The *Adams Challenge* Tax Court Decision Reinforces the Benefits of Foreign Taxpayers Filing Protective U.S. Returns

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In *Adams Challenge (UK) Ltd v. Commissioner (Dkt. No. 4816-15, Jan. 21, 2021)*, the United States Tax Court sided with the IRS on cross motions for summary judgment to deny deductions and credits to a foreign corporation that failed to file timely Forms 1120-F. The court applied a fairly straightforward interpretation of section 882(c)(2) of the Internal Revenue Code and also considered the impact of the US-UK tax convention (the "Treaty"). The court's analysis of the issues under the Treaty, in particular, plows new ground.

Section 882(c)(2) generally denies deductions to a foreign corporation engaged in a trade or business in the United States if it fails to file "a true and accurate return, in the manner prescribed" by the Code. The court determined that the taxpayer's deductions were subject to disallowance under this provision, and further held that neither Article 7 of the Treaty, which governs taxation of business profits, nor the nondiscrimination provisions in Article 25 precluded this result, even though section 882(c)(2)'s disallowance penalty for foreign corporations does not apply to U.S. corporations.

The statutory analysis was somewhat complicated by the uncertain status of regulations promulgated in 1990 (the "1990 Regulations") that prescribe a specific period within which taxpayers must file returns in order to avoid a presumption that the disallowance rule applies. In *Swallows Holdings, Ltd. v. Commissioner*, 126 T.C. 96 (2006) (reviewed), *vac'd and rem'd,* 515 F.3d 162 (3d Cir. 2008), the Tax Court had held the 1990 Regulations invalid, only to be overturned by the Third Circuit. The court in *Adams Challenge* skirted the issue by finding that the taxpayer would have been subject to disallowance under the case law that governed before the 1990 Regulations were adopted.

The takeaways for foreign corporations (and foreign individuals, which are subject to equivalent rules under section 874(a)) are straightforward: (1) taxpayers in doubt about whether they have a taxable U.S. presence should file protective returns, which if done properly will take disallowance off the table; and (2) if a taxpayer is approached by the IRS about a possible failure to file, there is a value in filing a return – including a protective return, if appropriate – as quickly as possible, even if the filings are already beyond the Regulations' presumptive deadlines.

Facts

In 2009 and 2010, Adams Challenge (UK) Limited, a UK corporation, ("Adams") chartered a "multipurpose support vessel" to an unrelated U.S. company to help with decommissioning oil and gas wells and with removing debris from the U.S. outer continental shelf. Adams failed to file U.S. returns reporting its income from the charter. The IRS identified Adams as a potential non-filer using a Lloyds ship registry and tracked its days on the OCS using a satellite-enabled tracking service. In 2014, the IRS prepared and subscribed returns for Adams and issued a notice of deficiency, in which it disallowed deductions and credits for 2009 and 2010 under Code section 882(c)(2). The taxpayer filed a petition with the Court challenging the IRS's disallowance in 2015, but did not file protective Forms 1120F for those years until 2017.

Adams made two arguments against the proposed deficiencies, each incorporating both statutory and treaty elements:

1. The IRS was not entitled to tax the income:
    a. Under the Code, because Adams was not engaged in a U.S. trade; and
    b. Under the Treaty, because Adams lacked a U.S. permanent establishment.
2. The IRS could not disallow deductions and credits:
    a. Under U.S. law, because the 23.5 month filing deadline lacked a statutory basis; and
    b. Under the Treaty, because Article 7 provides that foreign corporations shall be entitled to deduction of expenses, and because disallowance was inconsistent with Article 25 nondiscrimination provisions.

The court addressed Adams' first argument in *Adams Challenge (UK) Ltd. v. Commissioner*, 154 T.C. 37 (2020) (determining that the United States did have authority to tax Adams). This new decision addresses Adams' arguments under the second heading above.

