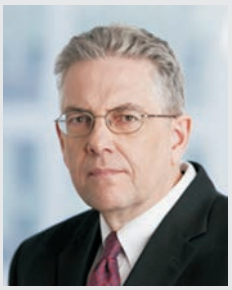
Brand X, *3M*, and Legal Restrictions On the Payment of Income

By Patrick J. Smith


Patrick J. Smith

Patrick J. Smith is a partner at Ivins, Phillips & Barker in Washington.

3M Co. has filed a Tax Court petition challenging the validity of provisions in the section 482 regulations that impose conditions on the circumstances in which the IRS will give effect to foreign legal restrictions on the payment of income between related parties. The principal legal issue in the case will be whether those provisions are invalid under *Brand X*, which addressed an agency's authority to issue regulations at odds with a court's earlier interpretation of the same statutory provision. The regulations challenged by 3M are arguably inconsistent with *First Security Bank*. Under the *Brand X* test, the regulations should be held invalid, because *First Security Bank* represented the Supreme Court's view on the only permissible interpretation.

In a Tax Court petition filed March 11, 2013, 3M Co. challenges the validity of regulatory provisions under section 482 that limit the circumstances in which the IRS will give effect to foreign legal restrictions on the payment of income.[1] The central legal question is whether those provisions are valid under the Supreme Court's 2005 decision in *Brand X*.[2]

Brand X prescribed a test for determining whether an agency may issue a regulation interpreting a statute in a way that differs from how a court previously interpreted the same provision. It is based on *Chevron*'s general test for determining the validity of agency statutory interpretations.[3]

In *3M*, the most significant prior judicial interpretation that is potentially inconsistent with the regulation is the Supreme Court's 1972 decision in *First Security Bank*.[4] There, the Court held that it was improper for the IRS to use its authority under section 482 to reallocate income to a corporation that was prohibited by federal law from receiving the type of income that the IRS reallocated.[5]

Twenty-two years later, in 1994, the IRS issued regulations under section 482 imposing conditions on the circumstances in which the IRS will respect the effect of foreign legal restrictions on the payment of income between commonly controlled entities. The question in *3M* will be whether the imposition of those conditions is consistent with the holding in *First Security Bank* under the *Brand X* test.

A. *Brand X*

In *Brand X*, the Supreme Court held that under some circumstances, an agency has the authority to adopt an interpretation of a statutory provision that differs from a court's prior interpretation of the same provision. Because *Brand X* applied and clarified principles that had been established in *Chevron*, some discussion of *Chevron* is necessary.

Chevron established a two-step analytical framework for courts to determine whether an agency interpretation of a statutory provision is controlling. The first step is for the court to determine "whether Congress has directly spoken to the precise question at issue."[6] "If a court, employing traditional tools of statutory construction, ascertains that Congress had an intention on the precise question at issue, that intention is the law and must be given effect."[7]

If the statute is silent or ambiguous regarding the specific issue, the question under the second step is whether the agency's interpretation is permissible or reasonable. "A court may not substitute its own

[1]Petition, *3M Co. v. Commissioner*, No. 5816-13 (T.C. filed Mar. 11, 2013). No briefs have yet been filed in the case.

[2]*National Cable & Telecommunications Association v. Brand X Internet Services*, 545 U.S. 967 (2005).

[3]*Chevron U.S.A. Inc. v. Natural Resources Defense Council Inc.*, 467 U.S. 837 (1984).

[4]*Commissioner v. First Security Bank of Utah N.A.*, 405 U.S. 394 (1972).

[5]*First Security Bank* was applied in the context of foreign legal restrictions in *Procter & Gamble Co. v. Commissioner*, 961 F.2d 1255 (6th Cir. 1992), and *Texaco Inc. v. Commissioner*, 98 F.3d 825 (5th Cir. 1996). Because both of those decisions were clearly based on *First Security Bank*, this article will focus exclusively on *First Security Bank*.

[6]*Chevron*, 467 U.S. at 842.

