Coke, 3M Tax Cases May Not Settle Blocked Income Debate

By **Matthew Frank and Amanda Varma** (March 11, 2021, 3:02 PM EST)

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There are two high-profile cases now pending in the U.S. Tax Court challenging the U.S. Department of the Treasury regulation adopted in 1994 under Internal Revenue Code Section 482 dealing with blocked income.[1] The cases are 3M Co. v. Commissioner[2] and The Coca-Cola Company v. Commissioner.[3]

This article focuses on an issue that is covered by the challenged regulation but is not necessarily controlled by it — the "in any form" concept, which requires taxpayers to report income from related parties if the income could have been collected in any form, including through receipt of dividends.

This is relevant to the aforementioned cases because while the taxpayers in those cases had affiliates in Brazil subject to royalty payment restrictions, the affiliates could have paid dividends and the taxpayers could have treated the income as royalties for U.S. tax purposes. The Internal Revenue Service urges that this defeats the taxpayers' claims that the income was blocked.

From the IRS perspective, the choice of paying royalties or dividends in this context is akin to the choice of paying by cash or check, and a taxpayer cannot sustain a blocked income position merely because its preferred method of payment is not available if an alternative is present — any alternative, the IRS might add, regardless of the costs and burdens associated with it.

Taxpayers argue, on the other hand, that royalties and dividends are very different things and they are under no obligation to engage in the type of payment and self-help recharacterization the IRS demands.

This article discusses the litigants' respective arguments on this point and the potential complication for the taxpayers' argument introduced by the conduct of one of them, the Coca-Cola Co., which paid billions of dollars of dividends in satisfaction of royalties over the years from many countries, including Brazil, showing the IRS' "in any form" concept in action.

The article concludes that even if the challenged regulation is struck down and the "in any form" language goes down with it, there will remain the question whether a taxpayer can defeat an IRS adjustment on a blocked income theory if the taxpayer had, but failed to avail itself of, alternative means to secure the payment, as through dividends.

This question would certainly be asked in future cases and may well be asked in the two pending cases, either before, after or in lieu of getting to the challenged regulation's validity.[4]

While the litigants seem to argue for categorical answers — the IRS urging that taxpayers must do whatever it takes and taxpayers urging they need not do anything at all — we expect courts may take a middle road, guided by a sense of reasonableness, and to decide

the question on the facts of each case.

Background

The IRS has a history of stubborn resistance to blocked income arguments in its enforcement of Section 482. For many years, its attitude could be aptly summarized thus: "We don't care that you can't get paid. We're not demanding that you get paid, only that you pay tax as if you had."

The IRS lost on this issue at the U.S. Supreme Court in 1972 in Commissioner v. First Security Bank of Utah.[5] The IRS in that case invoked Section 482 to allocate sales commission income to banks that were prohibited by U.S. law from receiving it.

The commissions related to insurance referral activities the banks had performed for their own benefit and for the benefit of their customers, which also benefited an affiliated insurance company.

The IRS argued that the legal prohibition against receipt of sales commissions by banks was irrelevant because the IRS was not requiring the payments but simply taxing the banks as if the payments had been made.

The Supreme Court rejected the IRS position for two reasons.

One, the court observed that the prohibition applied without regard to the source of the payment, whether from a related person or not, and thus the banks at issue were in the same position as if they were uncontrolled. The court said the "'purpose of section 482 is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer ... ' We think our holding comports with such parity treatment."[6]

Second, the court reasoned that Section 482 was designed to prevent parties under common control from using that control to distort their true income. The court said the corporate parent did not use its control to distort the income of the banks. Accordingly, the court held that the IRS could not use Section 482 to allocate income to the banks.

