3M CASE TO TEST "FOREIGN LEGAL RESTRICTIONS" REGULATIONS UNDER CODE §482

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INTRODUCTION

It is anticipated that by May of this year, the United States Tax Court (the "Tax Court") will begin considering the case of *3M Co. v. Commissioner* ("*3M*"), which will be decided on written record.[1] This decision could be an important challenge to the §482 regulation that addresses the issue of when the I.R.S. can make transfer pricing allocations without regard to foreign legal restrictions.[2] The *3M* case involves the petition of 3M Company ("3M" or the "Company") for redetermination of deficiencies for income tax in the amount of $4.8 million for the 2006 tax year issued by the I.R.S. According to 3M, the I.R.S. erroneously allocated $23.7 million of royalty income to 3M from its wholly-owned subsidiary, 3M do Brasil LTDA ("3M Brazil") under Code §482 even though Brazilian law prohibits payment of these royalties to 3M.

The §482 regulation at issue was adopted in 1994, shortly after the I.R.S. lost the *Procter & Gamble*[3] case, where the Tax Court, as well as the Court of Appeals for the Sixth Circuit, held that because foreign law, and not control over an affiliate, was the reason for the distortion of income, the I.R.S. could not reallocate income between the parties. The court relied on the Supreme Court decision in the case of *First Security Bank*,[4] where it held that when Federal law prevents a payment, the I.R.S. cannot use Code §482 to reallocate income between related parties.

THE FACTS OF THE *3M* CASE

3M Brazil has been doing business in Brazil since 1946. In 2006, it had approximately $563 million in sales and employed approximately 3,120 employees in its corporate headquarters and at four manufacturing sites.

In 1997, 3M and 3M Brazil entered into a license agreement (the "1997 License Agreement"), effective as of January 1, 1997, which permitted 3M Brazil (i) license to produce: an exclusive and non-assignable license to make, convert, process, and/or use certain licensed products of 3M in Brazil; (ii) license to market: a non-exclusive and non-assignable license to market, lease, distribute, and/or offer for sale the licensed products falling within the scope of 3M's licensed patents; (iii) non-patented technology: the availability of certain 3M data and know-how; and (iv) trademarks and copyrights: a non-exclusive and non-assignable license to use 3M trademarks and copyrights in Brazil. Under the 1997 License Agreement, 3M Brazil

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1 *3M Co. v. Commr.*, T.C., No. 5816-13, order, 1/7/16.

2 Treas. Reg. 1.482-1(h)(2)(i) and (ii).

3 *Procter & Gamble Co. v. Commr.*, 95 TC 323, Aff'd 961 F.2d 1255 (6th Cir. 1992).

4 *Commr. v. First Security Bank*, 405 U.S. 394 (1972).

was to compensate 3M with a royalty payment equal to 4% of the net selling price of products manufactured in Brazil by or for 3M Brazil.

Under Brazilian law, such agreements must be recorded with the Brazilian Patent and Trademark Office (the "B.P.T.O.") to facilitate the payment of royalties to non-Brazilian licensors. The parties attempt to record the 1997 License Agreement with the B.P.T.O. was rejected. To facilitate the recordation and the payment of royalties thereunder, 3M entered into three new agreements with 3M Brazil that granted 3M Brazil the right for an exclusive and non-assignable license to use, within Brazil, 3M's trademarks. Under these new agreements, royalties were set at 1% of the price invoiced by 3M Brazil for products that use 3M trademark and are sold in Brazil. These agreements were approved by the B.P.T.O. and were recorded.

3M decided that it was not able to amend or replace the 1997 License Agreement with respect to the intellectual property ("I.P.") other than trademarks due to objectionable B.P.T.O. rules, *e.g.*, those requiring that all improvements to technology belong to the improving party and requiring that licenses of certain older technology be royalty-free. As a result, 3M was not able to record the 1997 License Agreement. Since agreements must be recorded in order for the payment of royalties to be permitted under Brazilian law, only the 1% royalties on the trademarks could be remitted outside Brazil, and royalties for other items included in the 1997 License Agreement were not permitted.

In 1999, 3M formed 3M IPC, a Delaware corporation, for the purpose of holding certain I.P. Under the standard agreement for licensing the I.P. to many of 3M's domestic and international affiliates, the affiliates pay a marketing royalty of 1% of net sales and a manufacturing royalty of 6% of net sales. Both royalties are paid regardless of whether the customer is a related or unrelated person. 3M Brazil and 3M IPC did not enter into the standard agreement because 3M was advised by Brazilian counsel that the standard agreement would not satisfy the requirements of the B.P.T.O. and could not be recorded.

