

Harsh Tax Consequences for Foreign Businesses that Fail to File Timely U.S. Tax Returns

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Summary

In *Swallows Holding, Ltd. v. Comm'r* (2008 U.S. App. LEXIS 3442 (3d Cir. 2008)), decided on February 15, 2008 (“*Swallows Holding*”), the U.S. Court of Appeals for the Third Circuit reversed the Tax Court and upheld the requirement of the regulations under Code Section 882 that a foreign corporation file a tax return within a prescribed deadline in order to be entitled to deductions and credits related to its U.S. business income (the “timely filing requirement”). The Tax Court, in *Swallows Holding, Ltd. v. Comm'r* (126 T.C. 96 (2006)), had invalidated the timely filing requirement under the six-factor standard governing the judicial review of interpretative Federal tax regulations set forth in *Natl. Muffler Dealers Association v. United States* (440 U.S. 472 (1979)) (“*National Muffler*”). The Court of Appeals reversed, holding that the timely filing requirement was a reasonable exercise of the Treasury’s authority and that the Tax Court had erred in analyzing the reasonableness of the requirement under *National Muffler* rather than under the standard of *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.* (467 U.S. 837 (1984)) (“*Chevron*”), which is generally more deferential to agency action.

Implications

In the case of both foreign corporations and nonresident alien individuals, regulations issued in 1990 condition the allowance of deductions and credits with respect to U.S. business income on the filing of a tax return within a prescribed time period. The issue in *Swallows Holdings* was whether the validity of the timely filing requirement in the regulations should be evaluated under the generally more deferential *Chevron* standard or under the *National Muffler* standard, which evaluates agency action on the basis of several more criteria and allows the judiciary greater scope for review of agency action. The Court of Appeals found that the regulation should be analyzed under *Chevron*, not *National Muffler*, and that it was valid under *Chevron*. Although *Swallows Holdings* involved a foreign corporation, the Court’s reasoning would extend to the timely filing requirement imposed on nonresident alien individuals. In light of the Court of Appeals decision, non-U.S. persons may wish to consider whether it is advisable for them to file U.S. returns if, arguably, they are engaged in a U.S. trade or business.

Background

The Disputed Regulations

Under Code Section 882(c), a foreign corporation engaged in a U.S. trade or business may claim deductions and credits in determining its tax liability only if the deductions and credits are related to its U.S. business income and the foreign corporation files a true and accurate tax return “in the manner prescribed” in the Code, including all the information necessary to calculate such deductions and credits. The same rule applies to nonresident alien individuals under Code Section 874.

In 1990, the regulations under Code Sections 882(c) and 874 were amended to provide, for the first time, that a foreign corporation or nonresident alien individual must file a U.S. Federal income tax return on a timely basis, generally within eighteen months of the due date for such return, in order for otherwise allowable credits and deductions to be allowed. The preamble to the proposed regulations noted that “[s]ince the filing of a timely return is one of the requirements set forth in subtitle F, these regulations provide that otherwise allowable deductions and credits will be allowed only if a return is filed by the time limits as set forth in these regulations.”¹ While commentators on the proposed regulations questioned the requirement, it was not eliminated in the final regulations “since,” according to the Treasury and IRS, “the statute clearly provides for the denial of deductions and credits if returns are not filed in a timely manner. This requirement is justified because of different administrative and compliance concerns with regard to nonresident alien individuals and foreign corporations.”² Cases decided prior to the regulations had not as such imposed a timely filing requirement.

The Tax Court Decision

In *Swallows Holding*, the taxpayer was a Barbados corporation that owned real property in California. It earned rental income from the property, but its expenses exceeded its income each year. The taxpayer timely filed a corporate tax return for 1992 but filed no additional returns until 1999, when it filed returns for tax years from 1993 through 1996. On these returns, the taxpayer claimed taxable losses, attributable to real property and franchise taxes as well as license fees, effectively connected with a U.S. trade or business. The IRS disallowed all of the taxpayer’s claimed deductions for these years on the ground that the taxpayer had not satisfied the timely filing requirement set forth in the regulations.

The taxpayer challenged the IRS’s disallowance, contending that the creation of the timely filing requirement was an invalid exercise of the Treasury’s rulemaking authority. The Tax Court held for the taxpayer on the basis that the underlying statutory provision, Code Section 882(c)(2), required only that the taxpayer file a return “in the manner prescribed in subtitle F” and did not include a timely filing requirement. Analyzing the regulation under the multiple factors set forth in *National Muffler*, the Tax Court held that the timely filing requirement in the regulations under Code Section 882(c)(2) was unreasonable under a plain

¹ Sec. 1.882-4, Proposed Income Tax Regs., 54 Fed. Reg. 31547 (July 31, 1989).