Despite the loss, the IRS continued to press its theory and sought to distinguish the Supreme Court holding on insubstantial grounds.[7]

First Security Bank has been interpreted in later cases to stand for the principle that the IRS cannot make a Section 482 adjustment if the income distortion arises from external forces rather than from the controlling group's exercise of control, and this principle has been extended to cases involving foreign legal restrictions.[8]

In 1994, after a series of court losses, the Treasury Department sought to strengthen the IRS position by issuing regulations on the blocked income issue. The regulations were generally regarded as an act of defiance because the Treasury made the standards for securing blocked income recognition so rigorous as to be practically unachievable.

This history does not position the IRS sympathetically in the two cases pending in U.S. Tax Court. In both, the taxpayers argue that the regulation is invalid because the Treasury Department adopted it without complying with the Administrative Procedure Act and because the regulation is inconsistent with the statute it purports to implement.

The 3M case was fully briefed in 2016 and is awaiting decision. The Coca-Cola case was

decided by the Tax Court in November 2020 except for the blocked income issue, which the court deferred pending resolution of the issue in the 3M case.[9]

The taxpayers make similar arguments in both cases challenging the validity of the regulation. Predictably, the IRS defense of the regulation is similar as well.

Commentators give the taxpayers a good shot of having the regulation overturned.[10] There are credible arguments to do so, which are beyond the scope of this article.

Payment in Any Form

This discussion is focused on the part of the challenged regulation that states that if a U.S. taxpayer provides a good or service to a foreign related party and the related party is blocked from remitting payment because of foreign legal restrictions, the U.S. taxpayer must nevertheless report the blocked income unless the taxpayer can clear several hurdles, including the hurdle to show that the funds could not have been remitted to it in any form, including as a dividend.[11]

The IRS position is that a person at arm's length would make sure it got paid for its valuable goods or services through whatever means were available.

In the two cases now pending, both of which involve licensing of intangibles by a U.S. corporation to affiliates in Brazil, the IRS concedes that Brazilian law limited the royalties that could be paid but says the taxpayer affiliates could have paid dividends, which the taxpayers could then have reported as royalty income on their U.S. returns.[12]

The IRS has issued revenue procedures providing a path for taxpayers to do so.[13] The IRS says that since a path to pay and collect funds for the U.S. licenses was available, the taxpayers cannot rely on foreign legal restrictions to avoid including those amounts in income.

The taxpayers, 3M Company and Coca-Cola, say they were under no obligation to pay dividends in satisfaction of the royalties the IRS says were due.

The facts and arguments advanced by the parties highlight an interesting tension.

On the one hand, Procter & Gamble Co. v. Commissioner, a U.S. Court of Appeals for the Sixth Circuit decision from 1992, prior to the adoption of the challenged regulation, is thought by many to have resolved the issue in favor of taxpayers, concluding that taxpayers have no obligation under Section 482 "purposely [to] evade [foreign] law by making [prohibited] royalty payments under the guise of calling the payments something else."[14]

On the other hand, one of the taxpayers in the current litigation, Coca-Cola, fought successfully for the right to do exactly what the IRS is arguing all taxpayers in its position must do — pay dividends in satisfaction of royalties — which complicates a taxpayer argument that it would be an abuse of IRS discretion or purely arbitrary to expect taxpayer's in Coca-Cola's position to do the same.

Procter & Gamble

The IRS advanced a version of the "in any form" argument in the Procter & Gamble case[15], which involved the tax years 1978-1979 and thus occurred before the regulation.

The taxpayer in that case licensed a bundle of intangibles to an affiliate in Spain but did not charge or collect royalties because of Spanish legal restrictions. The IRS made an adjustment and the taxpayer challenged the adjustment as an abuse of the IRS' discretion on the ground that the taxpayer's Spanish affiliate was prohibited by law from paying the royalties.

The Tax Court and the Sixth Circuit ruled in favor of the taxpayer. The Tax Court, citing First Security Bank, said "section 482 does not impel the violation of a legal prohibition solely for the sake of matching income and expense."[16]

The Sixth Circuit affirmed, rejecting the IRS argument that the taxpayer could have paid dividends in satisfaction of the blocked royalties — an argument the IRS made in the court of appeals but which does not appear in the Tax Court opinion.

