayer's subsequent filing of a US return for that year, it later reversed course and conceded that the 2011 return was timely for Treas. Reg. § 1.882-4 purposes.

Yet, while Treas. Reg. § 1.882-4(a)(2) contains a timeliness requirement, none is to be found in the statute itself. Indeed, section 882 conspicuously lacks the language frequently employed by Congress to impose such a requirement. The taxpayer contends that the regulation is invalid under the *Chevron* test, which looks to whether Congress has spoken to the precise issue in question and, if not, whether the regulation is a reasonable interpretation of the statute. Interestingly, the Tax Court itself concluded that the regulation was invalid in *Swallows Holding v. Commissioner* in 2006, but was vacated by the Third Circuit, which took a different view as to the applicable level of deference.

However, *Adams Challenge* is not just a rehash of *Swallows*. The earlier case involved a Barbados corporation, but did not address treaty issues, perhaps because the Mexican owners of the corporation did not qualify under the limitation on benefits clause of the US-Barbados treaty. In *Adams Challenge*, the UK taxpayer had a US permanent establishment and is entitled to treaty benefits, and thus the case raises important treaty issues not previously addressed by the courts.

Article 7(3) of the US-UK treaty provides that, when computing the income of a permanent establishment, "there shall be allowed as deductions expenses that are incurred for the purposes of the permanent establishment", and the US Treasury's technical explanation clarifies that this is meant to "ensur[e] that business profits will be taxed on a net basis". Clearly, there is tension between the treaty's prescriptive language concerning deductions and the section 882(c)(2) rule that imposes gross basis taxation by denying the benefit of deductions and credits. The taxpayer contends that the treaty should control, while the IRS argues that there is no conflict because Article 7 is concerned with substantive, rather than procedural law. The taxpayer also argues, and the IRS disputes, that denying deductions under Treas. Reg. § 1.882-4 violates Article 25 of the treaty, which generally prohibits discrimination in one state's taxation of a resident of the other state.

Whether treaty provisions may trump section 882(c)(2) and the regulations thereunder is an important issue that has received scant consideration until now, and taxpayers and practitioners should watch the developments in *Adams Challenge* with interest. To guard against the denial of deductions and credits under section 882(c)(2), taxpayers who believe there is even a slight possibility that they may have effectively connected US income should file protective US returns under the section 882 regulations. Where the IRS asserts section 882(c)(2) arguments, taxpayers who can claim the benefits of US treaties should also consider seeking competent authority relief from the IRS advance pricing and mutual agreement programme (APMA). This would provide access to a bilateral process in which IRS positions may be tempered by the foreign competent authority during negotiations, and which thus may ultimately lead to a more reasonable outcome under the treaty.

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