[7]*Id.* at 843, n.9.

construction of a statutory provision for a reasonable interpretation made by the administrator of an agency.''[8]

Chevron left unresolved several questions regarding the application of its analytical framework. *Brand* X addressed one of them — namely, the relative priority of a judicial interpretation that differs from and precedes an agency interpretation that will trigger evaluation under *Chevron*. As Justice Clarence Thomas noted in his opinion for the majority in *Brand X*, ''There is genuine confusion in the lower courts over the interaction between the *Chevron* doctrine and *stare decisis* principles.''[9]

Brand X involved a Federal Communications Commission regulation that interpreted the underlying statute differently than the Ninth Circuit had previously interpreted it. When it considered the effect of the FCC's interpretation, the Ninth Circuit concluded that it was bound by its own prior interpretation of the statutory provision even though that interpretation differed from the agency's interpretation.[10] The *Brand X* majority concluded that the Ninth Circuit should have applied the *Chevron* framework to the agency interpretation rather than automatically following the prior opinion under the *stare decisis* principle.[11]

The Court in *Brand X* held that the *Chevron* framework takes priority over *stare decisis*. A previous judicial interpretation of a statutory provision takes priority over a subsequent contrary interpretation by the agency charged with interpreting the statute if, but only if, the prior judicial interpretation was based on a *Chevron* step 1 analysis that concluded the provision had only one permissible interpretation:

> The better rule is to hold judicial interpretations contained in precedents to the same demanding step one standard that applies if the court is reviewing the agency's construction on a blank slate.[12]
>
> The Court of Appeals erred in refusing to apply *Chevron* to the Commission's interpretation of the definition of ''telecommunications service.'' Its prior decision in *Portland* held only that the *best* reading of section 153(46) was that cable modem service was a ''telecommunications service,'' not that it was the *only permissible* reading of the statute.[13]

Thomas noted that a ''contrary rule would produce anomalous results,'' because the question whether the agency's interpretation or the court's interpretation takes priority ''would turn on the order in which the interpretations issue'':

> If the court's construction came first, its construction would prevail, whereas if the agency's came first, the agency's construction would command *Chevron* deference. Yet whether Congress has delegated to an agency the authority to interpret a statute does not depend on the order in which the judicial and administrative constructions occur. . . . Neither *Chevron* nor the doctrine of *stare decisis* requires these haphazard results.[14]

The principle established by *Brand X* is that a *Chevron* step 2 interpretation by a court (determining the best reading of the provision) can be overruled by a subsequent contrary agency interpretation, but that a *Chevron* step 1 interpretation by a court (determining that the provision has only one permissible reading) cannot. *Brand X* held that the *Chevron* two-step framework applied to the issue of statutory interpretation in the case and that the Ninth Circuit should have used that framework rather than automatically following its own prior interpretation of the statute under the *stare decisis* principle.[15] Under *Chevron*'s two-step framework, a court's step 1 holding determining *the only permissible* interpretation of a statutory provision necessarily precludes any other interpretation from being correct, but a court's step 2 holding determining *the best* interpretation does not preclude an alternative interpretation by an agency if that interpretation is reasonable and is adopted in a way that triggers *Chevron* analysis.

There is some technical imprecision in phrasing the *Brand X* test in shorthand form as being whether the prior judicial interpretation represented a *Chevron* step 1 holding or a *Chevron* step 2 holding. The *Chevron* two-step framework does not apply unless there is an agency interpretation of a type that under *Mead*[16] would trigger the *Chevron* two-step framework, and the *Brand X* issue arises only if the initial judicial interpretation occurred when there was no agency interpretation subject to the *Chevron* two-step framework. More substantively, this factor implicates one of the reasons why applying the *Brand X* principle is not straightforward.

