ABA Defending Liberty Pursuing Justice
Vol. 27 No. 3
SPRING 2008

Section of Taxation
NEWSQUARTERLY

Antibribery Laws and the Tax Treatment of a CFC's Payments to Foreign Government Officials and Employees

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In the last several years, multinational companies have become the subject of increased scrutiny for violations of the Foreign Corrupt Practices Act (FCPA) in the U.S. and similar antibribery and anticorruption laws in foreign countries. This scrutiny places additional pressure on U.S. companies with operations abroad to ensure that they understand the U.S. taxation of payments that may become the focus of investigation. Companies failing to do so may be at increased risk for the potential application of civil and/or criminal penalties for tax evasion. This article focuses, in particular, on the tax treatment of illegal payments made to foreign government officials or employees by controlled foreign corporations.

Overview

Section 162(c) disallows deductions for certain payments that would otherwise be deductible under section 162(a) as ordinary and necessary business expenses. Among the payments covered by section 162(c) are those made to an official or employee of a foreign government that are unlawful under the FCPA, which bans many, but not all, payments made to a foreign government official or employee for the purpose of influencing that person's acts or decisions. For instance, certain payments for "facilitating" routine governmental action are allowed. For further discussion of the deductibility of such payments, see Charles Gnaedinger, *Facilitating Payments Are Deductible in U.S.*, 2008 TNT 27-3 (Feb. 8, 2008).

For improper payments made through a foreign subsidiary, the U.S. tax consequences will depend on the ownership form used. The U.S. tax consequences that result when a controlled foreign corporation (CFC) makes an illegal payment to a foreign government official or employee are discussed below. For further discussion regarding the U.S. tax consequences of improper payments made by less than 50 percent owned foreign subsidiaries, by certain wholly owned foreign subsidiaries, and by domestic international sales corporations (DISCs), see Selva Ozelli, *Is This Bribe Deductible? Tax Implications of the U.S. Foreign Corrupt Practices Act*, 48 Tax Notes Int'l 1131 (Dec. 17, 2007).

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Tax Treatment of CFC Payments

Any illegal bribe, kickback, or other payment to a foreign government official or employee made directly by or on behalf of a CFC constitutes subpart F income if the payment would be illegal under the FCPA if the CFC were a U.S. person. Section 952(a)(4); Treas. Reg. § 1.952-1(a)(4). No exceptions apply to this category of subpart F income, so the entire amount of the currency paid to, or the full fair market value of the property or services given to, the foreign government official or employee will be included in subpart F income. *Id*. Therefore, a U.S. shareholder of the CFC (*i.e.*, a U.S. person who owns 10 percent or more of the CFC) generally must include his pro rata share of the payment in his gross income for the taxable year. Section 951(a)(1)(A)(i). The U.S. shareholder will escape current taxation on the full amount of the CFC's illegal payment only if section 952(c), which provides that a CFC's subpart F income for a taxable year cannot exceed its current earnings and profits, applies.

To further discourage illegal payments of this kind, section 964(a) denies a reduction in earnings and profits for the illegal payment. Section 964(a) was enacted at the same time as Section 952(a)(4), in 1976. Before that time, illegal payments by CFCs reduced earnings and profits, even though they were not deductible. *See* Rev. Rul. 77-442, 1977-2 C.B. 264. A reduction in earnings and profits equal to the amount of the illegal payment would be consistent with the general approach to computing earnings and profits for dividend purposes, which is based upon reasonable accounting concepts that take into account the economic realities of corporate transactions, and illegal payments made by domestic corporations and foreign corporations are generally considered to reduce earnings and profits. *Id*. Therefore, section 964(a) seems to be a purely punitive measure, with multiple negative effects for the U.S. shareholder. For instance, by preventing the reduction of earnings and profits, section 964(a) makes it less likely that section 952(c) will apply to limit subpart F income in the year of the illegal payment, so the illegal payment is more likely to be included in the current income of the U.S. shareholder. In addition, the denial of a reduction in earnings will reduce the amount of foreign tax credits that could otherwise be claimed by a U.S. shareholder with respect to subsequent actual or deemed distributions from the CFC or, potentially, from other foreign corporations. Sections 902(a), 960(a) (the denial of a reduction in earnings results in an increase in the denominator of the fraction set forth in section 902(a), and therefore a reduction in the size of the credit).

