U.S. INCOME TAX

Deductions for Non-U.S. Persons Under U.S. Income Tax Laws

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On February 15, 2008, the United States Court of Appeals for the Third Circuit rendered its decision in *Swallows Holding, Ltd. v. Commissioner*,[1] reversing a prior United States Tax Court decision[2] that had invalidated section 1.882-4(a)(3)(i) of the Treasury Regulations. That section imposes an 18-month time limit on foreign corporations to claim deductions against their income that is taxable in the United States because it is effectively connected with a U.S. trade or business. The Tax Court's decision that section 1.882-4(a)(3)(i) represented an unauthorized interpretation of Internal Revenue Code section 882(c)(2) had met with harsh criticism, and the Third Circuit's reversal had the effect of resurrecting the regulation and restoring the status quo ante. The result was the continuation in force of rules precluding deductions for foreign persons who file tax returns late. *Swallows* did not deal to any extent with the question of whether the regulation conflicts with the Business Profits and Non-Discrimination articles of various United States income tax treaties, including the treaty with Canada. Thus, although foreign persons[3] are clearly still subject to the 18-month deadline, further controversy is a distinct possibility.

History of Treasury Regulation 1.882-4

Under section 882(c)(2) of the Code, a foreign corporation subject to net U.S. income tax can receive the benefits of deductions and credits only by filing a "true and accurate return, in the manner prescribed in subtitle F ..."[4] The legislative history sheds little light on the statute's breadth and intent, leaving open the question whether, by requiring a return, Congress intended to impose a filing deadline after which a foreign corporation forfeits its right to deductions and credits.

In the late 1930s and early 1940s, the Board of Tax Appeals and the Fourth Circuit Court of Appeals wrestled with this issue in a series of cases under the predecessor to section 882(c)(2). In the first of these decisions, *Anglo-American Direct Tea Trading Co. v. Commissioner*, the Board held that a foreign corporation was entitled to the benefit of deductions claimed in an untimely return because Congress did not intend by use of the statutory term "manner" to include a timeliness element.[5] In subsequent cases, however, both the Board and the Fourth Circuit acknowledged that Congress could not have intended to allow taxpayers to wait indefinitely to file returns and still have the benefit of deductions. Both courts found that the purpose of the statute was to induce foreign corporations whose existence might otherwise not be discovered by U.S. tax authorities to advise the authorities of their income subject to U.S. taxation.[6] To achieve this purpose, some terminal date must exist after which a foreign corporation can no longer claim the benefit of deductions on a return. Otherwise, the corporation could simply wait for the Internal Revenue Service to assess a deficiency and then file its return and obtain all benefits to which it would have been entitled if the return had been timely filed.[7] Although the courts declined to prescribe a rigid deadline, they held that, absent compelling

[1] 515 F.3d 162 (3d Cir. 2008).

[2] 126 T.C. 96 (2006).

[3] The rules of section 1.882-4 have an analogy in section 1.874-1, relating to deductions for foreign individuals. There has never been much controversy regarding the rule relating to individuals, but the principles discussed in the text with respect to corporations would seem fully applicable to them. See *Espinosa v. Comm'r*, 107 T.C. 146 (1996) (applying case law decided under the predecessor to section 882(c)(2) to determine whether section 874(a) imposes a filing deadline beyond which a foreign individual cannot claim deductions).

[4] Subtitle F deals with procedure and administration and includes, among other provisions, deadlines for filing returns.

[5] 38 B.T.A. 711, 715 (1938).

[6] See *Blenheim Co. v. Comm'r*, 125 F.2d 906 (4th Cir. 1942), aff'g, 42 B.T.A. 1248 (1940); *Taylor Securities, Inc. v. Comm'r*, 40 B.T.A. 696 (1939).

[7] *Taylor Securities, Inc.*, ibid. at 703-704.

equitable considerations, a taxpayer may not wait for this purpose until after the Service files substitute returns on its behalf.

