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Forfeiture of Deductions for Failure to File Timely Return: *Swallows Holding, Ltd. v. Commissioner*

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A foreign corporation that is engaged in a trade or business within the United States must file a return "in the manner prescribed by subtitle F" of the Internal Revenue Code of 1986 ("IRC") in order to receive the benefit of deductions relating to such business.[1] If the corporation fails to file such a return, it is effectively subject to tax at full statutory rates on its gross business income.[2]

Although an essentially identical provision has been a part of the tax law for many years, it is not clear from the text of the statutory provision whether a foreign corporation's return must be filed on a timely basis in order for the corporation to obtain the benefit of deductions. The IRS has taken the position on audit that a timely return is required and disallowed foreign corporations' deductions by reason of their failure to file returns on a timely basis, but such disallowances were long ago rejected in decisions of the Board of Tax Appeals and the Court of Appeals for the Fourth Circuit.[3] Under these decisions, deductions could be claimed even if the foreign corporation's return was filed as late as the time at which the IRS set about to prepare a Federal income tax return on behalf of the corporation (as is authorized by the IRC with respect to any person that fails to file a required return, but frequently occurs quite late in the audit process).

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In an effort to make the statutory requirement of return filing more meaningful, Treasury Regulations were issued in 1990 requiring that a return be filed by a foreign corporation within a specified period, generally within 18 months after the due date of the return, in order to preserve the availability of deductions.[4] However, the Tax Court, in *Swallows Holding, Ltd. v. Commissioner*, 126 T.C. 96 (2006), held that the regulation was invalid insofar as it required a more timely filing that had been permitted under the old cases.

On appeal by the government, the Court of Appeals for the Third Circuit recently overturned the Tax Court decision and upheld the validity of the timely filing requirement as imposed by the regulation.

Facts in Swallows Holding

Swallows Holding, Ltd. (the "corporation") was incorporated under the laws of Barbados in June, 1991 by Raimundo Arnaiz-Rosas ("Rosas"), a citizen and resident of Mexico who was initially the sole shareholder of the corporation. Rosas transferred vacant land in San Diego, California, to the corporation later in the same year. In 1992, additional shares of stock of the corporation were issued to Rosas's sister, also a citizen and resident of Mexico.

In September, 1992, the corporation filed a Form 1120-F prepared by its accountant for an initial taxable year beginning with the month of incorporation and ending on May 31, 1992. That return reported that the corporation had no income or expenses and that it had not engaged in a trade or business in the United States.

The land remained unimproved throughout the taxable years in issue, ended May 31, 1994, 1995, and 1996, and no income tax returns were at first filed for those years. However, during those years the corporation received rents from the use of a portion of the property by an apparently unrelated lessee as a skydiving landing zone. In addition, payments were made to the corporation by reason of an option held by another person to purchase a portion of the property. During each of the years at issue, expenses incurred by the corporation for real property taxes payable to the County of San Diego and for franchise taxes payable to the State of California, and other fees, exceeded the revenues of the corporation.

In 1999, and apparently before any inquiry from the IRS to the corporation as to returns not filed, the accountant that prepared the Federal income tax return for the corporation's initial period advised the corporation that returns had to be filed by the corporation for each of fiscal years 1993 through 1996. Returns were filed shortly thereafter for those years showing, with respect to each of

1994, 1995, and 1996, a taxable loss effectively connected with the conduct of a trade or business in the U.S.[5]

Thereafter, the IRS issued a notice of deficiency disallowing all of the deductions claimed on the returns for the years at issue, and recomputed the corporate tax for each year by application of the regular corporate income tax rates to the corporation's gross income. The rationale for this disallowance was that none of the returns had been filed within the period required by the 1990 Regulations.

Decision of Tax Court

The corporation argued to the Tax Court that the regulation issued in 1990 under IRC § 882, in requiring that returns be filed, generally, within 18 months after the regular due date (which would, in turn, be 5-1/2 months after the end of the taxable year of the foreign corporation), was invalid. More specifically, the corporation argued, and the Tax Court agreed, that the determination of whether or not the regulation was a valid exercise of the Treasury's rule-making authority should be determined primarily on the basis of the various factors discussed in *National Muffler Dealers Association v. United States*, 440 U.S. 471 (1979), a Supreme Court case in which the judicial deference to be granted to an administrative interpretation (by regulation) of another provision of the Code was at issue.

The Tax Court concluded in *Swallows* (albeit with several judges dissenting) that the requirement in the regulation that a return be filed by a particular date, as a condition to allowance of deductions, was invalid. The factors relied upon in reaching this conclusion included: that the statute itself did not refer at all to regulating the time of filing, but rather only the manner of filing; that the regulation on which the IRS was relying was not issued substantially contemporaneously with the enactment of the statute, and came after several cases had interpreted the statute as not imposing a requirement of timely filing as a prerequisite to the allowance of deductions; and that the statutory provision had been reenacted by Congress on several occasions in substantially identical form after various courts had concluded that the statute there was no such "timely filed" requirement, without any effort by Congress to change the result indicated by these cases (sometimes referred to as the "legislative re-enactment" doctrine).

The Tax Court further concluded that the standard for testing the validity of a regulation, as established in *National Muffler*, had not been superseded by *Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984), a non-tax case concerning the validity of an administrative interpretation by the EPA of environmental legislation; and that the result under either the *National Muffler* or *Chevron* standard would be the same in the *Swallows* context.