Because the *Brand X* issue arises only if the *Chevron* two-step framework did not apply in the

[8] *Id.* at 844.
[9] *Brand X*, 545 U.S. at 985.
[10] *Id.* at 979.
[11] *Id.* at 980.
[12] *Id.* at 982.
[13] *Id.* at 984 (emphasis in original).
[14] *Id.* at 983.
[15] *Id.* at 980.
[16] *United States v. Mead Corp.*, 533 U.S. 218 (2001).

initial judicial interpretation of a statutory provision, that prior judicial interpretation would ordinarily not have been framed in terms of the *Chevron* framework or in a way that would make it easy to determine whether the decision should be considered a *Chevron* step 1 or step 2 holding. This difficulty is exacerbated when the judicial interpretation predates not only *Brand X* but also *Chevron*.

The problems in applying the *Brand X* principle were forecast in Justice Antonin Scalia's dissent:

> Of course, like *Mead* itself, today's novelty in belated remediation of *Mead* creates many uncertainties to bedevil the lower courts. A court's interpretation is conclusive, the Court says, only if it holds that interpretation to be ''the *only permissible* reading of the statute,'' and not if it merely holds it to be ''the *best* reading.'' Does this mean that in future statutory-construction cases involving agency-administered statutes courts must specify (presumably in dictum) which of the two they are holding? *And what of the many cases decided in the past, before this dictum's requirement was established?*[17]

3M presents precisely the type of situation described by Scalia — namely, a prior court decision (*First Security Bank*, which preceded *Chevron* and *Brand X*) interpreting a statutory provision (section 482) and a subsequent regulation (the 1994 IRS regulations) that adopted a position at least arguably inconsistent with the statutory interpretation adopted by the earlier court. The same type of situation was presented in *Home Concrete*, a tax case recently decided by the Supreme Court.[18] However, because there was no majority opinion on how *Brand X* applied under the circumstances of the case, *Home Concrete* provides little guidance on the application of *Brand X* in other cases.[19]

B. *Brand X* and *First Security Bank*

In *First Security Bank*, the Supreme Court held that it was improper for the IRS to use its authority under section 482 to reallocate income to a corporation that was prohibited by federal law from receiving the type of income that the IRS reallocated. A principal question in applying *Brand X* to *3M* is whether the *First Security Bank* holding represented the Court's view of the only permissible reading of section 482, or instead its view of the best reading of section 482. If the latter, the IRS was free under the *Brand X* test to issue regulations adopting a different view of section 482, as long as that view was reasonable.

A second question in applying *Brand X* is whether the *First Security Bank* Court relied on an IRS regulation in reaching its conclusion. Also, is the holding in *First Security Bank* limited to restrictions imposed by federal law on the receipt of income? Further, does the regulation being challenged in *3M* conflict with *First Security Bank* in light of the fact that the regulation only imposes conditions on the circumstances in which foreign legal restrictions will be respected, rather than saying such restrictions will never be respected?

1. Was *First Security Bank* a step 1 case? As noted above, to apply the *Brand X* test to *First Security Bank* and the 1994 regulations, it is necessary to determine whether the Court's decision in *First Security Bank* was in effect a *Chevron* step 1 holding. That is, did the holding that the IRS exceeded its authority under section 482 in allocating to a corporation a type of income that the corporation was prohibited by federal law from receiving represent the Court's view on the *only permissible* reading of section 482 on this issue or its view on the *best* reading of section 482 on this issue?

Obviously, it is necessary to look closely at the reasoning in *First Security Bank* to answer that question. It began as follows:

> We know of no decision of this Court wherein a person has been found to have taxable income that he did not receive and that he was prohibited from receiving. In cases dealing with the concept of income, it has been assumed that the person to whom the income was attributed could have received it. *The underlying assumption always has been that in order to be taxed for income, a taxpayer must have complete dominion over it.* ''The income that is subject to a man's unfettered command and that he is free to enjoy at his own option may be taxed to him as his income, whether he sees fit to enjoy it or not.'' *Corliss v. Bowers*, 281 U.S. 376, 378 (1930).
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> It is, of course, well established that income assigned before it is received is nonetheless taxable to the assignor. But the assignment-of-income doctrine assumes that the income would have been received by the taxpayer had he not arranged for it to be paid to another. In *Harrison v. Schaffner*, 312 U. S. 579, 582 (1941), we said:
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> > One vested with the right to receive income [does] not escape the tax by any

[17] *Brand X*, 545 U.S. at 1018 (emphasis in second sentence in original; emphasis in last sentence added; citations omitted).