In 1990, in an apparent effort to create a bright-line rule, the Internal Revenue Service issued regulations specifying the last point in time by which a foreign corporation could file its return without forfeiting deductions. Regulations section 1.6012-2(g)(2) generally requires that a foreign corporation file a federal income tax return on Form 1120-F if it engages in a trade or business in the United States at any time during the taxable year or has income subject to taxation in the United States. Under section 1.882-4(a)(3)(i), a foreign corporation required to file its first return or that filed a return for the immediately preceding year must file its return within 18 months of the filing deadline set forth in section 6072 to receive the benefit of deductions and credits.[8] Otherwise, the foreign corporation is allowed 18 months beyond the section 6072 filing deadline or until the date the Service mails a notice advising the corporation that the current year's return has not been filed, whichever is earlier.[9] According to the preamble to the regulation, the Service believed the filing deadline was justified "because of the different administrative and compliance concerns with regard to ... foreign corporations."[10]

Challenges to the Regulation Based on Treaty Provisions

In a 1999 Technical Advice Memorandum, the Internal Revenue Service considered a challenge to the filing deadline by a Canadian corporation on the grounds that the regulation conflicted with the Business Profits and Non-Discrimination Articles of the U.S.-Canada Income Tax Treaty.[11] In the same year, the Service also considered challenges to the regulation based on substantially identical provisions in the German and U.K. treaties, in two Field Service Advice Memoranda.[12]

The taxpayers in all three cases argued that the Business Profits Article of the pertinent treaty obligated the United States to allow deductions for expenses incurred with respect to a permanent establishment regardless of whether a return was timely filed.[13] The Service rejected this argument. Citing commentaries to the 1977 OECD Model Tax Treaty and the 1992 and 1998 OECD Conventions as support, it found the treaty provision was intended only to ensure the proper allocation of profits between the country of a corporation's residence and the country where the corporation does business through a permanent establishment. The provision was not intended to affect domestic law concerning tax administration or designed to ensure tax compliance. Since the regulation did not provide a mechanism for allocating income and expenses between a foreign corporation and its U.S. trade or business, the Service concluded that it did not conflict with the Business Profits provision.

With respect to the Non-Discrimination Article of the treaties, taxpayers argued that the denial of deductions is discriminatory because U.S. resident enterprises are not subject to a similar deadline.[14] The Service

[8] Under section 6072 and its regulations, a foreign corporation that has an office or place of business in the United States must generally file a return on or before the fifteenth day of the third month following the close of the taxable year. If the foreign corporation does not have an office or place of business in the United States, it has until the fifteenth day of the sixth month following the close of the taxable year in which to file its return.

[9] Treas. Reg. 1.882-4(a)(3)(i).

[10] T.D. 8322, 1990-2 C.B. 172.

[11] T.A.M. 199941007 (October 18, 1999).

[12] F.S.A. 199940012 (July 2, 1999) (German Treaty); F.S.A. 199944026 (August 6, 1999) (United Kingdom Treaty).

[13] Paragraph 3 of Article VI (Business Profits) of the 1984 Canada Treaty provides:

> In determining the business profits of a permanent establishment, there shall be allowed as deductions expenses which are incurred for the purposes of the permanent establishment, including executive and general administrative expenses so incurred, whether in the state in which the permanent establishment is situated or elsewhere. Nothing in the paragraph shall require a Contracting State to allow the deduction of any expenditure which, by reason of its nature, is not generally allowed as a deduction under the taxation laws of that State.

Paragraph 3 of the Business Profits Articles of the United Kingdom and German treaties are substantially identical.

[14] Paragraph 6 of Article XXV (Non-Discrimination) of the 1984 Canada Treaty provides:

also rejected this argument, holding that the non-discrimination provision was only intended to prevent discrimination to the extent a permanent establishment is "similarly situated" to a domestic corporation carrying on the same activities. Domestic and foreign corporations are not similarly situated, the IRS maintained, because it is generally more difficult for the Service to detect a non-compliant foreign corporation doing business in the United States than a non-compliant domestic corporation. The regulation was designed to address this difference, so the Service found that it did not violate the non-discrimination requirement. The Service conceded, however, that non-discrimination provisions require careful consideration of all facts and circumstances surrounding the application of section 882(c)(2) and the regulations thereunder in a particular case. This consideration should include an evaluation of whether the results of applying section 882(c)(2) are reasonable and whether the treaty partner would view those results to be consistent with its understanding of the role of reasonable administrative procedures applicable to permanent establishments.