The court said the taxpayer had no obligation "purposely [to] evade Spanish law by making royalty payments under the guise of calling the payments something else."[17]

The court explained:

The Commissioner argues that P&G could have paid, under Decree 16/1959, an annual "dividend." The Commissioner argues that P&G has not shown that a dividend would have been forbidden under Spanish law, and asserts that the Commissioner would have treated such a dividend as a royalty for United States tax purposes. Assuming that Espana had profits from which it could pay a dividend under Spanish law, we find that P&G had no such obligation. A taxpayer need not arrange its affairs so as to maximize taxes as long as a transaction has a legitimate business purpose. Salyersville National Bank v. United States, 613 F.2d 650, 653 (6th Cir. 1980). We firmly disagree with the Commissioner's suggestion that P&G should purposely evade Spanish law by making royalty payments under the guise of calling the payments something else.[18]

The Coca-Cola Company Experience

In 1992, the same year Procter & Gamble was decided, Coca-Cola did what the IRS insists all taxpayers must do in a blocked income situation if possible — it paid dividends that were later applied in satisfaction of royalties.[19]

For the three years at issue in its pending Tax Court case, 2007-2009, it paid dividends in satisfaction of royalties from seven foreign licensees totaling just over $1.8 billion.[20] A significant portion of this, $887 million, related to the company's operations in Brazil where its affiliate was restricted in its ability to pay royalties.

Coca-Cola made these dividend in lieu of royalty payments based on a 1996 closing agreement with the IRS, which provided that dividends would be credited against royalty obligations without requiring the taxpayer to satisfy the requirements of Revenue Procedure 65-17, which was in effect at the time and provided a method for the same such crediting.

Coca-Cola characterized its closing agreement as providing "the Company a self-help mechanism to cover its royalty obligations without gaining approval from local taxing authorities to pay royalties."[21]

The company noted that the ability to pay dividends in satisfaction of royalties was helpful as a mechanism to reduce its audit risk in at least one country outside Brazil where the "local tax authorities are very aggressive" and a "request for a royalty would trigger a local

audit that could result in additional foreign taxes."[22]

Coca-Cola observed that allowing dividends to be credited against royalties was consistent with IRS practice.

The IRS has long permitted taxpayers to offset transfer-pricing adjustments with dividends, which is logical because dividends are subject to Federal income tax in the same manner as royalties. Under the Royalty Closing Agreement, the IRS permitted petitioner to satisfy its obligation to report royalty income without a contemporaneous election under the relevant revenue procedures.[23]

Relevance of the Coca-Cola Experience to the Procter & Gamble Principle

The Coca-Cola experience suggests it had no difficulty paying dividends out of Brazil in satisfaction of royalties. Coca-Cola does not suggest it violated the law or engaged in subterfuge or circumvention. It simply paid dividends and availed itself of the agreed procedures to treat the dividends as payment in satisfaction of an arm's-length royalty.

This experience puts a spotlight on the question whether a taxpayer in a situation like Coca-Cola — where it has earnings and profits from which it can pay dividends — can successfully rely on the blocked income authorities of First Security Bank, Procter & Gamble and similar cases to defeat an IRS adjustment.

Do these cases apply to taxpayers in that situation or only to taxpayers in a situation where such payments would in fact be unlawful or at the very least represent an unseemly evasion of a legal duty?

Taxpayer Argument

The 3M Company, which addresses the issue in more detail than Coca-Cola, makes three principle arguments why the ability to pay dividends out of Brazil in satisfaction of royalties is irrelevant and does not defeat a blocked income defense.[24]

The first argument is that Procter & Gamble settles that the IRS cannot impose on the company an obligation to pay dividends. 3M argues that First Security Bank of Utah suggests the same.