In 2006, 3M received trademark license fees from 3M Brazil in the amount of $5.1 million. But, since the payment of royalties other than trademark royalties was unlawful under Brazilian law, 3M did not receive any other royalties.

In the notice of deficiency issued to 3M, the I.R.S. stated that the restrictions on the payment of royalties under Brazilian law would not be taken into account for purposes of computing the arm's length amount of royalty income because the conditions of Treasury Regulations §§1.482-1(h)(2)(i) and (ii) had not been met. As discussed in detail below, those regulations state that the I.R.S. will take into account the effect of a "foreign legal restrictions" (also described below) to the extent that such restriction affects the results of transactions at arm's length. That is, it must be shown that the restriction affected an uncontrolled taxpayer under comparable circumstances for a comparable period of time. The foreign legal restrictions may be temporary or permanent, and the following conditions must be met:

- The restrictions are publicly promulgated, generally applicable to all similarly situated persons (both controlled and uncontrolled), and not imposed as part of a commercial transaction between the taxpayer and the foreign sovereign.
- The taxpayer (or other member of the controlled group with respect to which the restrictions apply) has exhausted all remedies proscribed by foreign law

or practice for obtaining a waiver of such restrictions (other than remedies that would have a negligible prospect of success if pursued).

- The restrictions expressly prevented the payment or receipt, in any form, of part or all of the arm's length amount that would otherwise be required under Code §482 (*e.g.*, a restriction that applies only to the deductibility of an expense for tax purposes is not a restriction on payment or receipt for this purpose).
- The related parties subject to the restrictions did not engage in any arrangement with controlled or uncontrolled parties that had the effect of circumventing the restrictions, and have not otherwise violated the restrictions in any material respect.

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3M contends that the I.R.S. has no authority under Code §482 to allocate income to a taxpayer from a related party where the related party is legally prohibited from paying income to the taxpayer, and where the taxpayer did not in fact receive the income from the related party.

THE *PROCTER & GAMBLE* CASE

In 1992, Proctor and Gamble ("P&G") won a case on blocked income with a similar fact pattern.

P&G owned all of the stock of Procter & Gamble A.G. ("A.G."), a Swiss corporation. A.G. was engaged in marketing P&G's products, generally in countries in which P&G did not have a marketing subsidiary or affiliate.

P&G and A.G. were parties to a "License and Service Agreement," known as a package fee agreement, under which A.G. paid royalties to P&G for the nonexclusive use by A.G. and its subsidiaries of P&G's patents, trademarks, tradenames, knowledge, research and assistance in manufacturing, general administration, finance, buying, marketing and distribution. The royalties were based primarily on the net sales of P&G's products by A.G. and its subsidiaries. A.G. entered into agreements similar to package fee agreements with its subsidiaries.

In the late 1960's, P&G made plans to organize a wholly-owned subsidiary in Spain, called P&G España S.A. ("España"), to manufacture and sell its products in Spain. It was determined that A.G., rather than P&G, would hold a 100% interest in España.

Spanish laws in effect at that time closely regulated foreign investment in Spanish companies, including the amount of capital that could be contributed to a Spanish company by a foreign investor, and restricting payments to foreign investors for the transfer of technology. Accordingly, España was restricted from paying a package fee for royalties or technology to A.G. during the years at issue in the lawsuit.

In 1985, consistent with its membership in the European Economic Community, Spain liberalized its system of authorization of foreign investment. In light of these changes, España filed an application for removal of the prohibition against royalty payments. This application was approved, as was España's application to pay package fees retroactive to July 1, 1987.

The I.R.S. determined that a royalty of 2% of España's net sales should be allocated to A.G. as royalty payments under Code §482 for 1978 and 1979 in order to reflect A.G.'s income. The I.R.S. also argued that España should have paid a dividend to A.G. in the amount of the arm's length royalty payments that were not allowed.