Swallows Holding

In the two Field Service Advice Memoranda considering challenges to the regulation under the German and U.K. treaties, the Service also rejected arguments that section 882(c)(2) does not give it authority to impose a specific deadline beyond which deductions are denied. This was the sole issue addressed by the Tax Court and the Court of Appeals for the Third Circuit in *Swallows Holding, Ltd.*[15]

The taxpayer in *Swallows*, a Barbados corporation, owned undeveloped land in San Diego, California. The corporation timely filed a return in 1992 for its first fiscal year, reporting no income or expense and that it had not engaged in a trade or business in the United States. From 1993 to 1996, the corporation realized rental income and income from an option to purchase the land, but did not file any additional returns until 1999. In 1999, on the advice of its accountant and prior to any contact from the Revenue Service, the corporation filed returns for fiscal years ending in 1993, 1994, 1995, and 1996, claiming deductions that exceeded its reported gross income for each year.[16]

The Revenue Service disallowed the deductions because none of the returns was timely filed within the meaning of section 1.882-4(a)(3)(i), and it therefore determined deficiencies for each year. The taxpayer challenged the proposed deficiencies asserting that section 882(c)(2) does not require that returns be filed timely, and thus section 1.882-4(a)(3)(i) is invalid to the extent that it imposes such a requirement.

The Tax Court, applying a test set forth by the United States Supreme Court in *National Muffler Dealers Ass'n v. United States*,[17] agreed with the taxpayer that the regulation was an invalid interpretation of section 882(c)(2). Under *National Muffler*, an interpretive regulation is reasonable, and thus valid, only if it "harmonizes with the plain language of the statute, its origin, and its purpose." The Tax Court agreed with the Board of Tax Appeal's decision in *Anglo-American* that the plain meaning of the word "manner" as used in the statute does not include an element of time. Further, the Tax Court noted the absence of several factors identified by *National Muffler* as demonstrating that a regulation has legitimacy. The Tax Court focused on the fact that the regulation effectively reversed the decades-old holding in *Anglo-American*, and that it was issued after multiple reenactments of the statutory text,

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> Notwithstanding the provisions of Article XXIV (Elimination of Double Taxation), the taxation on a permanent establishment which a resident of the Contracting State has in the other Contracting State shall not be less favorably levied in the other State than the taxation levied on residents of the other State carrying on the same activities.

Paragraph 6 of the Non-Discrimination Articles of the United Kingdom and German treaties are substantially identical.

[15] 126 T.C. 96 (2006), rev'd, 515 F.3d 162 (3d Cir. 2008). The United States has an income tax treaty with Barbados, where the *Swallows* taxpayer was incorporated, but the question whether section 1.882-4(a)(3)(i) conflicts with the provisions of that treaty was apparently not raised.

[16] Although the taxpayer had not made an election under section 882(d), which allows foreign taxpayers to elect to treat real property income as if it were income effectively connected with a U.S. trade or business and deduct expenses attributable to real property, the parties agreed to treat the returns as such an election.

[17] 440 U.S. 472 (1979).

none of which altered *Anglo-American*'s interpretation of the text.

The Tax Court also considered the holding in *National Cable & Communications Ass'n v. Brand X Internet Service*,[18] in which the United States Supreme Court decided the validity of an agency interpretation that construed a statute inconsistently with a prior judicial interpretation. The Court had held that the prior judicial construction of a statute trumps an agency construction otherwise entitled to deference under *Chevron U.S.A., Inc. v. National Resources Defense Counsel, Inc.*[19] only if the prior court decision flows from the unambiguous terms of the statute and thus leaves no room for agency discretion.