[18] *United States v. Home Concrete & Supply LLC*, 132 S. Ct. 1836 (2012).

[19] For a discussion of the issues left unresolved by *Home Concrete*, see Patrick J. Smith, ''What We Didn't Learn From *Home Concrete*,'' *Tax Notes*, June 25, 2012, p. 1625.

> kind of anticipatory arrangement, however skillfully devised, by which he procures payment of it to another, since, by the exercise of his power to command the income, he enjoys the benefit of the income on which the tax is laid.[20]

The version of section 482 in effect when *First Security Bank* was decided provided as follows:

> In any case of two or more organizations, trades, or businesses . . . owned or controlled directly or indirectly by the same interests, the Secretary or his delegate may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses.[21]

Although the *First Security Bank* opinion does not refer to the text of section 482 in discussing why the IRS's action was impermissible, the Court's reasoning appears to be based on the authority given to the IRS by section 482 to ''distribute, apportion, or allocate gross income,'' in order to clearly reflect the income of commonly controlled entities. The Court concluded that the term ''income'' for purposes of section 482 and the tax code generally could not properly be interpreted so broadly as to encompass supposed income that the taxpayer was legally prohibited from actually receiving.

The failure to closely engage with the text of section 482 puts the reasoning of the *First Security Bank* opinion at odds with current Supreme Court practice in cases involving issues of statutory construction. The Court now focuses on the text of the provision being interpreted, in a way the *First Security Bank* opinion clearly did not.

However, in *Home Concrete*, when similarly faced with a situation in which the nature of the reasoning in the prior opinion was arguably at odds with the Court's current interpretative practices, all five justices in the majority made clear that this variance did not affect their conclusion that the prior opinion remained controlling. Justice Stephen Breyer's plurality opinion expressed that position as follows:

> It may be that judges today would use other methods to determine whether Congress left a gap to fill. But that is beside the point. The question is whether the Court in *Colony* concluded that the statute left such a gap. And, in our view, the opinion (written by Justice Harlan for the Court) makes clear that it did not.
>
> Given principles of *stare decisis*, we must follow that interpretation. And there being no gap to fill, the Government's gap-filling regulation cannot change *Colony*'s interpretation of the statute.[22]

Scalia's concurring opinion expressed the same position:

> It would be reasonable, I think, to deny all precedential effect to *Colony, Inc. v. Commissioner*, 357 U.S. 28 (1958) — to overrule its holding as obviously contrary to our later law that agency resolutions of ambiguities are to be accorded deference. Because of justifiable taxpayer reliance I would not take that course — and neither does the Court's opinion, which says that ''*Colony* determines the outcome in this case.'' That should be the end of the matter.
>
> The plurality, however, goes on to address the Government's argument that Treasury Regulation section 301.6501(e)-1 effectively overturned Colony. In my view, that cannot be: ''Once a court has decided upon its de novo construction of the statute, there no longer is a different construction that is consistent with the court's holding and available for adoption by the agency.'' *National Cable & Telecommunications Assn. v. Brand X Internet Services*, 545 U.S. 967, 1018, n.12 (2005) (SCALIA, J., dissenting).[23] [Citation and internal quotation marks omitted.]

Thus, based on the positions expressed in the *Home Concrete* plurality and concurring opinions, it is clear that the nature of the reasoning in *First Security Bank* does not itself affect whether the holding in that case remains controlling.

The reasoning from *First Security Bank* quoted earlier can only be read to mean that the Court concluded (in *Brand X* parlance) that the *only* permissible interpretation of the statutory term ''income'' — not merely the *best* interpretation — could not include amounts that the taxpayer was legally prohibited from receiving. Accordingly, the holding in *First Security Bank* should be viewed as, in effect, a *Chevron* step 1 holding that therefore cannot be overruled by an IRS regulation to the contrary.