Reversal by Third Circuit

On appeal, however, the Court of Appeals for the Third Circuit concluded that the standard for testing the validity of a regulation had been substantially changed by *Chevron*. The Third Circuit decision describes *Chevron* as calling for a two-step analysis. In the first step, it must be determined whether the regulation "give[s] effect to the unambiguously expressed intent of Congress." Where the language of the statute does not unambiguously address the precise question at issue, however, the court must give effect to the regulation so long as the regulation "is based on a permissible construction of the statute," which will turn on a determination (in the second step of the analysis) as to whether the regulation implements the Congressional intent in a reasonable manner. Whether the court would, absent the regulation, have interpreted the statute in a different manner, is not controlling.

Having phrased the required analysis in this manner, the Court of Appeals had little difficulty in concluding that IRC § 882(c) was ambiguous as to whether the IRS could require a timely filing of a return as a prerequisite to the allowance of deductions. The court then concluded that the solution reflected in the regulation promulgated in 1990, which essentially provides a foreign corporate taxpayer, in order for it to avoid a forfeiture of deductions, with an 18-month grace period, in addition to the normal filing period for a foreign corporation of 5-1/2 months after year-end, was a reasonable interpretation of the statutory directive that the return be filed in the manner prescribed and was within the power of the IRS to make reasonable judgments in the interests of preserving its ability to administer the tax system as it relates to foreign taxpayers in particular.

Turning to the Tax Court's reliance on the legislative re-enactment doctrine, the Court of Appeals also concluded, in a footnote, that the repeated enactment of the provision in substantially identical form on several occasions deserved little or no weight, because there was no evidence that the interpretation of the statute by the IRS on this point in various audit and litigation contexts (as requiring a timely filing) and the judicial response to this interpretation had been brought to the attention of Congress and focused upon in connection with the reenactment of the provision.

Observations

The regulation upheld by the Court of Appeals in *Swallows* does not require that the deductions of a foreign corporation engaged (or treated as engaged) in a U.S. trade or business that has failed to file a return within the prescribed period be forfeited in all instances. Rather, the regulation permits the Commissioner to waive the filing deadline if it is established to the satisfaction of the Commissioner that the taxpayer acted reasonably and in good faith.

The factors to be weighed by the Commissioner in determining whether the corporation acted reasonably and in good faith are enumerated in the regulation as including: whether the corporation identified itself as having failed to file returns as required, before discovery by the IRS; whether the corporation had previously filed a U.S. income tax return; and whether the failure to file a return was because of intervening

events beyond the corporation's control.

Of course, it is far better, as a planning matter, to avoid the risk of loss of deductions by filing returns as and when required, rather than to hope for administrative relief. Thus, the case underscores the need for U.S. advisors to a foreign corporation engaged or deemed engaged in a U.S. trade or business, even a corporation that regularly incurs losses and appears to have no U.S. tax liability, to be alert to the requirement that the corporation timely file U.S. returns, at least in part so as to preserve deductions that may otherwise be lost.

It should also be kept in mind that a foreign corporation that is uncertain as to whether or not it is engaged in a trade or business in the U.S. may file a protective return, without being precluded from taking the position that the corporation is not engaged in a trade or business in the U.S., thereby allowing the corporation to obtain the benefits of its deductions in the event that it is ultimately determined that the corporation was, in fact, engaged in a U.S. trade or business.

Beyond the relatively narrow deduction disallowance issue addressed by *Swallows*, the decision by the Court of Appeals may be indicative of a trend in Federal administrative law of granting further deference to administrative interpretations of legislation by Governmental agencies, at least where the interpretations are duly promulgated in the form of regulations.

More specifically, *Swallows* is consistent with a perception that the Tax Court, which addresses tax matters exclusively, is less inclined to defer to the tax expertise of the Internal Revenue Service and Treasury than the Courts of Appeals. The appellate courts spend much less time than the Tax Court on tax issues, but frequently deal with matters of administrative law not limited to the tax arena, and they may thus be more sensitive than the Tax Court to the trend in administrative law, as evidenced by *Chevron* and its progeny, of greater deference to the Executive Branch in interpretive matters.

Assuming that there is any merit to these perceptions of trends with respect to administrative law and greater deference to interpretive regulations in particular, only time will tell as to whether the trend of increasing deference to administrative interpretation will continue or be reversed in the future.

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1 IRC § 882(c)(2). A similar rule applies to credits.

2 Foreign corporations are also subject to Federal income tax on certain United States source income that is not effectively connected with the conduct of a trade or business in the United States, without reduction for related deductions or credits, but at a reduced rate. In the case of business income, the inability to claim deductions can, in certain cases, result in an effective tax rate well in excess of 100% of net income.

3 See, e.g., *Ardbern Co. v. Commissioner*, 120 F.2d 424 (4th Cir. 1941); *Anglo-American Direct Tea Trading Co. v. Commissioner*, 38 B.T.A. 711 (1938); and *American Investment and General Trust Co. v. Commissioner*, BTA Memo 1939-151 (1939).

4 T.D. 8322 (Dec. 11, 1990); Treas. Reg. § 1.882-4(a)(3)(i). In the case of returns filed after the due date, but within the 18-month period, deductions would be allowed, but penalties for late filing could still be imposed.

5 The mere rental of unimproved property that was held for investment and rented on a net lease basis (with the lessee being responsible for maintenance costs, utilities, license fees, and other costs associated with the use of the property) would not normally constitute a trade or business, and the returns did not include a statement to the effect that the corporation was electing under IRC § 882(d) to be treated as if it was engaged in a U.S. trade or business. However, the IRS treated the returns, with the acquiescence of the corporation, as making such an election. (Absent such an election, there would have been no U.S. trade or business, the corporation would have been taxable on its United States source gross rental income, and the deductions claimed on the returns would not have been allowable.)

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