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Chief Counsel Advice 202235009 and AM 2022-003: IRS Guidance Out of Step With the Times — and Its Own Precedent

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Managing the tax function at a U.S. multinational is no easy task these days. Among other things, it is unclear if, when, or in what form we will see the OECD's Pillars One and Two implemented. Unilateral tax measures continue to proliferate. The final foreign tax credit regulations are a headache. Guidance on the treatment of previously taxed earnings and profits (''PTEP'') continues to be deferred. New U.S. tax legislation raises lots of questions, with few answers in sight. And the revenue hole that the Covid-19 pandemic created and that continues to expand promises increased audit activity around the globe.

In this environment, just getting the law right and avoiding double taxation (or worse) is a victory — tax optimization strategies such as stateless income and deferral seem like hallmarks of a bygone era. Unfortunately, two recently released pieces of internal IRS guidance suggest that the IRS doesn't see it that way. In Chief Counsel Advice 202235009 (the ''CCA''),[1] the IRS concludes that a taxpayer's good faith challenge to Reg. §1.78-1(c) constitutes a negligent or intentional disregard of the regulation that allows the IRS to accelerate a §965 deficiency.[2] In AM 2022-003 (the ''AM''),[3] the IRS concludes that it is not possible to make a bona fide advance payment of §367(d) amounts.

Setting aside the fact that these conclusions are arguably incorrect, it is troubling that the IRS took the stance it did. Openly questioning the validity of a Treasury regulation and accelerating the movement of taxable income are not aggressive tax planning. A validity challenge reflects a taxpayer's reasoned determination that the law does not allow the taxpayer to do what Treasury requires, and disclosing that determination to the IRS puts Treasury on notice that it may be necessary for an independent branch of our government — i.e., the judiciary — to decide whether Treasury or the taxpayer is correct, while also providing the IRS with the opportunity to examine the reasons for the validity challenge and resolve the issue administratively where possible and permissible. Accelerating income reflects a desire to move cash to where it is needed, and to control the timing of income recognition, typically for reasons other than reducing tax.

I discuss the CCA and the AM below.

THE CCA

As readers will recall, §965 was supposed to be the toll charge for entering into the participation exemp-

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[1] (Aug. 9, 2022).

[2] All section or §references are to the Internal Revenue Code, as amended, or the Treasury regulations thereunder, unless otherwise indicated.

[3] (Sept. 9, 2022).

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tion regime that the 2017 Tax Cuts and Jobs Act (''TCJA'')[4] introduced. Generally speaking, §965 caused ''United States shareholders'' of ''controlled foreign corporations'' or ''CFCs'' to include in income their ratable share of earnings and profits (''E&P'') that had not been subject to U.S. tax under the rules that were in place before the TCJA.[5] §965 achieved this inclusion by increasing CFCs' subpart F income in their last taxable year beginning before January 1, 2018. For a calendar year taxpayer, that meant that the §965 inclusion would generally arise on December 31, 2017. For a fiscal year taxpayer, the §965 inclusion would generally arise on the last day of a taxable year ending on a date other than December 31, 2017 — e.g., March 31, 2018.

When the CFCs' United States shareholders included amounts in income under subpart F, they were also deemed to pay foreign taxes that were associated with the CFCs' E&P. Specifically, §960(a) provided that the deemed paid credit in §902 would apply to these United States shareholders ''as if the amount so included were a dividend paid by such foreign corporation.'' Taxes that the United States shareholders were deemed to pay were treated as dividends from the CFCs under §78.

The TCJA's participation exemption came in the form of §245A, which generally allows United States shareholders of CFCs a 100% dividends received deduction with respect to dividends stemming from the CFCs' foreign earnings.

Congress made §245A effective for *distributions* after December 31, 2017. Congress amended §78 and §960 to align with the new international tax regime that the TCJA introduced (e.g., GILTI) for *taxable years beginning* after December 31, 2017.