There was no discussion of the issue in that case but 3M argues that the absence of discussion is significant because it implies that the parties did not regard it as relevant that the legal prohibition in that case could have been bypassed by having the relevant member of the group pay dividends to a common parent followed by a contribution of those dividends to the banks.[25]

Second, 3M emphasizes that royalties and dividends have materially different accounting and tax attributes and that the adjustments required to conform the taxpayer's accounts could result in adverse tax consequences, such as the loss of indirect foreign tax credits on the recharacterized dividends.[26]

Third, the company states "the more fundamental problem" with the IRS position is that paying a dividend and invoking the revenue procedure path to characterize it as a royalty payment "would have been equivalent to a binding concession by 3M that the royalties that 3M Brazil could not pay under Brazilian law were nonetheless taxable to 3M."

The company notes, "The Commissioner does not explain why 3M would want to make such a concession when all legal authority (except for an invalid regulation) holds that 3M cannot be taxed on royalties that it did not receive and could not receive because of a legal restriction."[27]

Finally, more as an observation than as an argument, 3M notes the high stakes involved if the court were to require taxpayers to engage in the kind of self-help on which the IRS insists. "Because virtually all foreign countries allow the payment of dividends, this provision [referring to the "in any form" payment provision] in effect means that no foreign legal restriction will be recognized."[28]

IRS Reply

The IRS counterarguments, which are more or less clear from its briefs in the 3M case, start with the insistence that the situation involving 3M — and by extension Coca-Cola — is not controlled by Procter & Gamble because the payment of dividends out of Brazil in satisfaction of royalties would "not impel the violation of a legal prohibition," or require the parties to "evade [foreign] law" within the meaning of that case. Coca-Cola's benign experience paying dividends out of Brazil in satisfaction of royalties supports this.[29]

Second, the IRS argues the situation involving 3M — and by extension Coca-Cola — is not controlled by First Security Bank because the decision in that case rested on the court's conclusion that there was tax parity between related and unrelated taxpayers, therefore no adjustment was proper.

In contrast, the royalty ceiling in Brazil applies to related party payments only, creating a disparity, so it is incumbent on the taxpayers to take actions reasonably available to them — in the same manner parties at arm's length would conduct themselves — to secure payment to achieve the tax parity goal.[30] Failure to take such actions would be inconsistent with arm's length behavior.

The IRS does not address 3M's other arguments regarding, e.g., the loss of indirect foreign tax credits and the binding concession feature of seeking to treat dividends as royalties under the IRS revenue procedure. One may expect that the IRS would not be sympathetic, however, as the 3M objections are the normal consequences that apply where taxpayers avail themselves of the revenue procedure.

Relevance of Burden and Business Purpose

An issue that floats through the cases and through the arguments of the parties is the relevance of burden and business purpose in fixing the obligations of taxpayers and judging the reasonableness of IRS adjustments.

In the Sixth Circuit's 1980 decision, Salyersville National Bank v. U.S.,[31] cited in the Procter & Gamble passage quoted above, the Sixth Circuit rejected an IRS allocation of insurance income to a bank that was prohibited by law from receiving it, notwithstanding that the bank could have taken certain licensing steps to qualify for receipt of the income.

The IRS, according to the court, contended "that if the bank had the capability of making itself eligible to receive any commissions it was required to do so, even if it could legitimately choose not to do so."[32] However, the court recited reasons why the bank decided not to go down that path and concluded that the adjustment could not stand.

Although the court did not phrase it in these terms, it seems clear from the opinion that the court concluded that the bank acted in a reasonable, arm's-length manner in choosing not to secure the license that would have allowed it to obtain the funds. Equally clear, the court's analysis leaves open the possibility that if the court had concluded the bank acted in an unreasonable, non-arm's-length manner in choosing not to qualify for receipt of the funds, the court's decision to strike down the IRS adjustment might have been different.

Conclusion

If the blocked income regulation under Section 1.482-1(h)(2) is struck down, the "in any form" language will be gone but the issue examined in this article will remain and, indeed, may come to the fore.