In *First Security Bank*, the Court referred to an IRS regulation:

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[20]*First Security Bank*, 405 U.S. at 403-404 (footnote omitted; emphasis added).

[21]*Id.* at 395, n.1.

[22]*Home Concrete*, 132 S. Ct. at 1844.

[23]*Id.* at 1846 (some citations omitted).

One of the Commissioner's regulations for the implementation of section 482 expressly recognizes the concept that income implies dominion or control of the taxpayer. It provides as follows:

> The interests controlling a group of controlled taxpayers are assumed to have complete power to cause each controlled taxpayer so to conduct its affairs that its transactions and accounting records truly reflect the taxable income from the property and business of each of the controlled taxpayers.

This regulation is consistent with the control concept heretofore approved by this Court, although in a different context. The regulation, as applied to the facts in this case, contemplates that Holding Company — the controlling interest — must have ''complete power'' to shift income among its subsidiaries. It is only where this power exists, and has been exercised in such a way that the ''true taxable income'' of a subsidiary has been understated, that the Commissioner is authorized to reallocate under section 482. But Holding Company had no such power unless it acted in violation of federal banking laws. The ''complete power'' referred to in the regulations hardly includes the power to force a subsidiary to violate the law.[24]

This reference to the provisions of a regulation does not mean that the regulation was the basis for the Court's holding. Instead, it simply means that the provisions were consistent with the concept established by the Court's decisions that for a taxpayer to have income within the meaning of that term in the tax code, it must have dominion or control over the funds.

The Court did not say that the regulation *establishes* the concept that income implies dominion or control of the taxpayer. Instead, it merely said that the regulation *recognizes* that concept. Consequently, the reference to a regulation does not affect the conclusion that the decision in *First Security Bank* was a *Chevron* step 1 holding.

The Court's opinion in *First Security Bank* continued as follows:

> Apart from the inequity of attributing to the Banks taxable income that they have not received and may not lawfully receive, neither the statute nor our prior decisions require such a result. We are not faced with a situation such as existed in those cases, urged by the Commissioner, in which we held the proceeds of criminal activities to be taxable. Those cases concerned situations in which the taxpayer had actually received funds. . . . We think that *fairness requires* the tax to fall on the party that actually receives the premiums rather than on the party that cannot.[25]

The statement that fairness *requires* that a taxpayer not be allocated income that it is legally prohibited from receiving confirms that *First Security Bank*'s holding reflects what the Court viewed as the only permissible outcome. Similarly, in the final paragraph of the opinion, the Court stated: ''We conclude that the premium income received by Security Life *could not be attributable* to the Banks.''[26] This statement, too, confirms that *First Security Bank* leaves no room under *Brand X* for the IRS to issue a regulation reaching a different result.

That the legal restriction at issue in *First Security Bank* was imposed by federal law whereas the IRS regulation in *3M* deals with foreign law is not a significant distinction. The reasoning in *First Security Bank* is not tied to the fact that the legal restriction at issue was imposed by federal law.[27]

2. 1994 regulation and *First Security Bank*. As noted above, however, the application of *Brand X* to *First Security Bank* and the 1994 IRS regulation is complicated by the fact that the regulation does not impose a blanket rule that legal prohibitions on the payment or receipt of income will never be given effect under section 482. That rule would clearly conflict with *First Security Bank* and therefore be prohibited under *Brand X*.

Instead, the 1994 regulation limits the circumstances under which foreign legal restrictions on the payment or receipt of income will be given effect under section 482. It requires that a taxpayer meet one of two alternative tests. The first test is satisfied if the taxpayer can show ''that the restriction affected an uncontrolled taxpayer under comparable circumstances for a comparable period of time.''[28]

It seems that taxpayers could rarely if ever satisfy that test. In some cases, a foreign legal restriction will apply only to payments between related parties. For those restrictions, it will obviously be impossible to satisfy the first test. For foreign legal restrictions that are not limited to related parties, it would still typically be difficult for a taxpayer to

[24]*First Security Bank*, 405 U.S. at 404-405 (footnotes omitted).