Prior to the TCJA, §78 read as follows:

> If a domestic corporation chooses to have the benefits of subpart A of part III of subchapter N (relating to foreign tax credit) for any taxable year, an amount equal to the taxes deemed to be paid by such corporation under section 902(a) (relating to credit for corporate stockholder in foreign corporation) or under section 960(a)(1) (relating to taxes paid by foreign corporation) for such taxable year shall be treated for purposes of this title (*other than section 245*) as a dividend received by such domestic corporation from the foreign corporation. (emphasis added)

The TCJA amended §78 to read as follows:

> If a domestic corporation chooses to have the benefits of subpart A of part III of subchapter N (relating to foreign tax credit) for any taxable year, an amount equal to the taxes deemed to be paid by such corporation under subsections (a), (b), and (d) of section 960 (determined without regard to the phrase '80 percent of' in subsection (d)(1) thereof) for such taxable year shall be treated for purposes of this title (*other than sections 245 and 245A*) as a dividend received by such domestic corporation from the foreign corporation. (emphasis added)

Accordingly, the version of §78 that applied to fiscal year taxpayers who were determining their liability under §965 stated that the deemed paid credit was a dividend for purposes of provisions ''other than section 245.'' That meant that the deemed paid credit was a dividend for purposes of §245A. Therefore, a taxpayer with a year ending, e.g., March 31, 2018, could have concluded that it was required to treat its deemed paid credit as a dividend that was eligible for the 100% dividends received deduction under §245A. A calendar year taxpayer did not have that option, as §245A applied only to distributions made or deemed made after December 31, 2017.

Congress was aware of these effective dates, but it did not change the law. Treasury and the IRS responded by first proposing and then finalizing Reg. §1.78-1. Reg. §1.78-1 generally reproduces §78 as amended by the TCJA and provides that the §78 gross-up is not treated as a dividend for purposes of both §245 and §245A. To address the statutory effective date, Reg. §1.78-1 includes a retrospective effective date rule, which states that this rule ''also applies to section 78 dividends that are received after December 31, 2017, by reason of taxes deemed paid under section 960(a) with respect to a taxable year of a foreign corporation beginning before January 1, 2018.'' Treasury and the IRS therefore used Reg. §1.78-1 to change the effective date of the TCJA's amendment to §78, and they were open about doing so:

> Comments questioned whether the Treasury Department and the IRS have authority to treat section 78 dividends relating to taxable years of foreign corporations beginning before January 1, 2018, as ineligible for the dividends-received deduction under section 245A, which generally applies to certain dividends paid after December 31, 2017. Although some comments acknowledged that allowing a dividends-received deduction for section 78 dividends would provide taxpayers with a double benefit that clearly was not intended by Congress, the comments claimed that the statutory language directly provides for the dividends-received deduction, and therefore the rule applying proposed §1.78-1(c) to taxable years beginning before January 1, 2018, should be eliminated.

[4] Pub. L. No. 115-97 (Dec. 22, 2017), §14103(a).

[5] *See, e.g.*, §965(a), §965(d), §965(e).

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> The Treasury Department and the IRS have determined that §7805(a), §7805(b)(2), and §245A(g) provide ample authority for the rule and therefore finalize the proposed applicability date without change. Section 7805(a) provides that the Treasury Department and the IRS shall prescribe all needful rules and regulations for the enforcement of title 26, including all rules and regulations as may be necessary by reason of any alteration of law in relation to internal revenue. The enactment of the Act and the addition of section 245A necessitated regulations to ensure that section 78 continues to serve its intended purpose. The purpose of the section 78 dividend is to ensure that a U.S. shareholder cannot effectively both deduct and credit the foreign taxes paid by a foreign subsidiary that are deemed paid by the U.S. shareholder. See Elizabeth A. Owens & Gerald T. Ball, The Indirect Credit §2.2B1a n.54 (1975); Stanley Surrey, "Current Issues in the Taxation of Corporate Foreign Investment," 56 Columbia Law Rev. 815, 828 (June 1956) (describing the "mathematical quirk" that necessitated enactment of section 78). Allowing a dividends-received deduction for a section 78 dividend would undermine the purpose of the section 78 dividend because taxpayers would effectively be allowed both a credit and deduction for the same foreign tax. For this reason, section 78 (as revised by the Act) provides that a section 78 dividend is not eligible for a dividends-received deduction under section 245A.[6]

A court has yet to settle whether Treasury exceeded its rulemaking authority in promulgating Reg. §1.78-1(c). The Reg. §1.78-1 preamble sets forth the Treasury/IRS position. And a snippet from a recent taxpayer refund suit summarizes the contrary view nicely: "the Section 78 'special applicability date' contradicts the unambiguous effective date Congress included in the statute."[7] Regardless of the ultimate outcome, it is entirely reasonable for taxpayers to question the regulation's validity. The IRS, however, appears to disagree.