Looking to the statute, the case law and the surviving regulations, the question will be whether a taxpayer can defeat an IRS adjustment on a blocked income theory notwithstanding the taxpayer had, but failed to avail itself of, alternative means to secure the payment.[33]

The Salyersville National Bank and Procter & Gamble courts answered the question on the facts before them in the taxpayers' favor but neither suggested a taxpayer could defeat an adjustment by sitting on its hands in circumstances where a party at arm's length would take action.

The standard may be one of reasonableness, requiring the taxpayer to show that it acted reasonably in trying to secure payment but not demanding more than that. If this is the standard, the answer — like the facts — may differ from taxpayer to taxpayer, from country to country, or from year to year.

If the Tax Court strikes down the challenged block income regulation, taxpayers will once again have at least a fighting chance to defeat an IRS adjustment on blocked income grounds. But to succeed, taxpayers will need to marshal the facts to show that the income was indeed blocked and could not be reached through reasonable means available to them.

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[1] Treas. Reg. § 1.482-1(h)(2).

[2] 3M Co. v. Commissioner, No. 5816-13.

[3] The Coca-Cola Company v. Commissioner, No. 31183-15.

[4] Nearly all of the briefing in the 3M case is devoted to whether the challenged regulation is valid. The question whether the IRS adjustment could be upheld independent of the challenged regulation is addressed only in the final two pages of the IRS's reply brief. Answering Brief for Respondent, 3M v. Comm'r, pages 63-64. The IRS suggested this would be a question for the court to address "if the Court were to hold that [Treas. Reg.] section

1.482-1(h)(2) is not valid." Id. at 63. It is conceivable, however, that if the court were to answer the question in favor of the IRS, it might reach this question first, to avoid having to rule on the issue of regulation invalidity. In Coca-Cola, by contrast, we do not find an indication in the briefs that the IRS urged a backstop position in support of its adjustment, raising the question, not addressed here, whether that argument is available to the IRS, or may be reached by the court, in the event the challenged regulation is struck down.

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

[6] 405 U.S. at 407.

[7] In 1981, nine years after the Supreme Court spoke, the IRS proclaimed that it could allocate interest income on related-party loans at rates prohibited as usurious under state or local law. The issue surfaced when commentators complained that IRS interest rate transfer pricing adjustments could conflict with state usury laws. The IRS was unmoved, reasoning that local usury laws were not of concern because "Taxpayers can use any rate of interest, including a zero-interest rate, in the contract. If the interest rate used fails to satisfy … Section 482 … then interest may be imputed on the transaction, but only for federal purposes. The interest payable under the contract is not affected." T.D. 7781, 1981-2 C.B. 118, 120.

[8] See Exxon Corp. v. Commissioner, 66 TCM 1707 (1993), affirmed sub nom., Texaco, Inc. v. Commissioner, 98 F.3d 825 (5th Cir. 1996), cert. denied, 520 U.S. 1185 (1997); Procter & Gamble Co. v. Commissioner, 961 F.2d 1255 (6th Cir. 1992), affirming, 95 T.C. 323 (1990).

[9] The Coca-Cola Company v. Comm'r, 155 T.C. No. 10, 2020 U.S. Tax Ct. LEXIS 27 (2020).

[10] See, e.g., Stewart Lipeles, John McDonald, Joseph Myszka, Tackling Blocked Income, Taxes 5 (July 2013).

[11] Treas. Reg. § 1.482-1(h)(2)(ii)(C) and (h)(2)(v), Example 3. Treas. Reg. § 1.482-1(h)(2)(ii)(C) provides that a foreign legal restriction will not be considered unless it prevents "the payment or receipt, in any form, of … the arm's length amount that would otherwise be required under section 482."