On the other hand, in general, income that is deemed distributed to a U.S. corporation as a subpart F inclusion may carry with it an indirect foreign tax credit for foreign taxes deemed paid by the U.S. corporation under sections 960(a) and 902(a). Although the payment of an illegal bribe by a CFC is the only situation in which an expense item, rather than income, triggers subpart F treatment, there is no indication in the Code or Treasury Regulations that the subpart F income in this category may not give rise to a deemed paid credit. This contrasts with the treatment of income attributable to a CFC's participation in an international boycott, which is included in subpart F income under section 954(a)(3), but for which foreign tax credits are specifically denied under section 908.

Allowance of a foreign tax credit with respect to subpart F income resulting from a CFC's illegal payments seems inconsistent with the punitive intent of sections 952(a)(4) and 964(a), and it is unclear whether it was the intent to allow such a credit. Nonetheless, it appears that an illegal payment by a CFC may result in the acceleration of the U.S. shareholder's foreign tax credits by giving rise to a deemed paid credit upon the deemed distribution of the subpart F income. Presumably, the illegal payment, although it is actually an expense item, would be considered general basket income for purposes of the section 904 limitation on foreign tax credits. Section 904(d)(3)(B); Treas. Reg. § 1.904-5(c)(1). In addition, to the extent the foreign country denies a deduction to the CFC for its illegal payment (an action supported by the OECD in its Recommendation on the Tax Deductibility of Bribes to Foreign Public Officials, adopted on April 11, 1996, and accepted by full participants of the 1997 OECD Convention on Combating Bribery of Foreign Officials in International Business Transactions), the foreign tax credit will be increased because the foreign taxes will increase.

Conclusion

Given the increasing focus on activities that may fall within the category of bribery or corruption, both in the U.S. and abroad, U.S. multinationals should be aware of the U.S. tax issues that may arise with respect to such activities. In particular, U.S. corporations should take steps to determine whether any payment made to a foreign government official or employee by or on behalf of a CFC is an illegal payment that should be included in subpart F income, and they may wish to seek guidance from the Service regarding the appropriate path to follow with respect to any foreign tax credits that may arise from that subpart F inclusion. In addition, this would be an opportune time for the Service and the Treasury Department to provide general guidance on such issues under current law and consider whether any change in law with respect to these issues would be recommended. ■

Uniformity Clause Limitations on State Taxes

By Steve R. Johnson*

To be valid, state and local taxes must satisfy the requirements of both the federal Constitution and the state's own constitution. State Uniformity Clauses are among the most important of such constitutional provisions. The great majority of state constitutions contain Uniformity Clauses although their contents vary in important ways.

Uniformity Clauses often have been the basis of successful attacks against particular features of state taxes. Below, we first consider some examples of invalidation of state and local tax measures on uniformity grounds. Then, we describe an approach to understanding Uniformity Clauses built around five key questions pinpointing variation in uniformity law among the states.

Examples

Uniformity Clause challenges have succeeded in hundreds of cases around the country. Here are three examples. First, Arizona used to apply different valuation methods to the property of in-state telecommunications companies on the one hand and out-of-state telecommunications companies on the other hand. This practice was invalidated under Arizona's Uniformity Clause. *Citizens Telecomm. Co. v. Arizona Dep't of Revenue*, 75 P.3d 123 (Ariz. Ct. App. 2003).

Second, in New Hampshire, residential homeowners were granted a property tax exemption but only if the remaining value of their properties exceeded a stated dollar amount after taking the exemption into account. This arrangement was invalidated under the state's Uniformity Clause because it disproportionately benefited wealthy homeowners. *Felder v. City of Portsmouth*, 324 A.2d 708 (N.H. 1974).

Third, a Nebraska statute exempted certain agricultural properties from taxation despite the fact that no such exemption appeared in the state's constitution. Since the exemption prevented the imposition of taxes "uniformly and proportionately upon all tangible property," it was invalidated as contrary to the constitution's Uniformity Clause. *MAPCO Ammonia Pipeline, Inc. v. State Bd. of Equalization & Assessment*, 471 N.W.2d 734, 747 (Neb. 1991) (quoting Neb. Const. art. VIII, § 1).

Key Questions

The reach and rigor of state Uniformity Clause provisions vary greatly from state to state. The attorney representing a taxpayer cannot uncritically rely on precedents from different jurisdictions. The attorney must carefully analyze how a particular Uniformity Clause is worded and how it has been interpreted by that state's courts.