The CCA addresses a domestic corporation that elected to pay its §965 liability in installments on its Form 1120 and did not follow Reg. §1.78-1. By way of background, §965(h)(1) allows a taxpayer to pay its §965 liability in eight installments. §965(h)(4) generally extends installment treatment to any §965 deficiencies, and generally prorates deficiencies among the installments, including installments whose due date has yet to arrive. There is an exception to this general rule "if the deficiency is due to negligence, to intentional disregard of rules and regulations, or to fraud with intent to evade tax." In this case, the IRS may demand immediate payment of the deficiency.[8]

The CCA considers whether the failure to follow Reg. §1.78-1 constitutes "negligence" or an "intentional disregard of rules and regulations" that allows the IRS to accelerate any §965 deficiency attributable to the §78 gross-up. The CCA advises that the deficiency would be attributable to negligence or intentional disregard of Reg. §1.78-1 and therefore would be ineligible for proration. The CCA adds that the same conclusion would apply "[r]egardless of whether the domestic corporation filed a Form 8275-R or other disclosure of its position. . .because section 965(h)(4) and Treas. Reg. section 1.965-7(b)(1)(ii)(C) do not provide an exception in cases of disclosure of a disregarded rule."

The conclusion is both surprising and troubling. Taxpayers file Form 8275-R precisely because they are not disregarding regulations and want to avoid accuracy-related penalties in connection with good faith challenges to the regulations. Section 6662 imposes a 20% accuracy-related penalty where an underpayment is attributable to negligence or a disregard of regulations.[9] Reg. §1.6662-3 provides an exception to this penalty for good-faith challenges to regulations, where the taxpayer discloses its position on a Form 8275-R.[10] Nothing in §6662 indicates that Congress intended to except certain instances of negligence of or disregard for regulations or to give Treasury the authority to do so. While the Treasury Decision that initially promulgated the Reg. §1.6662-3 exception noted above in 1991 read, in relevant part, "No penalty under section 6662(b)(1) may be imposed on any portion of an underpayment that is attributable to negligence or a position contrary to a rule or regulation if the position is disclosed in accordance with the rules of paragraph (c)(2) of this section and, in the case of a position contrary to a regulation, the position represents a good faith challenge to the validity of the regulation,"[11] Treasury amended the regulation in 1995 to read, in relevant part, "No penalty under section 6662(b)(1) may be imposed on any portion of an

[6] T.D. 9866 (2019).

[7] *Kyocera AVX Components Corp. v. United States*, 6:22-cv-02440-TMC (D. S.C. July 28, 2022) (quoting *Chevron U.S.A. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837, 842 (1984) ("When a court reviews an agency's construction of the statute which it administers, it is confronted with two questions. First, always, is the question whether Congress has directly spoken to the precise question at issue. If the intent of Congress is clear, that is the end of the matter; for the court, as well as the agency, must give effect to the unambiguously expressed intent of Congress.")).

[8] Reg. §1.965-7(b)(1)(ii)(C).

[9] §6662(a), §6662(b)(1).

[10] Reg. §1.6662-3(c).

[11] T.D. 8381 (1991).

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underpayment that is attributable to a position contrary to a rule or regulation if the position is disclosed in accordance with the rules of paragraph (c)(2) of this section and, in case of a position contrary to a regulation, the position represents a good faith challenge to the validity of the regulation.''[12] Treasury thus omitted the reference to negligence in the 1995 version of the regulation. It is reasonable to conclude that Treasury and the IRS did not believe that a taxpayer that challenged a regulation openly, on a good faith basis, could be considered to have disregarded the regulation or engaged in negligence.