[25]*Id.* at 405 (footnotes omitted; emphasis added).

[26]*Id.* at 407 (emphasis added).

[27]The position that *First Security Bank* applies only to legal restrictions imposed by federal law was explicitly rejected by *Procter & Gamble*, 961 F.2d at 1259, and was implicitly rejected by *Texaco*, 98 F.3d at 828, in holding that a foreign legal restriction was subject to *First Security Bank*.

[28]Reg. section 1.482-1(h)(2)(i).

demonstrate that a specific uncontrolled taxpayer was affected in a comparable way by the foreign legal restriction. Thus, in light of the difficulty in satisfying the first test, a taxpayer would need to be able to meet the second test in order to have the foreign legal restriction given effect.

Under the second test, the taxpayer must agree that if the foreign legal restriction becomes inapplicable, it will at that time recognize the cumulative amount of income that has not been reported as a result of the restriction.[29] Further, the foreign legal restriction must satisfy four requirements for it to be given effect under the regulations:

> 1. the restrictions must be publicly promulgated, generally applicable to all similarly situated persons (both controlled and uncontrolled), and not be imposed as part of a commercial transaction between the taxpayer and the foreign sovereign;
>
> 2. the taxpayer (or other member of the controlled group to which the restrictions apply) must have exhausted all remedies prescribed by foreign law or practice for obtaining a waiver of those restrictions (other than remedies that would have a negligible prospect of success if pursued);
>
> 3. the restrictions must have expressly prevented the payment or receipt, in any form, of part or all of the arm's-length amount that would otherwise be required under section 482; and
>
> 4. the related parties subject to the restriction must not have engaged in any arrangement with controlled or uncontrolled parties that had the effect of circumventing the restriction, and must have not otherwise violated the restriction in any material way.[30]

The question that must be answered in applying *Brand X* is whether the above restrictions conflict with the holding in *First Security Bank* that the IRS may not under the authority of section 482 require a taxpayer to report as income amounts that it is legally prohibited from receiving.

One initial point is that in issuing the regulation, the IRS made no attempt to explain how these restrictions might be consistent with *First Security Bank*. The case was not even mentioned in the preambles to the proposed and final regulations. Given that failure, these regulations, like so many other IRS regulations, would be vulnerable to challenge under the Administrative Procedure Act's arbitrary and capricious standard.[31]

As interpreted by the Supreme Court in *State Farm*,[32] the arbitrary and capricious standard requires an agency to explain the reasoning behind its actions at the time the agency takes them:

> The agency must examine the relevant data and articulate a satisfactory explanation for its action including a ''rational connection between the facts found and the choice made.'' In reviewing that explanation, we must ''consider whether the decision was based on a consideration of the relevant factors and whether there has been a clear error of judgment.'' . . . The reviewing court should not attempt itself to make up for such deficiencies; we may not supply a reasoned basis for the agency's action that the agency itself has not given.[33]

The failure of the IRS to explain, when it issued this regulation, how the agency concluded that the restrictions imposed on the circumstances in which the IRS would give effect to foreign legal restrictions were consistent with *First Security Bank* would provide a strong basis for challenging the regulation under the arbitrary and capricious standard. Clearly, the question whether these regulatory limitations are consistent with *First Security Bank* is a relevant factor regarding the issuance of the regulations.

On the merits of whether the restrictions are consistent with *First Security Bank*, one way to analyze that question is to ask whether the legal restriction at issue in *First Security Bank* would have satisfied the regulatory requirements. As discussed below, it clearly would not.

Before explaining why, however, it makes sense to comment on the most unobjectionable of the regulatory requirements. It is difficult to object to the requirement that for a foreign legal restriction to be given effect, the taxpayer must agree to recognize any income that has not been reported by reason of the restriction, at the time the legal restriction no longer operates to prevent the taxpayer from receiving the income. This requirement is entirely reasonable, and it is hard to see any potential basis for challenging it.

