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INTERNATIONAL TAX

CASE SUMMARY

3M vs IRS (USA)

FEBRUARY 2023

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First Edition Published on 16 October 2024

Published by Academy Of Tax Law

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His more than 28 years' experience includes all aspects of income tax planning, Revenue Service administrative proceedings, and tax litigation.

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At the Adademy of Tax Law Dr Erasmus's primary responsibility within the academic panel is to ensure that all courses are developed and delivered professionally and that all faculty members deliver the most up-to-date information to students.

He is also the lead supervisor across all the MSc programmes, sharing his +30-year experience with students.

PART 1

SUMMARY

JUDGEMENT SUMMARY

CASE OVERVIEW

Court: United States Tax Court

Case No: 60 T.C. No. 3, Docket No. 5816-13

Applicant: 3M Company and Subsidiaries

Defendant: Commissioner of Internal Revenue

Judgment Date: 9 February 2023

Full Judgment: https://library.academyoftaxlaw.com/wp-content/uploads/2024/10/US-vs-3M-US-TC-Feb-2023.pdf

View Online: https://academyoftaxlaw.com/3m-transfer-pricing-case-us-tax-court/

JUDGMENT SUMMARY

This case involved the 3M Company and its subsidiaries (collectively referred to as the "3M consolidated group") disputing a section 482 adjustment made by the Commissioner of Internal Revenue. The dispute focused on the income tax treatment of intellectual property (IP) transactions between 3M's U.S. subsidiaries and its Brazilian subsidiary, 3M do Brasil Ltda (3M Brazil), for the tax year 2006.

3M Brazil used intellectual property, including trademarks, patents, and non-patented technology, owned by its U.S. affiliates. During 2006, 3M Brazil paid 3M Company royalties under three trademark licenses executed in 1998, which amounted to 1% of sales for each set of trademarks. However, the Commissioner of Internal Revenue issued a notice of deficiency, increasing the income of 3M Company's U.S. group by $23.65 million, arguing that the royalties under section 482 were insufficient to reflect an arm's-length transaction.

3M argued that Brazilian legal restrictions capped the royalties and payments for the IP use, particularly under Brazil's Law No. 8383/1991, which placed limits on remittances to foreign parent companies. 3M asserted that the adjustment should account for the maximum allowable payments under Brazilian law, claiming that U.S. tax rules must consider foreign legal restrictions when applying section 482.

The Commissioner, however, applied the U.S. Treasury Regulations (26 C.F.R. sec. 1.482-1(h)(2) (2006)), which limit the recognition of foreign legal restrictions only when such restrictions meet specific requirements, such as being publicly promulgated. The court ruled that the Brazilian restrictions did not meet these requirements and rejected 3M's arguments. The court upheld the Commissioner's position, confirming that the income of the 3M consolidated group should be increased to reflect arm's-length compensation for the IP use.

KEY POINTS

OF THE JUDGMENT

BACKGROUND

3M Company is a multinational corporation with U.S. and foreign subsidiaries. It has centralized the ownership of its intellectual property, with trademarks owned by the U.S. parent and other IP (patents and non-patented technology) held by a second-tier U.S. subsidiary. 3M's Brazilian subsidiary, 3M do Brasil Ltda, used these trademarks and IP in its business operations in Brazil.

During the 2006 tax year, 3M Brazil paid royalties for its use of trademarks under three separate licenses executed in 1998, which stipulated royalty payments amounting to 1% of sales per trademarked product. The Brazilian legal framework (particularly Law No. 8383/1991) imposed restrictions on the remittance of royalties abroad to foreign parent companies and capped the maximum amounts payable for such IP usage.

In the notice of deficiency, the Internal Revenue Service (IRS) increased 3M's reported income, citing that 3M Brazil should have paid more in royalties for using the intellectual property under the arm's-length principle of section 482 of the Internal Revenue Code. The IRS did not consider the Brazilian legal restrictions, arguing that such restrictions did not meet the U.S. Treasury Regulations' criteria for recognition.

