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Liberty Global Reflects a Continuing Decline of Regulatory Weight

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Courts are trending toward setting regulations aside and making determinations based on statutory interpretation alone.

In times past, when a taxpayer took a position based on relatively clearly articulated rules in regulations, the taxpayer generally could feel pretty comfortable that its position would not be challenged or rejected by a court. Those days may be over as more and more courts have set regulations aside and made determinations based on statutory interpretation alone. In the recent past, the Department of the Treasury's reaction to the ever diminishing influence of regulations and courts' growing hostility to regulatory overreach was to double-down, proposing and promulgating regulations that go far beyond implementing statutes' commands (*see, e.g.*, proposed and final disregarded payment loss rules, the 2024 proposed Previously Taxed Earnings and Profits rules, 2025 proposed corporate reorganization regulations, etc.). Treasury is now pulling back from its administrative adventurism, and a growing body of case law, both for and against taxpayers, supports a continuation of that trend.

This article analyzes the US Court of Appeals for the Tenth Circuit's recent decision in *Liberty Global, Inc. v. Commissioner* as well as other cases and how Treasury regulations have had a diminishing influence over judicial outcomes. *Liberty Global* concerns a U.S. company's sale of the stock of a Japanese controlled foreign corporation (CFC) and the amount of resulting gain that is treated as foreign source income (FSI) under §904(f)(3)(A) and its implementing regulations. This article first presents background information about the regulations at issue in

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the case. Then, Liberty Global's arguments and the court's decision in the context of other recent case law are analyzed.

Foreign Tax Credit Limitation and §904(f)(3)

The foreign tax credit (FTC) limitation ("FTC Limitation") is loosely designed to prevent taxpayers from using FTCs to reduce their US tax liability from US source income. An often applied shorthand for the computation of the FTC Limitation is:

Foreign Source Income x Tax Rate = FTC Limitation.

This means, for example, that if a taxpayer's FTC Limitation is $10 for a given taxable year, the taxpayer is only permitted to credit $10 of its FTCs for that taxable year. Thus, it is generally better for taxpayers to have more FSI because more FSI means more access to FTCs. Determinations with respect to the FTC Limitation become more complicated when taking into account that the limitation must be computed separately for different categories of income (generally, net CFC tested income (NCTI), passive income, foreign branch income, and everything else (general)). Fortunately, understanding the issues in *Liberty Global* does not require that we go into that detail.

We cannot completely avoid all complexity, however, as *Liberty Global* concerns the rules under §904(f), which apply to take into account years in which a taxpayer has a loss with respect to a limitation category (an overall foreign loss (OFL), or a separate limitation loss with respect to one or more individual separate limitation categories, like NCTI or foreign branch). A taxpayer has an OFL when deductions allocated and apportioned to FSI for a taxable year exceed gross FSI. When a taxpayer has an OFL for a taxable year, the taxpayer is not entitled to any foreign tax credits for the year of the loss, and, in subsequent years, net FSI of the taxpayer is recaptured as domestic source income until the OFL is offset.

The recapture rule contains a famous trap for the unwary, §904(f)(3), which applies when a taxpayer with an OFL (or separate limitation loss (SLL)) disposes of property used predominantly outside of the US or of stock of a CFC (when the taxpayer owns 50% or more of the CFC, by vote or value) (a "Relevant CFC")). Section 904(f)(3) provides:

"[T]he taxpayer, notwithstanding any other provision of this chapter…shall be deemed to have received and recognized taxable income from sources without the United States in the taxable year of the disposition, by reason of such disposition, in an amount equal to the lesser of the

excess of the fair market value of such property over the taxpayer's adjusted basis in such property or the remaining amount of the overall foreign losses which were not used under paragraph (1) for such taxable year or any prior taxable year."

Section 904(f)(3) is a trap for the unwary because it triggers gain recognition in transactions that are otherwise tax-free. For example, under the provision above, if a taxpayer transfers the stock of a Relevant CFC in a non-recognition transaction and the taxpayer has an OFL (or SLL), the taxpayer is required to recognize gain up to the amount of the OFL (or SLL). That gain is treated as FSI, and the FSI is recaptured as domestic source income.