Here are five questions to probe in determining the extent to which a given state's Uniformity Clause may be helpful to the taxpayer: (1) To which types of taxes does the Uniformity Clause apply? (2) Has the Uniformity Clause been interpreted as essentially congruent to federal and/or state Equal Protection Clauses, or has it been interpreted as being broader than them? (3) Does the Uniformity Clause permit classification of property, and, if so, to what extent? (4) Does the tradition of interpretation of the Uniformity Clause in the state emphasize form or substance? and (5) What degree of deviation from absolute equality have the state courts permitted? These questions are amplified below.

Type of Tax Covered

All Uniformity Clauses cover real property taxes while many reach personal property taxes and some apply also to other types of taxes or to all taxes levied in the state. *See, e.g.*, Me. Const. art IX, § 8; W. Va. Const. art. X, § 1; Kan. Const. art. 11, § 1; Nev. Const. art. 10, § 1.

The ambit of the Uniformity Clause at issue may lead to issues of categorization. For example, a frequently litigated issue is whether the given exaction is a fee (not covered by uniformity requirements) or a covered tax. *Compare City of Fairmont v. Pitrolo Pontiac-Cadillac Co.*, 308 S.E.2d 527 (W. Va. 1983) (holding that a so-called fire service fee was really an ad valorem property tax subject to the Uniformity Clause), *cert denied*, 466 U.S. 958 (1984), *with Wetzel County Solid Waste Auth. v. West Va. Div. of Natural Res.*, 462 S.E.2d 349 (W. Va. 1995) (holding that a solid waste assessment was a regulatory fee, not a tax). Similarly, there are fairly extensive lines of cases as to the categorizations of property tax versus excise tax, *e.g., City of Huntington Beach v. Superior Court*, 144 Cal. Rptr. 236 (Cal. Ct. App. 1978), and property tax versus income tax, *e.g., Featherstone v. Norman*, 153 S.E. 58 (Ga. 1930).

Same as or Broader than Equal Protection Clauses

The Equal Protection Clause of the Fourteenth Amendment to the federal Constitution applies to state and local taxes, and similar state constitutional Equal Protection Clauses are common. Except when suspect classifications, infringement on fundamental interests, or gender classifications trigger strict or intermediate scrutiny, equal protection challenges to state or local taxes are analyzed under the highly deferential "rational basis" standard of review. *See, e.g., Nordlinger v. Hahn*, 505 U.S. 1 (1992).

In some states, Uniformity Clause protections are essentially congruent

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with Equal Protection Clause safeguards. *E.g., Matter of McCannel*, 301 N.W.2d 910, 916 n.4 (Minn. 1980). In these states, a Uniformity Clause challenge would be largely duplicative of an Equal Protection Clause challenge.

However, in other states, the Uniformity Clause is construed as imposing "more stringent limitations than the equal protection clause on the legislature's authority to classify the subjects and objects of taxation ...." *Sun Life Assurance Co. of Can. v. Manna*, 858 N.E.2d 503, 512 (Ill. App. Ct. 2006). In these states, the Uniformity Clause can be the difference between winning and losing. *E.g., State ex rel. LaFollette v. Torphy*, 270 N.W.2d 187, 192-93 (Wis. 1978) (rejecting an equal protection challenge, but upholding a uniformity challenge to a state tax credit).

Degree of Permitted Classification

Some state constitutions declare, with few or no exceptions, that "taxation shall be equal and uniform throughout the State." WASH. CONST. art. VII, § 1. In many other states, however, classification is permitted to a greater or lesser degree. Sometimes, permitted classifications are set out in the constitution itself; other times the legislature is given classification authority. Legislative classifications typically are accorded considerable deference and are upheld as long as some rational basis for them can be discerned or even imagined. *See, e.g., Miller Brewing Co. v. State*, 284 N.W.2d 353, 356 (Minn. 1979) (setting out elements of constitutionally permissible classifications).

For example, a Minnesota statute separated residential rental properties of three or fewer units into one class for property tax purposes and residential rental properties of four or more units into a different class. The two classes were taxed at different rates. The Minnesota Supreme Court rejected a uniformity challenge to this scheme. It found a rational basis for the classification because of the "differences in size, management, ownership, markets, and appraisal approaches" between the classes. *Hegenes v. State*, 328 N.W.2d 719, 721 (Minn. 1983).

