U.S. Tax Review: *3M*, *Microsoft*, and *Eaton*; Dual Consolidated Loss Rules; Pillars 1 and 2

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In this installment of U.S. Tax Review, the authors review recent developments in *3M*, *Microsoft*, and *Eaton*, as well as recent guidance on the dual consolidated loss rules and comments on the OECD two-pillar approach.

3M

In a "reviewed by the court" opinion, a sharply divided Tax Court held in *3M*[1] that the IRS has the authority to reallocate foreign income under section 482 when that income is blocked under foreign law.

The Tax Court split 9 to 8, with seven judges joining a plurality opinion, two concurring in the result (and joining in a five-judge concurrence), and eight dissenting (in three dissenting opinions). There were six opinions, 346 pages, and no consensus. However, both the plurality and the concurrence (and therefore a majority of the court) held that reg. section 1.482-1(h)(2), which limits the extent to which foreign law curtails the IRS's powers under section 482, is valid in light of the statute's "commensurate with the income" sentence. Given the lack of a majority opinion, it is questionable how much precedential value this case has.

The IRS asserted a transfer pricing adjustment against 3M, claiming that additional royalty payments should be made for intangible property used by a Brazilian subsidiary (3M Brazil). 3M argued that the section 482 transfer pricing adjustment was improper because an additional royalty payment would have violated Brazilian law. 3M challenged the validity of reg. section 1.482-1(h)(2), which governs when foreign legal restrictions are considered for transfer pricing purposes. The plurality determined that reg. section 1.482-1(h)(2) was valid and that the Brazilian legal restriction at issue would not be taken into account under the regulation.

As of the 2006 tax year, the multinational group of which 3M Company is the common parent (3M Global) was one of the largest technology and manufacturing enterprises in the world, stating in its annual report that it had over $23 billion in worldwide gross sales and over $21 billion in worldwide assets.

In 1999 the U.S. parent company (3M Company) decided that much of its intellectual property should be held and managed by a newly formed U.S. subsidiary, 3M Innovative Properties

[1] *3M Co. v. Commissioner*, 160 T.C. No. 3 (2023).

Company (3M IPC). 3M Company also added to its corporate structure another newly formed U.S. corporation, 3M Financial Management Company (3M Financial Management). The purpose of 3M Financial Management was to facilitate currency management and intercorporate lending between 3M Company and its affiliates. The ownership structure of the four corporations was as follows:

- 3M Company owned 3M Financial Management;
- 3M Financial Management owned 3M IPC; and
- 3M IPC owned 3M Brazil.

3M Company then assigned and licensed all IP to 3M IPC, except for trademarks, to which it retained ownership.

3M Brazil's primary business operations included the manufacturing and distribution of 3M Global's products. Neither 3M Company nor 3M IPC owned any plant, property, or equipment in Brazil. 3M Brazil reported for U.S. income tax purposes about $563 million in sales and employed about 3,120 people at its corporate headquarters and its three manufacturing sites throughout Brazil, including a research and development facility at one of the manufacturing sites.

During the 2006 tax year, 3M Company and 3M IPC jointly licensed the 3M IP to most affiliates using a standard licensing agreement with a royalty of 6 percent of net sales. 3M Brazil was not among those affiliates. In Brazil, 3M Brazil paid a royalty to 3M Company for licensing trademarks, but did not license patents and other unpatented technology. The Brazilian Patent and Trademark Office prevented 3M Brazil from making royalty payments for patents and unpatented technology. The trademark licenses required 3M Brazil to pay 3M Company 1 percent of its net sales. The royalty was calculated using a stacking principle under which if a product used multiple trademarks covered by three separate agreements, then the licensee (3M Brazil) paid up to a 3 percent trademark royalty.

The IRS asserted that Brazil royalties should have been paid by 3M Brazil to 3M IPC on 6 percent of the net sales and made an adjustment of over $23 million.

3M argued that Brazilian law precluded 3M Brazil from paying any royalties other than the 1 percent trademark royalties. 3M conceded that the $23 million allocation reflects an arm's-length compensation for the use of the IP. However, it disputed the IRS's legal authority to make an allocation under section 482 because 3M Brazil was prevented under Brazilian law from paying more than the trademark royalty.