Aside from triggering gain in a non-recognition transaction, §904(f)(3) also serves as an exception from the standard rules for sourcing income and gain. For example, under §865(a), if a US person sells stock of a corporation, gain on the sale is generally sourced in accordance with the residence of the seller and is thus domestic source income. That sourcing outcome generally applies when a US person sells CFC stock, unless the foreign affiliate exception in §865(f) applies. Section 904(f)(3) upends that treatment and treats all or some of the gain realized on the disposition of a Relevant CFC as FSI. The question in *Liberty Global* was to what extent does §904(f)(3) treat gain on the sale of a Relevant CFC as FSI.

Liberty Global's Position

Turning to the specifics of the case, Liberty Global, a US corporation owned more than 50% (by vote) of Jupiter Telecommunications Co. Ltd. ("J:COM"), a Japanese CFC. Liberty Global sold its shares of J:COM in a taxable sale to an unrelated buyer for $3,961,608,988 and recognized $2,818,421,964 of capital gain. In the year of the sale, Liberty Global had an OFL of $474,372,166. Liberty Global took the position that under §904(f)(3), the entire $2,818,421,964 of capital gain was FSI. The Service countered that only $474,372,166 of the gain, the amount Liberty Global's OFL, was treated as FSI under §904(f)(3) and the remaining gain was domestic source, under §865(a).

Although §904(f)(3) only expressly provides FSI treatment for "an amount equal to the lesser of" the taxpayer's gain and its OFL, Liberty Global asserted that the limiting language in the statute only applies to non-recognition transactions, limiting the amount of gain the taxpayer is required to recognize, not the amount of gain that is treated as FSI. For a gain recognition transaction, Liberty Global asserted that all of the gain is FSI.

According to the Tenth Circuit, Liberty Global's key support in favor of its position was the regulation in effect at the time of the transaction (the "Pre-2012 Regulation") which stated:

"If a taxpayer disposes of property used or held for use predominantly without the United States in a trade or business [including a Relevant CFC] during a taxable year and that property generates foreign source taxable income subject to a separate limitation to which paragraph (a) of this section is applicable, (i) gain will be recognized on the disposition of such property, (ii) such gain will be treated as foreign source income subject to the same limitation as the income the property generated, and (iii) the applicable overall foreign loss account shall be recaptured as provided in paragraphs (d)(2), (d)(3), and (d)(4) of this section."

Subsequent regulations then went on to modify the above rule in the case of nonrecognition transactions to limit the gain recognized to the amount of the taxpayer's OFL.

Liberty Global argued that the Pre-2012 Regulation plainly provides that when a taxpayer has an OFL, gain on the sale of a Relevant CFC gives rise to FSI, period. Liberty Global had gain from the sale of a Relevant CFC and it had an OFL, thus, under the Pre-2012 Regulation, the gain was FSI. In 2012, in T.D. 9595, Treasury revised the §904(f) regulations to "clarify" that in a gain recognition transaction, the amount of gain recharacterized as FSI is limited to the amount of the taxpayers OFL (or SLL).

Tenth Circuit's Decision

In *Liberty Global*, the Tenth Circuit responded to and rejected the taxpayer's argument. The court found that §904(f)(3) was unambiguous and only provided for FSI treatment for gain up to the amount of the taxpayer's OFL. The Tenth Circuit further elaborated as follows:

"Given this, "the agency's regulations can only implement the statute's commands, not vary from them." *Whirlpool Fin. Corp. v. Comm'r of Internal Revenue*, 19 F.4th 944, 952-53 (6th Cir. 2021). Liberty Global's interpretation of the regulations would broaden § 904(f) well beyond the statutory language and create a conflict with §865."

The Tenth Circuit apparently agreed that Liberty Global's reading of the statute was the more natural reading, but upheld the Service's interpretation of the statute only because Liberty Global's interpretation of the regulation would yield a rule that Treasury was not authorized to impose. That is, the statute only calls for FSI treatment up to the amount of the taxpayer's

OFL/SLL and Treasury would not be authorized to implement a regulation calling for FSI treatment beyond the amount of the taxpayer's OFL/SLL.