The Tax Court held that the I.R.S.'s allocation of income was unwarranted and that there was no deficiency. It concluded that allocation of income under §482 was not proper in this case because Spanish law, and not any control exercised by P&G, prohibited España from making royalty payments. The Court of Appeals for the Sixth Circuit affirmed the Tax Court's decision, for the following reasons:

- The regulations under Code §482 recognize that in order for the I.R.S. to have authority to make a §482 allocation, a distortion in the taxpayer's income must be caused by the exercise of the control between two parties. But, in the *Procter & Gamble* case, there was no evidence that P&G or A.G. used its control over España to manipulate or shift income. Rather, the failure of España to make royalty payments was a result of the prohibition against royalty payments under Spanish law.

- The Supreme Court held in *First Security Bank* that the I.R.S. is authorized to allocate income under Code §482 only where a controlling interest has complete power to shift income among its subsidiaries and has exercised that power. That was not the case of P&G with respect to España.

- *First Security Bank* is a controlling case even though the Supreme Court's analysis was limited to instances in which allocation under Code §482 was contrary to Federal law, and not foreign law. The court stated that the Supreme Court focused on whether the controlling interests utilized their control to distort income. The court stated that the fact that foreign law is involved may require a heightened scrutiny to be sure the taxpayer is not responsible for the restriction on payment, but that otherwise, the analysis should not be altered when foreign law, as opposed to Federal law, causes the distortion.

- In response to the I.R.S.'s argument that P&G could have legally received, under Spanish law, an annual "dividend" to compensate it for the I.P. used by España the court held that even if España had the profits to pay dividends (there was evidence that it did not), it had no such obligation – a taxpayer has no obligation to arrange its affairs so as to maximize taxes, as long as a transaction has a legitimate business purpose. Further the court firmly disagreed with the I.R.S.'s suggestion that P&G should purposely evade Spanish law by making royalty payments under the guise of calling the payments something else.

- Treas. Reg. §1.482-1(b)(6), the so-called "blocked income" regulation, did not apply to the case. That regulation contemplates the situation where a temporary restriction under foreign law prevents payments, and defers the allocation of income until such time as the payments are no longer restricted. In the *Procter & Gamble* case, the payments to P&G were not temporarily restricted. Rather, Spanish law *prohibited* payment of royalties altogether. This prohibition cannot be viewed as temporary because it was ultimately repealed in 1987. At the time in question, there was no reason for P&G to believe that the Spanish government would lift this ban. Thus, the payments that España was prohibited from making under Spanish law cannot be viewed as temporarily blocked payments.

- The prohibition on royalty payments cannot be viewed as temporary because, as the I.R.S. argued, at some future time P&G could have liquidated España and taken its capital out of Spain. The court stated that this argument was meritless because P&G was not obligated to organize its subsidiaries in such a way as to maximize its tax liabilities.

THE 3M CHALLENGE

While the facts in the *3M* case are generally similar on their face to the facts in the *Procter & Gamble* case, the I.R.S. proposed income allocation based on a regulation promulgated after the *Procter & Gamble* decision. This regulation permits the allocation of income made by the I.R.S. in this case. However, 3M is claiming this regulation is invalid. More specifically, it is claiming that the I.R.S. exceeded its legal authority when it adopted this regulation and that the addition of prerequisites that the foreign legal restriction be applied similarly to controlled and uncontrolled parties is invalid. This poses the question of whether this regulation and the imposition of those conditions is consistent with the holding of the Supreme Court as to how Code §482 is to be interpreted in relation to the question of legal restrictions, and whether this is enough to invalidate a regulation. Note that the language of Code §482 – on that respect – was the same when the I.R.S. issued the notice to 3M as it was when the *First Security Bank* and the *Procter & Gamble* cases were decided (and is the same today).

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Additionally, while the *3M* petition provides that the recordation of agreements is required prior to remittance of royalty payments abroad to a related or unrelated party, the petition does not discuss whether the rules governing the recording of an agreement by the B.P.T.O. are applicable in the same manner to related and unrelated persons, and this fact can influence the controlling element of the parties, required under Code §482. Further, 3M Brazil made a dividend payment to 3M in 2006, and the I.R.S. may attempt to use this fact to distinguish the *3M* case from the Procter & Gamble case, potentially claiming that this shows 3M could have exercised the control needed for Code §482 to be applied regardless of this regulation.

CONCLUSION

This case is the first challenge of the Code §482 regulations on legally restricted payments, and it may have ramifications beyond the treatment of taxpayers having business operations in jurisdictions such as Brazil. The decision in this case may affect how regulations that conflict with judicial interpretations of a statute are addressed.