To support its position, 3M cited:

- the text of section 482;
- the legislative history of section 482; and
- four cases[2] in which courts held that, under prior versions of section 482 and its regulations, the IRS did not have authority to allocate income to a taxpayer that the taxpayer did not receive and could not legally receive.

Reg. section 1.482-1(h)(2) was promulgated in 1994, after the tax years at issue in the above cases. The IRS argued that reg. section 1.482-1(h)(2) applied to the 2006 tax year at issue in *3M*. 3M contended that the 1994 regulation is invalid under various administrative law principles and therefore is not controlling.

The plurality opinion provided a 149-page detailed summary of the legislative history of section 482, the Administrative Procedure Act, and the case law starting with the Revenue Act of 1921 and ending with the 2018 amendments to section 482. The opinion then analyzed whether the Brazilian legal restrictions satisfy the seven requirements in reg. section 1.482-1(h)(2) (2006) for taking into account foreign legal restrictions for transfer pricing purposes.

Reg. section 1.482-1(h)(2) (2006) provides that a foreign legal restriction is taken into account in making allocations under section 482 if seven requirements are met:

> 1) the restriction affected uncontrolled taxpayers under comparable circumstances for a comparable period;

[2] *L.E. Shunk Latex Products Inc. v. Commissioner*, 18 T.C. 940 (1952); *Commissioner v. First Security Bank of Utah*, 405 U.S. 394 (1972); *Procter & Gamble Co. v. Commissioner*, 961 F.2d 1255 (6th Cir. 1992), *aff'g* 95 T.C. 323 (1990); and *Exxon Corp. v. Commissioner*, T.C. Memo. 1993-616, *aff'd sub nom. Texaco Inc. v. Commissioner*, 98 F.3d 825 (5th Cir. 1996).

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; and

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.

3M did not dispute that the Brazilian restrictions failed the first, third, fourth, and sixth requirements. On the second requirement, 3M argued that the Brazilian Patent and Trademark Office interpretation of Brazilian law should be considered publicly promulgated even though 3M conceded that the agency's interpretation was unwritten; the plurality opinion disagreed. The plurality did not resolve the fifth and seventh requirements because it determined that five of the other seven requirements were not satisfied.

The plurality rejected 3M's argument that the Supreme Court in *First Security Bank* determined that the plain meaning of section 482 precludes the interpretation adopted in reg. section 1.482-1(h)(2) and held that *First Security Bank* was not decided under step one of the tests set forth in *Chevron*.[3]

The plurality also held that the four opinions cited by 3M were distinguishable because they construed the pre-1986 statutory provision that lacked the commensurate with income sentence. The plurality did not agree with 3M that the scope of the commensurate with income sentence added in 1986 is limited and does not broadly expand the scope of the IRS's powers under section 482 to disregard what is considered taxable income under foreign law.

3M also argued that an "arbitrary shifting of profits" under section 482 can result only from the voluntary setting of intercompany prices by the common owners of related companies. The plurality disagreed and stated that a legal restriction on intercompany payments could also arbitrarily shift profits under section 482. The plurality stated that even if the purpose of section 482 (as originally enacted in the Revenue Act of 1921) were to prevent the voluntary shifting of profits, "this does not mean that section 482 of the Internal Revenue Code of 1986 has the same purpose." The plurality seems to be suggesting that the second sentence in section 482, the commensurate with income sentence, changed the purpose and intent of the first sentence of section 482. That would be a troubling conclusion.

The plurality said its ruling did not depend on that conclusion. Even if section 482 should be narrowly interpreted to confine the IRS to correcting "arbitrary shifting of profits," the plurality said, a legal restriction on intercompany payments could arbitrarily shift profits and therefore justify a section 482 allocation.