KEY POINTS
OF THE JUDGMENT

CORE DISPUTE

The central issue in this case was whether the arm's-length compensation required under section 482 of the Internal Revenue Code should take into account the foreign legal restrictions imposed by Brazilian law, which limited 3M Brazil's royalty payments to 3M Company.

3M argued that the Brazilian law, which imposed caps on royalty payments and required official recordation with the Brazilian Patent and Trademark Office (BPTO), should reduce the amount of the section 482 adjustment. Specifically, 3M contended that the IRS's adjustment failed to account for Brazilian restrictions that limited royalty payments to a maximum of 1% for trademarks and other amounts for patents and technology.

The Commissioner countered by applying 26 C.F.R. sec. 1.482-1(h)(2) (2006), which sets stringent conditions for taking foreign legal restrictions into account in transfer pricing adjustments. The Commissioner argued that the Brazilian restrictions did not meet the requirement of being publicly promulgated or generally applicable to all similarly situated taxpayers, controlled and uncontrolled.

KEY POINTS
OF THE JUDGMENT

COURT FINDINGS

The court sided with the IRS, holding that the Brazilian legal restrictions on royalty payments were not recognized for U.S. tax purposes under the applicable Treasury Regulations. The court found that the Brazilian legal restrictions did not meet the requirements set forth in 26 C.F.R. sec. 1.482-1(h)(2) for taking into account foreign legal restrictions when making section 482 adjustments.

The court rejected 3M's claims under the Chevron doctrine, ruling that the regulation was valid and the limitations imposed by Brazil on royalty payments did not meet the requirements for public promulgation or general applicability.

Additionally, the court found that the Brazilian restrictions on royalty payments were not publicly available in written form and were applied in a discretionary manner by the BPTO, making them unsuitable for recognition

KEY POINTS
OF THE JUDGMENT

OUTCOME

The U.S. Tax Court ruled in favour of the Commissioner of Internal Revenue, upholding the section 482 adjustment that increased 3M's reported income by $23.65 million for the tax year 2006. The court rejected 3M's arguments that the adjustment should account for the Brazilian legal restrictions on royalty payments, holding that such restrictions did not meet the requirements of U.S. Treasury Regulations.

As a result, the 3M consolidated group's income was increased to reflect the arm's-length compensation for 3M Brazil's use of the intellectual property, disregarding the foreign legal restrictions. The court's decision affirmed that the U.S. section 482 regulations, which require arm's-length pricing in intercompany transactions, do not need to accommodate foreign legal limits unless strict regulatory conditions are met.

TP METHOD
HIGHLIGHTED (IF ANY)

In this case, the IRS applied the Comparable Uncontrolled Transaction (CUT) method under section 482 to determine the appropriate arm's-length royalty rate for the intellectual property used by 3M Brazil. This method compares the royalties paid by 3M Brazil to those paid by uncontrolled parties for the use of similar intellectual property.

PART 2

SIGNIFICANCE

MAJOR ISSUES

AREAS OF CONTENTION

The major contention in this case revolved around whether the U.S. transfer pricing rules should accommodate foreign legal restrictions, particularly those that limit payments for the use of intellectual property. 3M Company argued that Brazilian laws, which capped the amount of royalties that could be remitted to foreign parent companies, should reduce the arm's-length adjustment under section 482.

Another significant point of dispute was the interpretation of the Treasury Regulations (26 C.F.R. sec. 1.482-1(h)(2)) concerning the recognition of foreign legal restrictions. 3M claimed that these regulations were either invalid or improperly applied, particularly arguing that the IRS should consider Brazilian laws as valid legal constraints when calculating the arm's-length royalty amounts..

EXPECTED
OR CONTROVERSIAL?

The decision was not unexpected, given the U.S. Tax Court's long-standing reliance on the Treasury Regulations under section 482 of the Internal Revenue Code. However, it can be considered controversial from the perspective of multinationals with subsidiaries operating in countries that impose strict legal restrictions on remittances to foreign entities. The case highlights a divergence between the U.S. transfer pricing rules and the practical limitations companies face in certain jurisdictions, such as Brazil.