The Tax Court in *Swallows* questioned whether *Brand X* was applicable since it had determined that *National Muffler*, rather than *Chevron*, provided the standard by which the regulation must be evaluated, but it refused to decide that issue because it found that *Brand X* could be distinguished. In *Brand X*, the FCC had adopted its position after careful review of technological developments, while the Service's rationale for adopting its regulation under section 882(c)(2) was perfunctory. The FCC's regulations were not inconsistent with prior FCC rulings, while the Service had altered the section 882 regulation as it stood in 1990 to include a timeliness requirement. In *Brand X*, the FCC had not been a litigant in the case that was overturned by the agency's ruling, and the case had not been a long-standing decision. Finally, the Tax Court found that the *Anglo-American* line of cases applied the unambiguous meaning of the term "manner" and thus could not be overturned by subsequent agency action.

The Third Circuit reversed, holding that the Tax Court should have applied *Chevron* and deferred to the agency when evaluating the validity of the section 882 regulation.[20] The Court of Appeals rejected the argument that the regulation did not merit *Chevron* deference because it was merely interpretive (as opposed to legislative). Relying on case law that *Chevron* deference is appropriate when Congress would expect the agency to speak with the force of law, it held that *Chevron* applied because the Service had opened the regulation as proposed to public comment, indicating agency action carrying the force of law. The Court also rejected the Tax Court's holding that the *Anglo-American* line of cases pre-empted *Chevron* analysis.

Under the two-prong analysis of *Chevron*, a court must first determine whether the statutory language is clear and unambiguous. When a provision is found to be ambiguous, the ambiguity is viewed as an implicit congressional delegation of authority to an agency, allowing it to fill the gap with reasonable regulation. The Court noted that Congress has not uniformly used the phrase "time and manner" when it desired a Code provision to embody a timing element. Thus, the use of the term "manner" was not clear and unambiguous, and the Service was justified in promulgating a rule that prescribed a filing deadline. Applying a second *Chevron* prong, the Court found that the highly complex and technical nature of the Internal Revenue Code required heightened deference to the agency. *Chevron* recognizes that the IRS is in a superior position to make judgments concerning administration of statutory ambiguities. In this case, the Service had found that eighteen months served as a balance between its desire for compliance with the federal tax laws and a foreign corporation's desire to obtain valuable tax deductions. In the circumstances, the Court of Appeals held that regulation was a reasonable exercise of the Service's authority.

Conclusion

The Third Circuit's decision in *Swallows* has upheld section 1.882-4(a)(3)(i) as a valid exercise of the Internal Revenue Service's interpretive authority, and thus foreign corporations are again subject to the 18-month deadline imposed by that regulation. The current regulation is, however, somewhat less harsh than the regulation applied to the taxpayer in *Swallows*. Prior to 2002, the regulation provided that the Commissioner could only waive the deadline for good cause "in rare and unusual circumstances." The current regulation allows the Commissioner to waive the deadline when a foreign corporation establishes that it acted reasonably and in

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[18] 545 U.S. 967 (2005).

[19] 467 U.S. 837 (1984). In *Chevron*, the Court had held that the judiciary should afford discretion to an agency to interpret ambiguous provisions of the agency's organic or enabling statute.

[20] *Swallows Holding, Ltd. v. Comm'r*, 515 F.3d 162 (3d Cir. 2008).

good faith and sets forth several factors the Commissioner must consider in determining whether the foreign corporation so acted.

Nevertheless, the Service's 1999 rulings on the consistency of the regulation with various treaty provisions, especially the Non-Discriminations provisions, are not very convincing, and the regulation appears vulnerable to further attack. It cannot be gainsaid that the regulation applies only to foreign, and not to U.S., corporations. The Revenue Service justified the different (i.e., discriminatory) treatment on the ground that foreign and U.S. corporations are not "similarly situated" insofar as ease of detection is concerned. Whether foreign and U.S. corporations, which are never identical, are really so "dissimilarly situated" as to support the discriminatory regulation is a good question – one that has yet to be judicially addressed and that may prove an independent basis for a challenge to the filing deadline.

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