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[29]Reg. section 1.482-1(h)(2)(iii)(B); reg. section 1.482-1(h)(2)(iv).

[30]Reg. section 1.482-1(h)(2)(ii).

[31]5 U.S.C. section 706(2)(A). For a discussion of why many IRS regulations are vulnerable under this standard, see Smith, ''The APA's Arbitrary and Capricious Standard and IRS Regulations,'' *Tax Notes*, July 16, 2012, p. 271.

[32]*Motor Vehicle Manufacturers Association v. State Farm Mutual Automobile Insurance Co.*, 463 U.S. 29 (1983).

[33]*Id.* at 43 (citations omitted).

It is also difficult to object to the fourth requirement — that the related parties subject to the foreign legal restriction have engaged in no arrangement with controlled or uncontrolled parties that had the effect of circumventing the restriction and that they have not otherwise violated the restriction in any material respect. This requirement is unobjectionable for several reasons. First, if the parties subject to the restriction have been able to avoid its effect in some fashion, obviously, a restriction on the payment of income that a taxpayer has been able to avoid should not be respected. Second, it is hard to object to this kind of ''clean hands'' rule. Thus, this requirement should not be vulnerable to challenge. Some of the other requirements are more problematic, however.

The third regulatory requirement clearly conflicts with *First Security Bank*. The legal restriction in *First Security Bank* would not have satisfied the requirement that the restriction expressly prevented the payment or receipt, in any form, of part or all of the arm's-length amount that would otherwise be required under section 482.

The income at issue in *First Security Bank* was insurance premiums. The Court discussed the legal restriction that prevented the taxpayer from being able to receive that type of income as follows:

> We note at the outset that the Banks could never have received a share of these premiums. National banks are authorized to act as insurance agents when located in places having a population not exceeding 5,000 inhabitants, 12 U.S.C.A. section 92. *Although section 92 does not explicitly prohibit banks in places with a population of over 5,000 from acting as insurance agents, courts have held that it does so by implication.* The Comptroller of the Currency has acquiesced in this holding, and the Court of Appeals for the Tenth Circuit expressed its agreement in the opinion below.[34]

There are several reasons why the legal restriction in *First Security Bank* would not have satisfied the requirement in the regulations that the legal restriction expressly prevented the payment or receipt of part or all of the arm's-length amount that would otherwise be required under section 482. First, the legal prohibition on national banks acting as insurance agents was not explicitly stated in the relevant statutory provision but instead was only inferred as a matter of statutory interpretation by the courts and the comptroller of the currency. For that reason alone, the restriction would have failed the requirement in the regulations that the legal restriction be explicit.

Second, even if the legal restriction had been explicit in the relevant statutory provision, it would still have failed the regulatory requirement because the restriction did not prohibit the receipt of income. It instead prohibited banks from engaging in the type of activity that would give rise to the income: It barred banks from acting as insurance agents. This is not the same thing as prohibiting banks from receiving insurance premiums.

The fact that the legal restriction in *First Security Bank* would not have satisfied the regulatory requirements for giving effect to foreign legal restrictions is strong evidence that the regulations are invalid under *Brand X* because they conflict with the *Chevron* step 1 holding in *First Security Bank*.

The restriction at issue in *First Security Bank* would probably satisfy the first regulatory requirement — that the foreign legal restriction be publicly promulgated and generally applicable — even though that restriction was not explicitly stated in the applicable statutory provision but only inferred by the courts and the comptroller of the currency. This legal restriction was publicly known as a result of the court decisions and thus would probably satisfy the requirement in the regulations that the restriction be publicly promulgated. However, the fact that the legal restriction at issue in *First Security Bank* might have satisfied some of the requirements in the regulation does not necessarily mean that these requirements do not conflict with the principle established in *First Security Bank*.