Section 882(c)(2)

The court summarized the law under section 882(c)(2) and its predecessors, as it stood before the issuance of the challenged regulations, as follows (Opinion at 23):

> The case law interpreting section 233 of the 1928 Act, coupled with the 1957 regulations interpreting section 882(c), established several propositions as to which there was no conflicting authority. The statute does not require a foreign corporation to file a timely return--i.e., to file a return within the time prescribed in subtitle F--in order to preserve its entitlement to deductions and credits. However, the statute does establish a "terminal date" by which such a return must be filed. That "terminal date" is the date on which the Commissioner exercises his authority to prepare and subscribe a return for the taxpayer under section 6020(b) or its predecessor. This terminal period for filing a return was not fixed but varied depending on when the Commissioner exercised that authority. As the Fourth Circuit held in *Ardbern Co*., 120 F.2d at 426, a taxpayer's failure to file within the terminal period could be excused upon a showing of "good faith." And while the requirement of a "true and accurate return," sec. 882(c)(2), did not require perfection, the omission of "material information" from a timely filed return was fatal to a claim for deductions, *Brittingham*, 66 T.C. at 409.

The 1990 Regulations added a grace period – generally eighteen months after the unextended due date for Form 1120-F – within which corporate taxpayers could file delinquent tax returns without fear of losing their deductions. Under the current version of the 1990 Regulations, after expiration of this grace period, a taxpayer can only preserve its right to deductions by establishing to the satisfaction of the Commissioner that it had acted "reasonably and in good faith," considering several factors, the first and foremost of which is "whether the corporation voluntarily identifies itself to the Internal Revenue Service . . . before the Internal Revenue Service discovers the failure to file." Regs. § 1.882-4(a)(3)(i). The Regulations' focus is on discouraging taxpayers from playing the "audit lottery." A taxpayer that comes forward only after becoming aware that it is on the IRS's radar screen potentially begins with a substantial black mark against it.

The Tax Court had held the 1990 Regulations invalid in *Swallows Holding*, reasoning that the courts had not previously read a timeliness requirement into the statutory requirement that taxpayers file returns "in the manner prescribed" in the Code, and the provision had survived sixty years and several re-enactments without Congress adding one. However, that decision was reversed by the Third Circuit Court of Appeals. The Court in *Adams Challenge* noted that its earlier opinion had relied heavily on *National Muffler Dealers Ass'n v. United States*, 440 U.S. 472 (1979), while the appellate court applied the more deferential language in *Chevron, U.S.A., Inc. v. Nat. Res. Def. Council,* 467 U.S. 837 (1984). The Supreme Court has since endorsed applying *Chevron* to tax regulations in *Mayo Foundation for Medical Education & Research v. United States*, 562 U.S. 44 (2011), and the Tax Court's discussion (Opinion, p. 40) suggests some receptiveness to the Third Circuit's view that the 1990 Regulations' "not unreasonable" deadlines would pass muster under *Chevron*. That said, the Tax Court's decision in *Swallows Holding* remains precedent in that court (except for cases appealable to the Third Circuit), unless it is formally overruled in conference.

The court in *Adams Challenge* concluded that it did not have to reach the issue of validity of the 1990 Regulations because Adams had lost its right to claim deductions even under pre-1990 law. Applying the principles laid out in the quoted passage above, the court concluded that the "terminal date" had passed before Adams filed its protective forms 1120-F. The IRS prepared and subscribed returns in 2014, while the taxpayer did not file protective returns for those years until 2017. (The taxpayer did file a protective return for 2011 in 2013, before the IRS acted. The opinion does not explain why Adams did not file U.S. returns for 2009 and 2010.) The court also rejected Adams' claim that a common law "good faith" exception should apply: "the relevant question is not whether the taxpayer displayed good faith in some abstract sense, but whether it attempted in good faith to file a U.S. income tax return before the IRS prepared a return for it." Opinion at 36.

Treaty Articles 7 and 25

That set the stage for the most significant part of the court's opinion: addressing the treaty arguments. As the court observed, virtually every tax treaty to which the US is a party contains counterparts to the two Articles cited by Adams, and the court was effectively writing on a blank slate in what seems to have been the first decision in any judicial forum addressing the relationship between section 882(c)(2) and tax treaties. (As discussed in the opinion, *Espinosa v. Commissioner*, 107 T.C. 146 (1996), would have presented similar issues if the U.S.-Mexico treaty had been in effect in the years at issue before the court.)

