Kluwer International Tax Blog

The 3M Decision: Did Treasury or Congress Overturn Past Jurisprudence?

William Byrnes (Texas A&M University Law) · Saturday, February 11th, 2023

> *The Tax Court issued a nine to eight split decision of six opinions (three in favor and three dissenting) upholding the Service's 1994 blocked income regulations.*

Yesterday, February 9, 2023, the Tax Court finally issued its 'split' decision regarding the 3M "blocked income" issue (formally, a decision regarding the validity of the Treasury Regulation regarding foreign legal restrictions).[1] The decision runs a total of 346 pages. 284 pages over three opinions in favor of the Service, supported by nine judges, albeit no opinion attracted a majority of the Tax Court. The remainder pages included the three dissenting opinions of eight judges, none of the dissents attracting all eight. Six opinions without an actual court majority signing any one opinion helps explain why this decision required six years of the Tax Court's internal deliberation. Moreover, given the number of arguments in favor and against, the issue of whether the 1994 blocked income regulation is valid is ripe for Appellate review. For context of the number of pages, the Tax Court's 2017 Amazon decision required 207 pages,[2] the 2019 Ninth Circuit Amazon decision about the same,[3] and the Tax Court's 2016 Medtronic initial decision required 144 pages.[4]

Boiling down the decision to its bare essence, the outcome is determined by whether the validity of the blocked income regulation is controlled by the Supreme Court Court's 1972 decision *Comm'r v. First Security Bank of Utah* ("First Security")[5] and whether the blocked income regulation meets the promulgation requirements of the Administrative Procedure Act.[6]

What's telling about the Tax Court's decision, and that, in my opinion, this decision will likely be rewritten and possible reversed at the Appellate level (I think at the Eighth Circuit because 3M is headquartered in Minnesota), is the nature of its split and multiple opinions for each side. Six judges, including the Chief Judge (Judge Kathleen Kerrigan), concurred with the primary opinion of Judge Morrison holding in favor of the Service (i.e. Judge Morrison the opinion writer, the Chief Judge, and Judges Gale, Gustafson, Nega, Ashford, and Marshall), thus seven votes in total. Chief Judge Kerrigan wrote a concurring opinion responding to the dissenting opinions of which four additional judges concurred (Gale, Paris, Ashford, and Copeland) for a total of five. Judge Copeland wrote an additional concurring opinion concurred by three judges (Kerrigan, Gale, and Paris) thus a total of four.

Eight judges dissented (Foley, Buch, Pugh, Urda, Jones, Toro, Greaves, and Weiler) from the ultimate decision. Judges Buch, Pugh, and Toro each wrote a dissent, focusing on different

challenges to the majority decision.

Judge Buch wrote the initial dissenting opinion with four concurrences (Judges Urda, Jones, Toro, and Greaves). Boiling it down, Judge Buch states that the Supreme Court, various Appeals Courts, and the Tax Court, have unequivocally held that blocked income may not be taxed.[7] Judge Buch argues that Treasury may not overrule these decisions through drafting a regulation.[8]

Judge Pugh, with concurrences by Judges Foley, Buch, Urda, and Toro, wrote a second dissent that argues the 1986 'commensurate with income' sentence addition to I.R.C. Section 482 did not alter the meaning of the term "income". Thus, the 1986 addition did not authorize Treasury to issue a regulation that contravenes the Supreme Court's and Sixth Circuit's pre-1986 decisions of *First Security Bank* and *Procter & Gamble*, respectively.[9]

Judge Toro submits a third, and final dissent (concurrence by Judges Urda, Jones, and Greaves) relying on Treasury's violation of the Administrative Procedure Act (the "APA").[10] Treasury stated in its promulgation of the regulation that it was not required to adhere to the APA. The primary opinion in favor of the Service states that "the regulation is not invalid for want of explanation."[11] Thus, seven tax court judges held that, at least for this regulation, a notice and comment period is not required by the APA. The majority held that it can definitively divine Treasury's explanation of the regulatory promulgation from Treasury's description of the rule: to advance the goal of arm's length comparisons.[12] The dissent counters that Treasury's description of a regulation is not the same as explaining the regulation's rationale or reason for adopting it.[13] Moreover, Judge Toro's writes that the 1983 *State Farm* Supreme Court decision disallows a reviewing court to divine an administrative agency's rationale after the fact.[14]