Reg. §1.6662-3 does not define, ''disregard.'' The conclusion above nevertheless makes sense because the word, ''disregard,'' principally means, ''to pay no attention to.''[13] A taxpayer that challenges a regulation and makes it clear to the relevant agency that it is doing so is emphatically *not* paying no attention to the regulation in any way. The taxpayer is considering the regulation closely and then concluding that the regulation does not have the force and effect of law for one or more reasons.[14]

Reg. §1.6662-3(b)(1) defines negligence, in relevant part, as ''any failure to make a reasonable attempt to comply with the provisions of the internal revenue laws or to exercise ordinary and reasonable care in the preparation of a tax return.'' Taking a position contrary to a regulation based on a careful reading and application of statutory effective dates does not constitute a failure to make a reasonable attempt to comply with the internal revenue laws. And expressly complying with the regulatory requirement to disclose a position contrary to Treasury regulations demonstrates that the taxpayer has taken ordinary and reasonable care in preparing its return.

In the CCA, IRS Chief Counsel appears to have misconstrued both ''disregard'' and ''negligence'' to mean ''a failure to follow'' (e.g., ''because section 965(h)(4) and Treas. Reg. section 1.965-7(b)(1)(ii)(C) do not provide an exception in cases of disclosure of a disregarded rule''). That construction is not in line with the construction under §6662. On the theory that the Internal Revenue Code and the Treasury regulations should be read as a coherent whole, the terms ''disregard'' and ''negligence'' should have the same meaning in §965(h)(4) as they do in §6662(b)(1).[15] Therefore, a taxpayer that takes a position contrary to Reg. §1.78-1(c) on the grounds that the regulation is substantively and/or procedurally invalid, and informs the IRS that it is doing so on Form 8275-R, should not be treated as having engaged in an intentional disregard of, or negligence with respect to, the regulation for purposes of §965(h)(4).[16]

THE AM

Under §367(d), a U.S. person that transfers intangible property to a foreign corporation in a §351 or §361 exchange is treated as having sold the property in exchange for payments that are contingent on the productivity, use, or disposition of the property, and as receiving amounts that reasonably reflect the amount the person would have received annually in the form of these payments over the useful life of the property.[17] If the foreign corporation does not pay the U.S. person an amount that corresponds to the deemed payment in a given year, the U.S. person establishes an account receivable, which the foreign corporation can pay without further U.S. tax consequences.[18] If the foreign corporation does not pay the receivable by the end of the third year following the year to which the receivable relates, the foreign corporation is deemed to have settled the receivable, and the U.S. person is deemed to have contributed an equivalent amount to the capital of the foreign corporation.[19]

In the AM, a domestic corporation (''USP'') contributes intangible property with a useful life of 10 years to a foreign corporation (''FC'') in a §351 exchange. USP includes in income §367(d) inclusions in the amount of $10 for Year 1, $12 for Year 2, and $12 for Year 3. In Year 3, FC pays $60 to USP. USP treats $34 of the $60 as settling the accounts receivable for Years 1–3 and the remaining $26 as an advance payment of subsequent §367(d) inclusions.

The AM concludes that the $26 is not an advance payment and will be ''analyzed under general tax

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[12] T.D. 8617 (1995).

[13] *See The Compact Oxford English Dictionary, 2d ed.* (Oxford Univ. Press 1996), at 453; Merriam-Webster's Collegiate Dictionary, 11th ed. (Merriam-Webster, Inc. 2006), at 362.

[14] Reg. §1.6662-3(c) states that ''[a] disregard is 'intentional' if the taxpayer knows of the rule or regulation that is disregarded.'' That gloss informs the construction of the word ''intentional'' in §965(h)(4)'s reference to ''intentional disregard,'' but it does not get at the core question of what the term ''disregard'' means.

[15] *See, e.g.*, *Gustafson v. Alloyd Co., Inc.*, 513 U.S. 561, 562 (1995) (''The normal rule of statutory construction that identical words used in different parts of the same Act are intended to have the same meaning applies here.'').