The federal Railroad Revitalization and Regulatory Reform Act of 1976 ("the Act"), Pub. L. No. 94-210, 90 Stat. 31 (codified as amended at 49 U.S.C. § 11501), limits state and local taxation of railroads and airlines. One line of classification cases involves state responses to the Act. Some states have honored the federal requirements as to railroads and airlines but have taxed other types of transportation and related property less favorably. Nebraska's Uniformity Clause does not permit such classification, so the Nebraska courts invalidated the differential. *Northern Natural Gas Co. v. State Bd. of Equalization & Assessment*, 443 N.W.2d 249 (Neb. 1989), *cert denied*, 493 U.S. 1078 (1990), *overruled on other grounds, MAPCO Ammonia Pipeline, Inc. v. State Bd. of Equalization*, 471 N.W.2d 734 (Neb. 1991). In states permitting classification, however, such disparate treatment has been sustained, with the force of the Act providing the rational basis for the disparity. *E.g., Williams Natural Gas Co. v. State Bd. of Equalization*, 891 P.2d 1219 (Okla. 1994) (citing cases from Alabama, Kansas, and Tennessee), *cert. denied sub nom. ANR Pipeline Co. v. Oklahoma Bd. of Equalization*, 516 U.S. 816 (1995).

Substance Versus Form

The familiar rule that substance controls over form usually applies in uniformity litigation. However, interpretational differences exist among the states in this regard. One area in which such differences have emerged involves credits. For example, in South Carolina, proceeds of a local option sales tax funded a property tax credit in some areas of the state. The Uniformity Clause was held not to apply because the feature was viewed as the distribution of state revenue through spending rather than the raising of state revenue through taxation. *Westvaco Corp. v. South Carolina Dep't of Revenue*, 467 S.E.2d 739, 741 (S.C. 1995).

In contrast, a Wisconsin statute provided tax credits to certain property owners. The credits were paid from general state revenues. The state defended the arrangement on the same ground that succeeded in the South Carolina case above. The Wisconsin Supreme Court, however, rejected the argument and invalidated the provision. The court observed: "It is the effect of the statute, not the form, which determines whether it is a tax statute subject to the uniformity clause. . . . The fact that a rebate credit is paid to certain property owners and not to others leads to the indisputable conclusion that taxpayers owning equally valuable property will ultimately be paying disproportionate amounts of real estate taxes. This is not uniformity." *Torphy*, 270 N.W.2d at 192-93.

Permitted Degree of Deviation

"[P]erfect uniformity is not possible since property values fluctuate continuously, and far more frequently than taxing authorities could conceivably perform county-wide reassessments." *Hromisin v. Board of Assessment Appeals*, 719 A.2d 815, 818 (Pa. Commw. Ct. 1998), *appeal denied*, 737 A.2d 1227 (Pa. 1999).

Courts in the various states differ in the degree to which they view disparities as inevitable and, therefore, constitutionally acceptable. In general, temporary discrepancies in treatment are permitted when the state or locality has a program of revaluation which is carried out "in an orderly manner and pursuant to a regular plan, and . . . not done in an arbitrary, capricious or intentionally discriminatory manner ...." *Sator v. State Dep't of Revenue*, 572 P.2d 1094, 1097 (Wash. 1977). *See also Recanzone v. Nevada Tax Comm'n*, 550 P.2d 401 (Nev. 1976). ■

Proposed S Corporation Regulations Close to Final

By Michael L. Griffin*

The American Jobs Creation Act of 2004 (the "2004 Act") and the Gulf Opportunity Zone Act of 2005 (the "2005 Act") made several changes to sections 1361, 1362, and 1366. To implement and interpret these provisions of the 2004 Act and 2005 Act, the Service published proposed S corporation regulations on September 28, 2007. 72 Fed. Reg. 55132. According to a Service representative associated with the proposed regulations (and whom this author contacted), the Service received no written comments on these proposed regulations. Because there were no requests to speak at the public hearing scheduled for January 16, 2008, the Service cancelled the public hearing. 73 Fed. Reg. 1131 (2008).

Given this sequence of events, it seems unlikely that any significant changes will be made before publication in final form. And given that these regulations are listed on the Service's business plan for the period ending June 30, 2008, we might soon expect to see these proposed regulations published in final form. Therefore, this is an appropriate time to discuss what the proposed regulations provide.