Judge Toro points out that the majority acknowledges that the blocked income regulation is a departure from Treasury's previous 1968 taxpayer friendly regulation on the same issue.[15] He thus responds that "when an agency changes an existing policy, the APA requires that it "must at least 'display awareness that it is changing position' and 'show that there are good reasons for the new policy.'"[16] Judge Kerrigan's concurrence counters that Judge Toro's dissent, if adopted, would place a greater burden on both the administrative agency and the court system because it would result in the undoing of years of regulatory promulgation creating uncertainty for both taxpayers and Treasury.[17] Judge Copeland's concurrence in favor of the Service's 1994 blocked income regulations finds that Congress intended to change the existing law under section 482 as it related to the transfer and license of intangibles evidenced by Congress' conferees report that included a sentence: "… a comprehensive study of intercompany pricing rules by the Internal Revenue Service should be conducted and that careful consideration should be given to whether the existing regulations could be modified in any respect."[18]

A complete analysis of argument and counter argument of the majority opinions and dissenting ones is forthcoming. A certain takeaway from this case is that, for the Tax Court, the issues regarding the validity of this regulation are not clear cut.

[1] 3M v. Commissioner, 160 T.C. No. 3 (Feb. 9, 2023) addressing the validity of Treasury Regulation § 1.482-1(h)(2).

[2] Amazon.com, Inc. v. Comm'r, 148 T.C. No. 8 (2017).

[3] Amazon.com, Inc v. Comm'r, 2019 U.S. App LEXIS 24453 (9th Cir. 2019).

[4] Medtronic, Inc. v. Comm'r, T.C. Memo 2016-112 (2016) ("Medtronic I").

[5] Commissioner v. First Security Bank of Utah, N.A., 405 U.S. 394 (1972).

[6] 5 U.S.C. §§ 551–559.

[7] Most directly as to the issue of foreign legal restrictions blocking payments, see *Procter & Gamble Co. v. Commissioner*, 961 F.2d 1255 wherein the Sixth Circuit held that section 482 could not be used to allocate income to a taxpayer when the controlled entity was prohibited by foreign law from making payments to the taxpayer. See also, Texaco, Inc. v. Commissioner, 98 F.3d at 825 wherein the Fifth Circuit, upheld the Tax Court, that the Service lacked authority, pursuant to *First Security Bank*, to reallocate blocked income.

[8] Treasury Regulation § 1.482-1(h)(2).

[9] 3M v. Commissioner, 160 T.C. No. 3 at 306 (Feb. 9, 2023). Before this current 3M decision, under the "blocked income" rule, if a legal restriction prohibits the taxpayer's receipt of income, section 482 and the arm's-length standard do not require the taxpayer to take the prohibited income into account, pursuant to Commissioner v First Security Bank of Utah, 405 US 394 (1972); Procter & Gamble Co. v Commissioner, 961 F2d 1255 (6th Cir 1992); and Texaco Inc. v. Commissioner, 98 F3d 825 (5th Cir 1996).

[10] 5 U.S.C. §§ 551–559.

[11] 3M v. Commissioner, 160 T.C. No. 3 at 267 (Feb. 9, 2023).

[12] 3M v. Commissioner, 160 T.C. No. 3 at 266 (Feb. 9, 2023).

[13] 3M v. Commissioner, 160 T.C. No. 3 at 312 (Feb. 9, 2023).

[14] Citing to State Farm, 463 U.S. 29 at 43 ("The reviewing court should not attempt itself to make up for [the agency's] deficiencies; we may not supply a reasoned basis for the agency's action that the agency itself has not given." (citing SEC v. Chenery Corp., 332 U.S. 194, 196 (1947)).

[15] 3M v. Commissioner, 160 T.C. No. 3 at 314 (Feb. 9, 2023); Treasury Regulation § 1.482-1(h)(2) and Treasury Regulation § 1.482-1(d)(6) (1968).

[16] Citing Encino Motorcars, LLC, 579 U.S. at 221 (quoting Fox Television Stations, Inc., 556 U.S. at 515).

[17] 3M v. Commissioner, 160 T.C. No. 3 at 280 (Feb. 9, 2023).

[18] 3M v. Commissioner, 160 T.C. No. 3 at 282 (Feb. 9, 2023).

To make sure you do not miss out on regular updates from the Kluwer International Tax Blog, please subscribe here.

Kluwer International Tax Law

The **2022 Future Ready Lawyer survey** showed that 78% of lawyers think that the emphasis for 2023 needs to be on improved efficiency and productivity. Kluwer International Tax Law is an intuitive research platform for Tax Professionals leveraging Wolters Kluwer's top international content and practical tools to provide answers. You can easily access the tool from every preferred location. Are you, as a Tax professional, ready for the future?

Learn how **Kluwer International Tax Law** can support you.

This entry was posted on Saturday, February 11th, 2023 at 4:38 am and is filed under Uncategorized
You can follow any responses to this entry through the Comments (RSS) feed. You can leave a response, or trackback from your own site.