² T.D. 8322, 55 Fed. Reg. 50827 (December 11, 1990).

reading of the statute and an application of *National Muffler* and that the requirement was invalid.

The Court of Appeals Decision

The key issues decided by the Court of Appeals in *Swallows Holding* were (1) whether the Tax Court erred in applying the *National Muffler* standard rather than the *Chevron* standard in determining the validity of the timely filing requirement and (2) if the *Chevron* standard applied, whether the timely filing requirement was valid under a *Chevron* analysis.

The Correct Standard

The Court of Appeals first determined whether the *Chevron* standard governed in the instant case. Relying on judicial precedent, the Court of Appeals concluded that *Chevron* deference is the appropriate standard where Congress intends a particular agency action to wield the force of law. Although the taxpayer contended that interpretative regulations (such as the regulation involved in this case) do not merit *Chevron* deference, insofar as interpretative regulations do not speak with the force of law, the Court of Appeals disagreed and concluded that interpretative regulations may in certain cases carry the force of law. According to the court, the fact that the regulation was open to public comment before its final issuance indicated that the regulation was issued with the force of law.³ Accordingly, the court held that the regulation was entitled to *Chevron* deference if it passed the *Chevron* two-prong analysis.

Analysis with Chevron

(i) Ambiguity of the Statute

The first prong of the *Chevron* analysis is to determine whether or not the meaning of the relevant statutory language is ambiguous. As framed by the Court of Appeals, “Under *Chevron*, if the statutory language is clear and unambiguous, our inquiry ends and the plain meaning of the statute governs the action...If, however, the statutory provision is ambiguous, such ambiguity is viewed as an implicit congressional delegation of authority to an agency, allowing the agency to fill the gap with a reasonable regulation.”⁴

The language of Code Section 882(c)(2) provides that “a foreign corporation shall receive the benefit of the deductions and credits allowed to it in this subtitle only by filing or causing to be filed with the Secretary a *true and accurate return, in the manner prescribed in subtitle F* (emphasis added).” According to the Court of Appeals, the fact that prior court decisions had struggled over whether the word “manner” in analogous statutory provisions included a timing element suggested that the statutory language in Code Section 882 is ambiguous on its face. The Court of Appeals further observed that the term “manner” unaccompanied by “time” had been employed in other sections of the Code, and that in some of these instances, valid regulations had been issued that included temporal components, implicitly

³ *Swallows Holding* at 16, citing *United States v. Mead Corp.*, 533 U.S. 218, 229-30 (2001).

⁴ *Swallows Holding* at 20.

interpreting the statutory term “manner” to include a timing element.⁵ The Court of Appeals further looked to the dictionary definition of the word “manner” and the contextual use of “manner” with reference to subtitle F, which itself includes timing elements, to conclude that Congress’s use of the word “manner” in Code Section 882(c)(2) created ambiguity. Accordingly, the Court of Appeals held that because Congress had not spoken to the precise question at issue and because the statute was ambiguous, the Treasury was justified in promulgating a regulation that prescribed a filing deadline.

(ii) *Reasonableness of the Regulation*

The second prong of the *Chevron* test evaluates whether the agency action in question is a permissible construction of the statute. The Court of Appeals explained that, in determining whether the regulation was reasonable, “[w]e “need not conclude that the agency construction was the only one it permissibly could have adopted to uphold the construction.”⁶ The Court of Appeals emphasized that deference is all the more warranted in cases involving a “complex and highly technical regulatory program,” such as the Code.⁷

The Court of Appeals observed that a rule that creates an eighteen-month window within which foreign corporations must file a federal tax return in order to claim deductions and credits did not appear to be unreasonable. Moreover, the Court of Appeals proclaimed that, from an institutional perspective, “drawing this temporal line is a task properly within the powers and experience of the IRS. *Chevron* recognizes the notion that the IRS is in a superior position to make judgments concerning the administration of the ambiguities in its enabling statute.”⁸

Accordingly, the Court of Appeals vacated the judgment of the Tax Court and remanded the case for further proceedings in accordance with its opinion.

⁵ *Id.* at 21, citing Code Sections 179(c), 835(c)(2); Treas. Regs. Sections 1.179-5, 1.826-1(a)(3)(i).

⁶ *Id.* at 23, quoting *Chevron* at 843 n.11, 845.

⁷ *Id.* at 23, quoting *Robert Wood Johnson Univ. Hosp. v. Thompson*, 297 F.3d 273 (3d Cir. 2002) at 282 (quoting *Thomas Jefferson Univ. v. Shalala*, 512 U.S. 504, 512 (1994)).

⁸ *Id.* at 24.