The situation described in the *3M* petition illustrates how the requirement in the regulations that the foreign legal restriction be publicly promulgated and generally applicable might conflict with the holding in *First Security Bank* on a more general level, even though the particular legal restriction in *First Security Bank* would probably satisfy that requirement. The *3M* petition describes attempts to record with a Brazilian agency a license for the use of patents and non-patented technology.[35] Recordation is necessary in order for royalties to be paid under the license, under rules established by the Brazilian Central Bank.[36]

According to the petition, the Brazilian agency said it would approve the recordation only if the license agreement were amended in several ways that the petition asserted were impossible to comply with, including imposing limits on the rate at

[34]*First Security Bank*, 405 U.S. at 401-402 (footnotes omitted; emphasis added).

[35]Petition, *supra* note 1, at 6-10.

[36]*Id.* at 6, 10.

which royalties could be paid.[37] As a consequence, the license agreement was not recorded, and royalties were not paid.[38]

It would seem that the rules of the Brazilian Central Bank prohibiting the payment of royalties under unrecorded license agreements should satisfy the regulatory requirement that the foreign legal restriction be publicly promulgated and generally applicable for license agreements that the agency refused to record. However, for parties that could satisfy the requirements imposed by the Brazilian agency and thus record their license agreements and pay royalties at the limited rate, the restrictions imposed by the Brazilian agency would not satisfy the requirement that the foreign legal restriction be publicly promulgated and generally applicable because the limitation was a result of the particular agreement between the Brazilian agency and the specific party recording a particular license agreement. Moreover, for those parties, the rules imposed by the Brazilian Central Bank would not satisfy the requirement that the foreign legal restriction be publicly promulgated and generally applicable because those rules are not the source of the limitation on the amount of the royalties. That limitation is instead a result of the conditions imposed by the Brazilian agency.

However, it is difficult to see why the limitations imposed by the Brazilian agency would not come within the holding in *First Security Bank*. Because of the combination of the Brazilian Central Bank rules and the conditions imposed by the Brazilian agency, the amount of royalties that could be paid was limited. It would seem that the holding of *First Security Bank* should apply in that situation even though the restriction was the result of a specific agreement with a government agency rather than a generally applicable rule. However, the requirements in the regulation for giving effect to foreign legal restrictions would not be met.

Thus, even though the particular legal restriction at issue in *First Security Bank* would probably satisfy the requirement in the regulations that the foreign legal restriction be publicly promulgated and generally applicable, the Brazilian legal restrictions described by the *3M* petition illustrate why this requirement conflicts with the holding in *First Security Bank*. That conflict is an additional reason why the requirements in the regulations are invalid under *Brand X*.

The second of the four regulatory requirements is that the taxpayer must have pursued all legal remedies to obtain a waiver of the restrictions unless there was a negligible chance of success in obtaining that waiver. It is unclear whether this requirement would have been met in *First Security Bank*. Regardless, it imposes an unreasonable and unrealistic burden on taxpayers. The regulations do not define the term ''negligible,'' but this standard would seem to require an attempt to obtain a waiver in circumstances in which it would otherwise be unreasonable to do so. This requirement seems difficult to reconcile with the holding in *First Security Bank*, since a taxpayer that does not attempt to obtain a waiver when the chance of success is merely small but not negligible is no less subject to the foreign legal restriction than a taxpayer that attempts to obtain a waiver and fails.

Thus, the regulatory requirements conflict with the holding in *First Security Bank* for several reasons. As a result, they are invalid under *Brand X*.

C. Conclusion

Under the *Brand X* test, the Supreme Court's holding in *First Security Bank* that section 482 does not empower the IRS to allocate income to a taxpayer if the taxpayer is legally prohibited from receiving the income was a holding that represented the Court's view on the only permissible reading of section 482. As a consequence, an IRS regulation to the contrary is invalid under *Brand X*. The holding in *First Security Bank* conflicts with the requirements established by the issued regulations under section 482. Under *Brand X*, those requirements are therefore invalid.

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[37] *Id.* at 7-10.
[38] *Id.* at 10.