The Tenth Circuit appears to adopt the rule articulated by the US Court of Appeals for the Sixth Circuit in *Whirlpool Financial Corporation v. Commissioner*, that regulations are limited to implementing statutory command. *Whirlpool* dealt with the application of the branch income rule under §954(d)(2). Section 954(d) generally treats income from certain CFC sales as foreign base company sales income (FBCSI), a type of subpart F income. Very generally, a key condition for a CFC sale to gives rise to FBCSI is that the property sold must be purchased from or sold to a related person. Related to that condition, the branch income rule applies to prevent taxpayers from using a branch or disregarded entity (DRE) to avoid having a related person purchase or sale. The branch income rule applies when the use of the branch or DRE "has substantially the same effect as if such branch or similar establishment were a wholly owned subsidiary corporation." A famously complex set of regulations apply to determine when that condition is satisfied, applying a rate disparity test (RDT). Additionally, under the regulations, when the condition for the branch income test is satisfied, the result is that sales between the CFC and the branch are treated as related party sales for the purpose of the FBCSI test. The sales do no automatically cause the CFC branch owner's sales (directly or thought the branch) to be treated as FBCSI.

The Sixth Circuit ignored these regulations, determining that the statutory branch income rule was unambiguous (despite its express direction that it be applied under regulations prescribed by the Secretary and despite a number of other issues) and, contrary to the regulations, the condition to trigger the rule is not dependent on the RDT. Instead, the branch income rule applies when use of the branch results in deferral of US federal income tax, and, also contrary to the regulations, once the branch income rule applies, the relevant income is automatically FBCSI. It is still hard to believe that any court would support the outcome of the Sixth Circuit in *Whirlpool* as it relates to the interpretation and application of §954(d)(2), but the notion articulated in *Whirlpool*, that regulations cannot implement rules that go beyond the rules articulated by statute, has clearly caught on.

Another case that these considerations bring to mind is the US Court of Appeals for the First Circuit's decision in *TBL Licensing LLC v. Commissioner*, which dealt with the "disposition rule" under §367(d). Very generally, under §367(d), when a US person transfers intangible property to a foreign corporation in a non-recognition transaction, the US transferor is treated as receiving annual royalty-like payments with respect to the transferred intangible and, under the

disposition rule, the US transferor is required to recognize gain on the outbound transfer when there is a subsequent direct or indirect disposition of the intangible. *TBL Licensing* involved an outbound F reorganization of a corporation that owned intangible property. The taxpayer asserted that the outbound F reorganization did not trigger the disposition rule, and the Service asserted that the disposition rule was triggered. An extensive set of temporary regulations dealt with different transactions and which of those transactions are, and which are not, dispositions for the purpose of triggering the disposition rule. Both the taxpayer and the Service agreed that the treatment of an outbound F reorganization was not addressed in the regulations. However, the taxpayer pointed out that in every situation addressed in the regulations that involved a transfer to a related person, the transfer was not treated as a "disposition"—implying that the statutory reference to a disposition, in Treasury's view, encompassed only a disposition to an unrelated person.

The First Circuit did not find this argument compelling, concluding that the word "disposition," in the statue was to be applied based in its plain meaning (i.e., any transfer) absent express guidance to the contrary. In other words, even though the regulations showed a clear pattern of treating related party dispositions as non-dispositions, in a situation not expressly addressed by the regulations, the pattern was of no consequence, and the applicable rule defaults to the plain meaning in the statute. The commonality between *TBL Licensing*, on one hand, and *Liberty Global* and *Whirlpool*, on the other, is the courts' asserting the primacy of statutory interpretation and the ease with which courts set aside regulations or principles that may be derived from regulations.

Takeaways

There is nothing particularly novel about the *Liberty Global* case itself and the rules that it interprets. The interesting element of the case is*Liberty Global*'s place in the recent trend of courts setting aside, or otherwise diminishing the importance of, Treasury regulations and asserting the primacy of statutory interpretation. *Loper Bright* (a non-tax case) and the demise of the *Chevron* Doctrine of course, is the most significant milestone in this trend, as reflected in the US Court of Appeals for the Eight Circuit's recent decision in *3M v. Commissioner*.

In *Loper Bright* and *3M*, the courts determined the extent of executive authority to impose regulations and the degree of executive control over statutory interpretation. Other recent high-profile tax cases, like *FedEx Corporation v. United States* and *Varian Medical Systems v. Commissioner*, follow this theme, with courts reigning in regulatory overreach. The court's

decision in *Liberty Global*, like the Sixth Circuit's decision in *Whirlpool* and the First Circuit's decision in *TBL Licensing LLC v. Commissioner*, indicate that the trend asserting primacy of statutory interpretation and the diminishing influence of regulations is a two-way street, however. Taxpayers are simply not as safe as they once might have been relying on the weight of regulations.

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