3M's argument—that the Brazilian legal restrictions should reduce the U.S. section 482 adjustment—presented a novel challenge to the IRS's position. However, the Tax Court's decision to uphold the IRS's interpretation of the Treasury Regulations under section 482 aligns with previous rulings that have strictly applied the arm's-length principle, irrespective of foreign legal limitations. The court's reliance on the Chevron doctrine to validate the regulations further cemented the IRS's authority in applying these rules uniformly across jurisdictions.

While the decision was expected by many U.S. tax practitioners, it remains controversial in international tax circles. It raises concerns about double taxation risks for multinationals that are subject to both foreign legal restrictions and U.S. transfer pricing adjustments, as in 3M's case. This decision underscores the need for multinationals to carefully navigate both domestic and international tax laws to avoid significant tax liabilities in multiple jurisdictions.

SIGNIFICANCE
FOR MULTINATIONALS

This case has significant implications for multinationals operating in countries with legal restrictions on the remittance of royalties and other payments for intellectual property. The Tax Court's decision confirms that, for U.S. tax purposes, foreign legal restrictions on the amount of royalties that can be paid to a U.S. parent company may be disregarded under section 482 unless the restrictions meet the stringent requirements set forth in Treasury Regulations.

For multinational enterprises (MNEs), this means that the U.S. arm's-length standard will apply irrespective of foreign legal constraints, potentially resulting in significant adjustments to income if the foreign subsidiary pays less than an arm's-length amount for intercompany transactions. In jurisdictions like Brazil, where legal caps on payments to foreign entities are common, multinationals must be prepared for the possibility of higher tax liabilities in the U.S. due to transfer pricing adjustments.

This decision underscores the importance of developing robust transfer pricing documentation and considering potential U.S. tax adjustments when structuring intercompany transactions in countries with restrictive legal regimes. Multinationals should also anticipate increased scrutiny from tax authorities and potentially higher compliance costs as they navigate these complex cross-border issues.

SIGNIFICANCE

FOR REVENUE SERVICES

For tax authorities, particularly the IRS, this case reaffirms the principle that foreign legal restrictions do not automatically influence the calculation of arm's-length prices under section 482. The court's ruling reinforces the IRS's ability to make adjustments based on U.S. transfer pricing rules without considering foreign constraints unless those restrictions meet the narrow requirements under the Treasury Regulations.

This decision provides the IRS with a strong precedent to continue applying its transfer pricing rules uniformly, even when multinationals argue that foreign legal restrictions should reduce the arm's-length compensation for intercompany transactions. It also serves as a warning to other revenue services globally that legal restrictions in their jurisdictions may not be recognised by U.S. tax authorities, potentially leading to more aggressive enforcement of section 482.

Revenue services in countries like Brazil may face pressure to align their legal restrictions with internationally accepted norms to reduce the risk of double taxation for multinational enterprises. This decision highlights the importance of international cooperation and harmonisation of transfer pricing rules to avoid conflicts that could lead to significant tax disputes.

SIMILAR CASES

ALTERA CORP. V. COMMISSIONER

This case involved stock-based compensation costs and whether these should be included in the cost-sharing arrangements between related parties. The U.S. Tax Court initially ruled in favour of Altera, holding that the Treasury Regulations under section 482 requiring the inclusion of these costs were invalid. However, the Ninth Circuit Court of Appeals reversed the decision, upholding the IRS's interpretation of section 482.

Relevance: Like the 3M case, Altera challenged the validity of Treasury Regulations under section 482, arguing that they did not reflect economic reality. Both cases demonstrate the IRS's consistent position in enforcing section 482 and its regulations, regardless of taxpayer arguments that challenge the fairness or applicability of the rules.

XILINX INC. V. COMMISSIONER

Xilinx disputed the IRS's inclusion of stock-based compensation costs in its cost-sharing agreements with its Irish subsidiary. The case hinged on the interpretation of section 482 and the arm's-length standard. Initially, the U.S. Tax Court ruled in favour of Xilinx, but the Ninth Circuit later reversed the decision before the case was ultimately settled.