Members of a Family

The 2004 Act and the 2005 Act both addressed issues related to "members of a family." The 2004 Act amended section 1361(c) to provide for counting a "common ancestor" and lineal descendants as one shareholder for purposes of the new 100-shareholder limit under section 1361(b)(1)(A). The 2005 Act made aggregation automatic by eliminating a requirement of the 2004 Act to make an election to be treated as "members of a family." In making this change, the 2005 Act provided an "applicable date" on which treatment as a "common ancestor" would be determined. Identification as a "common ancestor" depends upon being no more than six generations removed from the youngest generation of shareholders who would be included as "members of a family." I.R.C. § 1361(c)(1)(B)(ii). The statute does not require the "common ancestor" to have owned stock or even be alive on the "applicable date." No chain of ownership is required.

Because of the six-generation test, on the "applicable date" treatment as "members of a family" is limited to the identified "common ancestor" and the six lineal generations descending from that common ancestor (as well as spouses or former spouses of the common ancestor and lineal descendents, adopted children, and certain foster children). I.R.C. §§ 1361(c)(1)(B)(ii) and 1361(c)(1)(C). Under section 1361(c)(1)(B)(iii), the "applicable date" is the latest of (I) the date the S election is made, (II) the earliest date an individual who is a "member of a family" holds stock in the S corporation, or (III) October 22, 2004.

Proposed section 1.1361-1(e) incorporates the "members of a family" provisions presented in section 1361(c)(1). Of critical importance to S corporations with large numbers of family shareholders, the proposed regulation makes clear that the six-generation test applies only at the "applicable date" and does not later limit treatment as "members of a family" for future generations: "The test is only applied as of the applicable date, and lineal descendents (and spouses) more than six generations removed from the common ancestor will be treated as members of the family even if they acquire stock in the corporation after that date." Prop. Reg. § 1.1361-1(e)(3)(i).

Proposed section 1.1361-1(e) further provides that "members of a family" treatment applies to each person who individually would qualify as a "member of a family" and who also is either a "potential current beneficiary" under an electing small business trust ("ESBT"), the income beneficiary of a qualified subchapter S trust ("QSST"), a beneficiary of a voting trust, a deemed owner of a grantor trust, or an owner of a disregarded entity. Additionally, an estate of a deceased "member of a family" will be considered a "member of a family" during the period in which the estate holds stock in the S corporation.

Further, trusts described in section 1361(c)(2)(A)(ii) and (iii) will be considered "members of a family" during the period in which such trusts hold stock in the S corporation.

It is also worth noting that proposed section 1.1361-1(e)(3)(i) states: "Although a person may be a member of more than one family under this paragraph (e)(3), each family (not all of whose members are also members of the other family) will be treated as one shareholder."

Proposed section 1.1361-1(h)(1)(vii), regarding individual retirement account owners of stock in S corporation bank and depository institution holding companies, incorporates the requirements of section 1361(c)(2)(A)(vi).

ESBTS and Powers of Appointment

The 2004 Act amended section 1361(e)(2) to state that unexercised powers of appointment will be disregarded in determining an ESBT's potential current beneficiaries for any period.

In its current form, section 1.1361-1(m)(4)(vi) conflicts with section

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1361(e)(2) as amended. Under current section 1.1361-1(m)(4)(vi), each potential recipient under a power of appointment is treated as a "potential current beneficiary." This means that a general power of appointment, or even a broad special power of appointment, can result in a number of "potential current beneficiaries" exceeding the 100-shareholder limit.

Under proposed section 1.1361-1(m)(4)(vi)(A), a person is not treated as a "potential current beneficiary" under a power of appointment unless the power is exercised in favor of that person during the period under consideration. Under proposed section 1.1361-1(m)(4)(vi)(B), a class of charitable organizations permitted to own S corporation stock under section 1361(c)(6) is counted as a single "potential current beneficiary" under a power of distribution other than a power of appointment. However, when specific charities are named in the instrument as beneficiaries of a power of distribution other than a power of appointment, each such charity is counted as a "potential current beneficiary." Examples illustrating application of these rules are found at proposed section 1.1361-1(m)(8).

The 2004 Act also extended, to a full year from what had formerly been 60 days, the period during which an ESBT may dispose of S corporation stock after an ineligible shareholder becomes a "potential current beneficiary." I.R.C. § 1361(e)(2). Proposed section 1.1361-1(m)(4)(iii) incorporates this statutory amendment.