The court began its analysis by confirming that, though the "later in time" rule applies to treaty provisions that postdate a Code provision, "'a later treaty will not be regarded as repealing an earlier statute by implication unless the two are absolutely incompatible.'" *See* Opinion at 47-48 (citations omitted). The court further emphasized that, when interpreting a treaty, "the agency's interpretation 'is entitled to great weight.'" Opinion at 48 (citations omitted). With these two principles in mind, the court proceeded to its analysis of whether the cited provisions necessarily clashed with the disallowance rule in section 882(c)(2), and concluded that they did not.

Article 7 – Business Profits

The court first found no conflict with the statement in article 7(3) that deductions "shall be allowed" to a foreign corporation engaged in a U.S. trade or business, because "this phrase typically means 'shall be allowed so long as certain conditions are met.'" Opinion at 49. The court concluded that:

section 882(c)(2) simply specifies the administrative steps that a U.K. taxpayer must take in order to report (and ultimately obtain) such deductions: It must (1) file a U.S. tax return and (2) file that return before the IRS prepares a return for it. These administrative requirements are not "absolutely incompatible" with the business profits article of the Treaty. We accordingly conclude that the statute and the Treaty can 'be read harmoniously, to give effect to each.'

Opinion at 52 (citations omitted).

Article 25 – Nondiscrimination

The court next found that section 882(c)(2) did not discriminate against U.K. corporations in a manner prohibited by paragraph 25(1). The court cited several factors as indicating that no impermissible discrimination had occurred:

- Even under the 1990 Regulations, foreign corporations are not at risk of losing deductions until long after the due dates applicable to U.S. corporations;
- Foreign corporations that want to dispute whether they are taxable can preserve deductions by filing timely protective returns;
- The OECD model treaty commentary's admonition that foreign corporations should not be subject to more onerous returns, payments or prescribed times were not violated – protective returns are simple and foreign corporations have more time to file than U.S. corporations;
- Foreign corporations are not in the same circumstances as U.S. corporations when it comes to filing returns because foreign corporations are better able to avoid identification by the IRS, which makes them "'pregnant with possibilities of tax evasion,'" Opinion at 57 (citations omitted), and, absent a fear of losing deductions and credits, might be encouraged to game the system; and
- Other U.S. Code provisions treat foreign and domestic corporations differently, without violating the treaty (e.g., information reporting requirements for foreign persons holding investments in U.S. real property).

Finally, the court rejected Adams' assertion that section 882(c)(2) violates Article 25(2), which provides that U.S. taxes should not be "less favourably levied" on U.K. corporations than on U.S. corporations. Adams was effectively being taxed on its gross income in 2009 and 2010, but "[i]t was entirely within petitioner's control whether it would be taxed on a gross or a net basis for 2009 and 2010, as it was for 2011. Petitioner simply had to follow the administrative requirements of U.S. law with respect to how its deductions needed to be claimed." The court found this to be consistent with the negotiating, drafting and/or administrative history of the U.S.-U.K. Treaty, the U.S. Model Treaty and U.S. treaties in general.

It remains to be seen whether Adams appeals the Tax Court's ruling (to the District of Columbia Circuit) and asserts the regulations promulgated under section 882(c)(2) violate the APA. The treaty issues are also highly likely to be revisited on appeal or in other litigation.

However, the court's ruling offers a stark warning to foreign taxpayers: they should timely file nonresident tax returns – including protective filings in borderline cases – in order to take the denial of deductions off the table.

More specifically, *Adams Challenge* also drives home that nonresident taxpayers are well advised, if the IRS commences an audit or otherwise contacts them, to file protective returns before the IRS prepares and subscribes returns (i.e., the "termination date" determined under Code section 882(c)(2) itself, as discussed above). Beating the IRS to the punch in this manner could protect the right to deductions if the court does not apply the 1990 Regulations, and in any event might bolster the case that the taxpayer was acting reasonably and in good faith.

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