Chief Judge Kathleen Kerrigan made a similar argument in her concurring opinion: Because the Brazilian blocking statute prevents 3M Company from receiving royalty income that is "commensurate with the income attributable to the intangible," the regulation disregards that blocking statute and thereby accomplishes Congress's purpose in enacting the commensurate with income standard in the second sentence of section 482 (the 1986 amendment).

Chief Judge Kerrigan's concurrence and a separate concurring opinion by Judge Elizabeth Copeland both state that the 1986 amendment to section 482 was a significant change to the statute. "None of the cases cited in Judge [Ronald L.] Buch's dissent interpreted the version of section 482 that controls this case," Chief Judge Kerrigan wrote. Judge Copeland wrote that "the result of this case is dictated by the plain text of section 482 — specifically, the second sentence added by

[3] *Chevron v. Natural Resources Defense Council Inc.*, 467 U.S. 837, 844 (1984).

amendment in 1986." Each joined in the other's concurring opinion.

Having rejected the argument that reg. section 1.482-1(h)(2) is invalid under *Chevron* step one, the plurality then considered the argument that portions of the regulation are invalid under *Chevron* step two. A regulation satisfies *Chevron* step two if it is a "reasonable interpretation" of the statute.[4] 3M argued that various requirements imposed by the regulation are not reasonable interpretations of section 482.

3M argued that the first requirement of the regulation regarding the effect on uncontrolled taxpayers is invalid. 3M's argument had two parts. First, that section 482 should be interpreted to address only misallocations of income attributable to controlled transactions; second, that a transaction is not a controlled transaction to the extent that a legal restriction prevents a payment of consideration. 3M's position was that 3M Company did not control the amounts that 3M Brazil paid to 3M IPC for the use of patents and for unpatented technology. That control was exercised by the government of Brazil through its legal restrictions.

While the plurality agreed that section 482 is aimed at controlled transactions, it stated that section 482 authorizes the IRS to allocate income among commonly controlled businesses if the allocation is necessary to clearly reflect the income of the businesses. However, the plurality ruled that the statutory text authorizing the allocation of income between controlled businesses to clearly reflect their income is broad enough to accommodate Treasury's interpretation that foreign legal restrictions are taken into account only if the restrictions affect uncontrolled taxpayers.

The second part of the argument — that a transaction is a not a controlled transaction if payment for the transaction is controlled by law — is founded on the Supreme Court opinion in *First Security Bank*. The plurality admitted that *First Security Bank* seemingly implies that there can be no control without legal control but then disposes of the Supreme Court's opinion by claiming that the "complete-power" sentence on which *First Security Bank* relied is no longer in the regulatory scheme for tax years beginning after April 21, 1993. This is an important point on which Judge Buch's dissent disagrees. The Supreme Court "did not rely on that regulation, but merely cited it for the proposition that even the Commissioner recognized that blocked income could not be taxed. Indeed, the Court was clear that it was interpreting the statute, not the regulations," Judge Buch wrote. The plurality ruled that the effect-on-uncontrolled-taxpayers requirement in the regulation is a reasonable interpretation of section 482 and is consistent with the goals of the statute, which are (1) tax parity and (2) arm's-length results.

3M also argued that the second requirement in the regulation, the public-promulgation requirement, is an unreasonable interpretation of section 482 because it does not take into account the fact that many countries rely on unpromulgated administrative guidance that is nonetheless considered binding. The plurality ruled that the requirement was valid under *Chevron* step two.

3M also argued that the foreign legal restriction regulation failed the test of *State Farm*[5] because Treasury did not provide a satisfactory explanation for its actions and did not provide adequate response to comments. The plurality stated that Treasury satisfactorily explained the reason for the regulation, which was to advance the goal of tax parity. The plurality also ruled that Treasury did adequately respond to comments.

Judge Buch's dissent stated that blocked income is income that a taxpayer is prohibited by law from receiving and that blocked income cannot be taxed. The IRS can use section 482 in myriad ways to allocate income among commonly controlled entities, but that taxpayer must have "complete power" over that income, he argued.