[16] The CCA is consistent with Treasury and the IRS's general approach to enforcing §965, which is to try to eliminate any risk that §965 liabilities will be unsatisfied, no matter how small. *See, e.g.*, Reg. §1.965-7(b)(3) (noting that a ''disposition of substantially all of the assets'' of a person that elects to pay its §965 liability in installments constitutes an acceleration event) and T.D. 9846 (2019) (refusing to exclude F reorganizations from acceleration events on the grounds that tax-free exchanges like these could somehow pose ''a risk to the IRS's ability to collect the full amount of the section 965(h) net tax liability'').

[17] §367(d)(2)(A).

[18] Reg. §1.367(d)-1T(g)(1)(i).

[19] Reg. §1.367(d)-1T(g)(1)(ii).

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principles.'' In a footnote, the AM speculates that the $26 will be treated as a distribution of property from FC to USP. The AM respects the $34 as settling accounts receivable in respect of prior §367(d) inclusions.

The basis for the AM's conclusion is that (i) nothing in §367(d) addresses advance payments,[20] (ii) taxpayers are free to structure their transactions as sales, licenses, or exchanges subject to §351 or §361, and (iii) contingent sales and licenses are sufficiently different from §351/361 exchanges that it is not appropriate to justify advance payments of §367(d) amounts by reference to those transactions. For example, the AM notes that the ''the character and timing'' of income in a true contingent sale may differ ''fundamentally'' from what §367(d) prescribes — although the AM does not explain how. In addition, the AM continues, in a license, the licensee does not own the property, whereas the §367(d) transferee does, and a §367(d) transferee is not required to make payments, whereas a licensee typically is. The AM therefore views the fact that advance payments may be given effect in the contingent sale or licensing context as ''irrelevant'' to whether they are permissible in the context of §367(d).

The AM nevertheless acknowledges that Notice 2012-39 [21] actually *mandates* treating boot in an outbound asset reorganization that involves intangible property as an advance payment of the §367(d) amount to the extent the boot is allocated to that property. The AM attempts to reconcile Notice 2012-39 with the conclusion in the AM:

> The conclusion of the Notice, which only addressed the treatment of payments in the different setting where boot is received in an initial section 367(d) exchange, is not inconsistent with the conclusion in this Memorandum. The receipt of boot in an initial section 367(d) exchange is distinguishable factually, legally, and in terms of applicable policy, from the advance payment at issue in this Memorandum.

Unfortunately, the AM does not explain *how* the receipt of boot in an initial §367(d) exchange is ''distinguishable factually, legally, and in terms of applicable policy.'' The rationale for the rule in Notice 2012-39 is simple — without that rule, a U.S. person could purchase an intangible property-rich U.S. target corporation for cash, the target could engage in an outbound asset reorganization with a foreign corporation in which the target receives cash without recognizing gain under §361(b), and the target could distribute the cash to the U.S. person without either the U.S. person recognizing income under §356's ''boot within gain'' rule or the target recognizing income under §361(c). The U.S. person could include §367(d) amounts in income over time while receiving cash in an amount equal to the value of the intangible property up front. Notice 2012-39 attempts to shut this transaction down by allocating the cash ratably across all the property the target transfers and then treating the portion of the cash that is allocated to the intangible property as a prepayment of the §367(d) amount that the target must recognize.[22] To avoid taxing the same income twice, Notice 2012-39 treats this prepayment as a credit against the contingent annual payments that the U.S. person — referred to in the Notice as the ''qualified successor'' of the target that goes out of existence in the reorganization — would otherwise have to include in income under §367(d).[23]

The AM effectively takes a position that is directly contrary to Notice 2012-39. Notice 2012-39 recharacterizes cash that would have benefited from being treated as a distribution as an advance payment. The AM recharacterizes an advance payment as a distribution. Inconsistent treatment of similar transactions is difficult to justify, which may be why the AM seems to struggle so much.