Relevance: The Xilinx case is relevant because it similarly dealt with section 482 and the application of the arm's-length principle to cross-border transactions between related parties. Like 3M, it underscores the complexities multinationals face when dealing with transfer pricing rules and their potential conflicts with local laws or practices.

https://academyoftaxlaw.com/xilinx-v-commissioner-landmark-decision-transfer-pricing-esos/

PROCTER & GAMBLE CO. V. COMMISSIONER

In this case, Procter & Gamble (P&G) disputed the IRS's section 482 adjustment concerning intercompany pricing for imported products. The court ruled that the prices paid by P&G's subsidiaries to foreign affiliates were not at arm's length, resulting in a significant income adjustment.

Relevance: The Procter & Gamble case is relevant because it involved the application of section 482 to determine whether intercompany pricing was consistent with the arm's-length standard. Like 3M, it demonstrates the importance of adhering to the arm's-length principle in cross-border transactions and the potential for substantial tax liabilities when companies fail to do so.

PART 3

PREVENTION

ENGAGING EXPERTS

Engaging transfer pricing experts is essential for multinationals dealing with complex cross-border transactions. Experts can help navigate the intricate and often conflicting requirements of different tax jurisdictions, ensuring that intercompany pricing aligns with both local laws and international standards. In cases like 3M's, where foreign legal restrictions limit the amount of royalties or other payments that can be made to a U.S. parent, experts can provide valuable advice on how to structure transactions in a way that minimises tax risks while complying with section 482 of the U.S. tax code.

Transfer pricing experts also play a crucial role in preparing robust documentation to defend against potential tax audits and disputes. In the 3M case, having comprehensive transfer pricing reports that consider both U.S. and foreign legal requirements might have helped mitigate the size of the IRS adjustment. Experts can also provide guidance on the appropriate transfer pricing method to use, as well as benchmarking studies to support the arm's-length nature of transactions.

PREVENTATIVE

MEASURES TO AVOID SIMILAR CASES

TAX RISK MANAGEMENT PROCESS

Implementing a comprehensive tax risk management process is essential to identify, assess, and mitigate tax risks associated with cross-border transactions. This process should involve:

- Regular reviews of intra-group transactions to ensure they have genuine economic substance.
- Proactive engagement with tax authorities to seek clarity on the application of anti-abuse rules.
- Thorough documentation of the business rationale for each transaction to support

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TAX INTELLIGENCE: THE 7 HABITUAL TAX MISTAKES MADE BY COMPANIES

Tax Intelligence: The 7 Habitual Tax Mistakes Made by Companies" by Dr. Daniel N. Erasmus is a must-read for businesses seeking to navigate the intricate world of tax compliance and risk management. By highlighting common pitfalls and offering strategic solutions, Erasmus equips companies with the knowledge to improve their tax practices and secure financial stability.

https://support.academyoftaxlaw.com/product/tax-intelligence-by-prof-dr-daniel-n-erasmus/

PREVENTATIVE

MEASURES TO AVOID SIMILAR CASES

TAX STEERING COMMITTEE

Establishing a tax steering committee can help ensure that tax policies are aligned with the broader business strategy and that transactions are vetted for both commercial and tax implications. A tax steering committee can:

- Review all significant cross-border transactions before they are executed.
- Ensure that tax decisions are made in the context of overall business objectives, not solely for tax savings.
- Monitor changes in international tax laws to ensure ongoing compliance and avoid disputes like the X BV case.

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DRIVING TAX COMPLIANCE: THE ESSENTIAL ROLE OF THE TAX STEERING COMMITTEE

The eBook "Driving Tax Compliance: The Essential Role of a Tax Steering Committee" by Prof. Dr. Daniel N. Erasmus, Renier van Rensburg, and Gilbert Ferreira, emphasizes the critical importance of establishing a Tax Steering Committee (TSC) within multinational corporations to ensure tax compliance and manage tax-related risks effectively.

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