The Buch dissent stated that section 482 is silent on blocked income, and the regulations in effect from 1934 through 1993 did not explicitly purport to tax blocked income. The IRS

[4] *Mayo Foundation for Medical Education and Research v. United States*, 131 S. Ct. 704 (2011); *Chevron*, 467 U.S. at 844.

[5] *Motor Vehicle Manufacturers Association of the United States Inc. v. State Farm Mutual Automobile Insurance Co.*, 463 U.S. 29 (1983).

repeatedly attempted to use section 482 (and its predecessor) in an effort to tax blocked income and lost in court. Faced with a string of losses, Treasury promulgated regulations purporting to authorize the allocation, and thus taxation, of blocked income.

In *Brand X*,[6] relying on the framework set forth in *Chevron*, the Court held 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.

Judge Buch argued that the Supreme Court, in deciding *First Security Bank*, foreclosed the allocation, and thus the taxation, of blocked income. Without using the word "unambiguous," the Court made clear that blocked income is not, and cannot be, allocated to someone who did not and cannot receive it. Every court to have considered *First Security Bank* in the context of blocked income has understood it as describing a limit on the IRS's power to allocate income, the Buch dissent argued.

The Buch dissent then stated:

> If the Supreme Court had not already answered the question before us, a court would need to turn to the plain meaning of "income" to determine whether a taxpayer could be taxed on income that it did not receive and that it was prohibited from receiving. Because I would find *First Security Bank* controlling, I need not answer that question. But because the opinion of the Court does not find *First Security Bank* controlling, it must wrestle with interpreting the operative statute.

The Buch dissent argued that 3M had a blocked income problem in that its Brazilian subsidiary was compelled by foreign law to pay below-market royalty rates. In *First Security Bank*, the Supreme Court held that section 482 cannot be used to allocate blocked income to someone who did not receive it and could not receive it. The Buch dissent argues that Congress has not amended section 482 in any way that would materially alter the Supreme Court's holding in *First Security Bank*.

Judge Richard Morrison wrote the plurality opinion, in which Chief Judge Kerrigan and Judges Joseph Gale, David Gustafson, Joseph Nega, Tamara Ashford, and Alina Marshall joined. Judges Copeland and Elizabeth Crewson Paris concurred with the result only. Chief Judge Kerrigan filed a concurring opinion, in which Judges Gale, Paris, Ashford, and Copeland joined. Judge Copeland filed a separate concurrence, in which Chief Judge Kerrigan and Judges Gale and Paris joined. Judges Patrick Urda, Courtney Jones, Emin Toro, and Travis Greaves joined in Judge Buch's dissent. Judge Cary Douglas Pugh also wrote a dissent, in which Judges Maurice Foley, Buch, Urda, and Toro joined. Judge Toro filed a dissent, in which Judges Buch, Urda, Jones, Greaves, and Christian Weiler joined.

Microsoft FOIA Case

In *Microsoft*,[7] the court held that the IRS was not required under the Freedom of Information Act to search for and provide records of outside law firms that the IRS used during its audit. The IRS began an audit of Microsoft in 2007 for the tax years of 2004 through 2006 and hired Boies Schiller Flexner LLP and Quinn Emanuel Urquhart & Sullivan LLP to assist in its section 482 examination of Microsoft.[8] The decision to hire outside law firms to assist in the audit was heavily criticized. The opinion notes that this audit of Microsoft is one of the largest audits in the Service's history.

Previously in *United States v. Microsoft*,[9] the court enforced summonses that Microsoft argued were invalid partly because of the outside law firms' involvement in the audit. The court was troubled by the law firms' level of involvement but ruled that Microsoft failed to prove that the summonses were issued in bad faith or for an

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[6] *National Cable & Telecommunications Association v. Brand X Internet Services*, 545 U.S. 967 (2005).

[7] *Microsoft Corp. v. IRS*, No. 2:15-cv-01605 (W.D. Wash. 2023).

[8] For prior coverage, see James P. Fuller and Larissa Neumann, "U.S. Tax Review," *Tax Notes Int'l*, May 7, 2018, p. 727.

[9] *United States v. Microsoft Corp.*, No. 2:15-cv-00102 (W.D. Wash.).