As the AM acknowledges, Congress enacted §367(d) to prevent taxpayers from deducting R&D expenses in the United States and then using §351 or §361 exchanges to move the profits associated with the intangible property the R&D created offshore. §367(d) therefore tries to eliminate the distortive effect that §351 and §361 might have had on taxpayer behavior by putting taxpayers in a roughly similar position whether they license or sell intangible property to an affiliate or transfer the intangible property for affiliate stock.[24]

In that regard, it seems entirely appropriate for taxpayers that can and often do make advance payments of royalties and obligations under contingent sale agreements to also be entitled to make advance payments of §367(d) inclusions. Consistent with Notice 2012-39, and subject to the generally applicable income recognition rules under, e.g., §451, the advance

[20] In contrast, as noted above, the §367(d) regulations expressly permit the settlement of accounts receivable that arise under §367(d).

[21] 2012-31 I.R.B. 95 (2012).

[22] Notice 2012-39, §4.02.

[23] Notice 2012-39, §4.04 (''The income attributable to a qualified successor's proportionate share of the contingent annual payments is excluded from gross income to the extent of the income included by the U.S. transferor under section 4.02 of this notice that is attributable to the qualified successor (credit amount)'').

[24] The consequences of a lump sum or contingent payment sale are also intended to be similar, as §482 provides that income in connection with any controlled ''transfer'' of intangible property must be ''commensurate with the income attributable to the intangible.''

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payment accelerates the relevant U.S. person's §367(d) inclusion in the year the U.S. person receives the payment and then functions as a credit against §367(d) amounts the U.S. person would otherwise include in income.[25] When the credit is exhausted, the annual income inclusions resume. If the advance payment exceeds the remaining §367(d) amounts, the U.S. person retains the excess and could be treated as receiving a distribution on the foreign corporation's stock — just as would be the case in the context of an advance payment of contingent royalties or contingent sales proceeds that exceeds actual royalties/sales proceeds. That result is simply part of the risk of engaging in advance payments of contingent amounts, under §367(d) or otherwise.

Although the AM suggests that allowing for advance payments of §367(d) amounts ''would require the Service to evaluate whether a purported advance payment ultimately captured undetermined amounts of future inclusions, which would raise significant administrative concerns,'' the same issue is present in the context of any advance payment of contingent amounts, as noted above. It is not clear that these administrative concerns are ''significant,'' either. If the taxpayer maintains a record of the amount the foreign corporation pays in advance, tracks the inclusions that would have arisen, and subtracts those inclusions from the credit, the IRS ought to be able to see whether the taxpayer is understating its §367(d) liability.

[25] *See generally* §451; *Schlude v. Commissioner*, 372 U.S. 128 (1963); *Am. Auto.Ass'n v. United States*, 367 U.S. 687 (1961). There is of course more to making an effective advance payment than what is contained in the paragraph above.

It may seem that the AM ought to matter less now than it might have before the TCJA, given that a distribution from a CFC to its United States shareholder is often PTEP or E&P that can benefit from the §245A dividends received deduction. There are still reasons for concern with the approach in the AM, however. First, even PTEP distributions can potentially give rise to capital gain if there is insufficient basis in the stock of the distributing corporation. Second, the §904 implications of accelerating §367(d) amounts and distributing PTEP/§245A E&P are different — for instance, a distribution of §245A E&P will not increase general or passive category limitation that a taxpayer may need. Third, treating an advance payment as a distribution may result in §367(d) accounts receivable never being settled if the advance payment exhausts the foreign corporation's cash, thereby increasing basis in the foreign corporation's stock and potentially impacting interest expense allocation and apportionment. Last, there may be reasons for accelerating income that are specific to the taxpayer. For example, there may be a strategic, non-tax benefit that a taxpayer seeks to achieve simply by paying more tax in a given period and paying less tax in another period — a result that the U.S. income recognition rules unequivocally permit.

IN SUM

The AM and the CCA reflect the IRS's misperception that U.S. multinationals are focused on eroding the U.S. tax base. In today's environment, U.S. multinationals just want to survive (and maybe thrive). Treasury and the IRS ought to come to terms with the new reality, and soon. These days, protecting the U.S. fisc also means protecting U.S. taxpayers.

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