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Adams Challenge's Challenge to the Disallowance of Deductions Against ECI

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Folks who practice international tax on the ''inbound'' side of things are no doubt familiar with Internal Revenue Code §882(c) and, in particular, paragraphs (1) and (2) and the regulations thereunder. These are the statutory and regulatory provisions that govern the extent to which a foreign corporation with income effectively connected with the conduct of a U.S. trade or business (''ECI'') may take deductions against that income.

In *Adams Challenge*,[1] the taxpayer did not comply with the statutory requirements, according to the Tax Court, and, therefore, the taxpayer lost the benefit of its offsetting deductions. Moreover, the court said, the U.S.-U.K. income tax treaty did not change this result.

Adams Challenge, a U.K. company, chartered a vessel to a U.S. company to decommission oil and gas on the U.S. Outer Continental Shelf in return for charter income. An earlier Tax Court decision[2] held that the taxpayer was engaged in a U.S. trade or business and that its charter income was ECI.

The specific years in issue were 2009 and 2010, with respect to which Adams Challenge had not, at least initially, filed U.S. tax returns to report the ECI (and to benefit from allowance of its deductions against its ECI). As it turned out, the IRS, in 2014, prepared and subscribed tax returns for the taxpayer under the authority of §6020(b) for each of those years and issued a notice of deficiency determining that Adams Challenge was not entitled to take deductions because it failed to file returns. Subsequent to filing its response, Adams Challenge, in 2017, submitted protective returns for each of those years.

At issue in the case was §882(c), the regulations thereunder and the U.S.-U.K. tax treaty. Section 882(c)(1) provides that deductions are allowed only if they are properly allocated and apportioned to a foreign corporation's gross income that is ECI. Section 882(c)(2) provides, however, that the deductions will be allowed only if a true and accurate tax return is filed by the foreign corporation in the manner prescribed in Subtitle F. Notice that the statute makes no reference to a ''timely'' filing, although Reg. §1.882-4(a)(3)(i) provides a ''timeliness'' requirement, generally speaking, 18 months after the due date otherwise prescribed for the filing of a corporate tax return.

Adams Challenge, citing the *Swallows* case,[3] argued that because the statute, i.e., §882(c)(2), did not impose a ''timely'' requirement, the regulations which did impose a ''timely'' requirement were invalid and that, therefore, Adams Challenge's filing (even in 2017) was enough to allow it to deduct the expenses against its ECI.

While the court observed that, on appeal, *Swallows* held the regulations to be valid under the *Chevron*[4] tests affording the IRS a reasonable exercise of its authority, the court noted that it need not even decide the regulation's authority in light of the ''terminal date'' rule of the statute itself.

If you're looking for the ''terminal date'' language in §882(c)(2), you won't find it. The court, however,

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[1] 156 T.C. No. 2 (2021).

[2] *Adams Challenge (UK) Ltd. v. Commissioner*, 154 T.C. 37 (2020).

[3] *Swallows Holding Ltd. v. Commissioner*, 126 T.C. (2006), *vac'd and rem'd*, 515 F.3d 162 (5th Cir. 2008).

[4] 467 U.S. 837 (1984).

devoted much time and energy to the historical evolution of §882(c)(2), as well as the associated case law development, and determined that §882(c)(2) has a built-in terminal date rule. The ''terminal date,'' after which submitted returns would be deemed late for purposes of §882(c)(2), is the date by which the IRS exercises its authority under §6020(b) to subscribe and prepare tax returns for the taxpayer. Thus, the court determined that a return filing after the IRS files the tax return on behalf of the taxpayer is too late, citing the *Blenheim*[5] case, amongst others.

The more interesting aspect of the case is the Tax Court's treatment of Adams Challenge's treaty arguments. The taxpayer argued that the statutory requirement of filing by a so-called ''terminal date'' in order to secure deductions, conflicted with two provisions of the U.S.-U.K. treaty, in particular, Article 7 (''Business Profits'') and Article 25 (''Nondiscrimination'').

With respect to the business profits article, the taxpayer argued that the treaty provides for the deduction of all expenses ''incurred for purposes of the permanent establishment'' maintained by the taxpayer without any reference to ''timeliness'' or any other requirements for that matter.

The court might have agreed with Adams Challenge if it felt that there was a conflict between the statute and the treaty provision. However, it did not see any such conflict. The court found that the tax provisions (Article 7 and §882(c)(2)) were perfectly compatible in the sense that §882(c)(2) merely provided for the required administrative steps to be taken when claiming the deductions as allowed by both the treaty and the statute. The treaty did not immunize the taxpayer from having to meet the filing deadlines, according to the court, and these administrative requirements are not inconsistent with the treaty. Bottom line, says the court: since there is no conflict, the court can give effect to each of the provisions.

As to the nondiscrimination article, Adams Challenge argued that the §882(c)(2) requirement to file timely, i.e., before the IRS prepares and subscribes a return on behalf of the taxpayer (the ''terminal date''), violates the nondiscrimination article in that it provides for more burdensome requirements with respect to a foreign corporation than for a domestic corporation.

The court disagreed, stating that, while it is true that domestic corporations do not forfeit deductions in the case of a late filing, §882(c)(2), in fact, provides for a greater time period within which a foreign corporation may file returns in order to obtain the benefit of deductions. Moreover, the court stated that a foreign corporation could always file a protective return as sanctioned by the regulations.

Reasonable people can differ as to whether the treaty articles are in conflict with the statute, but it is clear that the Tax Court believed that there was no conflict — that the treaty provisions and the statute were compatible, each of which would be given effect.

[5] *Blenheim Co. v. Commissioner*, 125 F.2d 906 (4th Cir. 1942).

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