[12] See Opening Brief for Respondent, 3M v. Comm'r, pages 73-75 ("3M could have complied both with Brazilian law and with section 482 by electing to treat a portion of the dividends it received from 3M Brazil as the payment of arm's length royalties for U.S. tax purposes"); Answering Brief for Respondent, 3M v. Comm'r, pages 57-58 ("Nor does 3M claim that it would have violated Brazilian law by availing itself of the administrative relief provisions under Rev. Proc. 99-32, 1999-2 C.B. 296 … which would have permitted 3M to treat a portion of the dividends it already received from 3M Brazil as royalties for U.S. tax purposes."); see also Respondent's Simultaneous Opening Brief, Coca-Cola v. Comm'r, page 486 (the Brazil restrictions "would not have prevented the Brazil Supply Point from paying arm's length amounts in the form of distributions as part of a proper election for dividend offset treatment under Rev. Proc. 99-32.").

[13] See note 23, infra, and accompanying text.

[14] Procter & Gamble Co. v. Comm'r, 961 F.2d 1255, 1259 (6th Cir. 1992), affirming, 95 T.C. 323 (1990).

[15] Id.

[16] 95 T.C. at 339.

[17] 961 F.2d at 1259.

[18] 961 F.2d at 1259. The court noted later in the same paragraph that the Spanish affiliate did not have distributable reserves from which to pay dividends even if it tried.

[19] See Exhibit 0242-J, Schedules 1-F, Coca-Cola v. Comm'r, No. 31183-15.

[20] The IRS sought to deny The Coca-Cola Company credit for the dividend payments on the ground that the closing agreement did not apply during the years at issue and the company failed to comply with the requirements set forth in the governing Revenue Procedure (Rev. Proc. 99-32), which provides an alternative basis for this mechanism. The Court ruled for the taxpayer, concluding that the technical defects were not consequential.

[21] Petitioner's Simultaneous Opening Brief Coca-Cola v. Comm'r, ¶ 610, page 184.

[22] Petitioner's Simultaneous Opening Brief Coca-Cola v. Comm'r, ¶¶ 618-619, pages 186-187.

[23] Petitioner's Simultaneous Opening Brief, Coca-Cola v. Comm'r, page 407. The company elaborates: "The IRS has a longstanding practice – reflected in revenue procedures – of permitting taxpayers to initiate adjustments to offset dividends against section 482 allocations." Id. at page 535, citing Rev. Proc. 99-32, 1999-2C.B. 296, sections 4 and 5, and Rev. Proc. 65-17, 1965-1 C.B. 833, sections 4 and 5. Rev. Proc. 99-32, in combination with Treas. Reg. § 1.482-1(a)(3), allows a taxpayer to self-report a transfer pricing adjustment, then to create an account receivable and treat dividends as satisfaction of the account receivable. See also TAM 9736003 (Sept. 5, 1997) (IRS allows taxpayer to treat a dividend as a royalty in blocked income situation).

[24] 3M Company observes that Brazil puts a ceiling on related party royalty payments and adds in a footnote that "3M Brazil could face civil penalties were it to attempt to evade the rate ceilings." Brief for Petitioners, 3M v. Comm'r, page 140, note 26. 3M Company does not elaborate, however, whether it believes that 3M Brazil's payment of a dividend in satisfaction of a royalty would constitute evasion for this purpose.

[25] Brief for Petitioners, 3M v. Comm'r, pages 139-141.

[26] Reply Brief for Petitioners, 3M v. Comm'r, pages 67-68.

[27] Reply Brief for Petitioners, 3M v. Comm'r, pages 66-68.

[28] Brief for Petitioners, 3M v. Comm'r, page 72.

[29] See FSA 200139008 (Sept. 28, 2001), 2001 FSA LEXIS 121 (distinguishing Procter & Gamble).

[30] Answering Brief for Respondent, 3M v. Comm'r, pages 57-58.

[31] Salyersville National Bank v. United States, 613 F.2d 650 (6th Cir. 1980).

[32] 613 F.2d at 652.

[33] As in most transfer pricing cases, the taxpayer would have to show that the IRS abused its discretion in raising the adjustment under the circumstances. The Coca-Cola Company v. Comm'r, 155 T.C. No. 10, 2020 U.S. Tax Ct. LEXIS 27 (2020).