Stock Transfers Between Spouses or Incident to Divorce

The 2004 Act amended section 1366(d) to allow transfer of losses or deductions limited by the basis limitation of section 1366(d)(1) to be treated as incurred by the corporation in the succeeding tax year with regard to a transferee spouse, including a divorcing spouse to whom section 1041(a) applies. Proposed section 1.1366-2(a)(5) incorporates this statutory amendment and provides detailed examples.

At Risk and Passive Activity Loss Limitations

The 2004 Act amended section 1361(d)(1) to treat S corporation stock disposed of by a QSST as, instead, disposed of by the QSST beneficiary for purposes of sections 465 and 469. Proposed section 1.1361-1(j)(8) incorporates this statutory amendment.

QSSS Relief for Inadvertent Invalid Elections or Terminations

The 2004 Act amended section 1362(f) to provide that a qualified subchapter S subsidiary ("QSSS") is eligible for relief from inadvertent invalid elections or terminations on the same basis as such relief is available to S corporations. Proposed section 1.1362-4 incorporates this statutory amendment.

Increasing Number of Permitted Shareholders

The 2004 Act increased the number of permitted shareholders of an S corporation from 75 to 100. Proposed section 1.1361-1(b)(1)(i) would eliminate reference to 75 as the maximum number of permitted shareholders and would replace it with a simple reference to the statute imposing the limit. This is a wise move in light of this limit's history of periodic increases.

Effective Date

The proposed regulations would be effective on the date of publication in the Federal Register of the Treasury Decision adopting the regulations as final.

Conclusion

While several matters addressed in these proposed regulations merely incorporate statutory amendments made by the 2004 Act and the 2005 Act, the proposed regulations go further. Important additions include clarification on application of the six-generation rule, entity ownership, and membership in multiple families, all under the "members of a family" provision. Of importance to practitioners working with ESBTs and providing estate planning services, the proposed regulations give specific guidance on treatment of powers of appointment and offer detailed examples.

Because the Service received no comments regarding the proposed regulations, practitioners should expect to see these regulations finalized soon. ■

Swallows Holding Update

By Kathryn Morrison Sneade*

Recently, the Third Circuit reversed the Tax Court's 2006 decision in *Swallows Holding v. Commissioner*, and upheld the validity of Treasury Regulations promulgated under section 882 that require a foreign corporation to file timely returns to receive the benefit of deductions otherwise allowed. *See Swallows Holding Ltd. v. Commissioner*, 515 F.3d 162 (3d Cir. Feb. 15, 2008), *rev'g* 126 T.C. 96 (2006). The Service victory was not unexpected—the dissenting judges in *Swallows Holding* offered a more satisfying explanation of the law than the majority did, as I noted in a previous Point to Remember on this topic. *See* Kathryn J. Morrison, *Are Timely Filed Returns a Prerequisite for Foreign Corporation Expense Deductions*, 25 ABA Section of Taxation Newsquarterly 13 (Summer 2006).

The Tax Court, relying mainly on the analysis set forth by the Supreme Court in *National Muffler Dealers Association v. United States*, 440 U.S. 472 (1979), held that the regulations under section 882 were invalid to the extent that they imposed a timing requirement. The majority of the Tax Court, which took the position that a plain reading of section 882 showed that the statute included no timely filing requirement, noted that the result would be the same under a *Chevron* analysis. *In Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984), the Supreme Court applied a two-prong analysis to determine the validity of agency regulations: (1) if the statutory language is clear and unambiguous, the agency must give effect to the unambiguously expressed intent of Congress; and (2) if the statutory language is ambiguous, the agency may "fill the gap" with a reasonable regulation.

The dissenting Tax Court judges disagreed with the majority's conclusion that the statute unambiguously precludes the imposition of a timing requirement, and took the position that the regulations reasonably filled a gap in the statute and therefore were valid under *Chevron*. Unlike the majority's decision, the dissent's decision was consistent with cases decided by the Board of Tax Appeals and the Fourth Circuit, which imposed limitations on taxpayers' ability to claim deductions based on delinquent returns. *See, e.g., Taylor Securities v. Commissioner*, 40 B.T.A. 696 (1939). In 2006, I predicted that circuit courts reviewing the regulations might choose to adopt this approach. The Third Circuit, in reversing the Tax Court's decision, has done just that, holding that the regulations at issue reasonably interpret an ambiguous statute and are therefore valid. ■

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