Comment

PROCTER & GAMBLE CO. v. COMMISSIONER: SHOULD FOREIGN LAW CONTROL U.S. TAX LIABILITY OF U.S. SHAREHOLDERS?

I. INTRODUCTION

In *Procter & Gamble Co. v. Commissioner*,[1] the United States Tax Court held that the Internal Revenue Service (IRS) was powerless to allocate income among controlled[2] foreign taxpayers, pursuant to section 482 of the Internal Revenue Code (IRC), where foreign law effectively precluded the payment of the income that the IRS sought to allocate.[3] The Tax Court based its holding on *Commissioner v. First Security Bank of Utah*,[4] in which the United States Supreme Court held that the Commissioner cannot make a section 482 allocation when a law prohibits the taxpayer's receipt of the income sought to be allocated.[5]

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1. 95 T.C. 323 (1990).

2. The IRS defines the term "controlled" as any "kind of control, direct or indirect, whether legally enforceable, and however exercisable or exercised. It is the reality of the control which is decisive, not its form or the mode of its exercise. A presumption of control arises if income or deductions have been arbitrarily shifted." Treas. Reg. § 1.482-1(a)(3) (1986).

3. Unless otherwise stipulated, all statutory references are to the Internal Revenue Code of 1988. As originally drafted, § 482 of the Internal Revenue Code of 1954 stated:

> In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) 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.

I.R.C. § 482 (1954). The Tax Reform Act of 1986 added the following sentence to § 482: "In the case of any transfer (or license) of intangible property (within the meaning of § 936(h)(3)(B)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible." Tax Reform Act of 1986, Pub. L. No. 99-514, § 1231(e)(1), 100 Stat. 2085, 2562-63 (1986).

4. 405 U.S. 394 (1972).

5. *See infra* text accompanying notes 86-109 (discussing the Court's holding in *First Security*).

Procter & Gamble AG (AG), a Swiss corporation wholly owned by the Procter & Gamble Company (P&G), owned 100% of Espana, a corporation organized in Spain.[6] During the years at issue,[7] Spanish law precluded Espana from making royalty payments to AG. The IRS allocated income from Espana to AG pursuant to section 482 in order to clearly reflect the income of AG.[8] This allocation increased P&G's Subpart F[9] income under section 951 for the tax years 1978 and 1979.[10]

On September 18, 1990, the Tax Court held that the Commissioner was not warranted in making the section 482 allocation because Spanish law prohibited Espana from making royalty payments to AG, thereby blocking AG's receipt of the income.[11] The IRS filed a motion for reconsideration on October 18, 1990, arguing that foreign law should be immaterial with respect to the application of section 482.[12] Relying on *First Security*, the Tax Court rejected the IRS's argument and denied the motion for reconsideration.[13]

This comment will discuss the evolution and application of section 482. Specifically, the Tax Court's decision in *Procter & Gamble Co. v. Commissioner* will be analyzed, with a focus on the ramifications of the decision. This author concludes that the Tax Court erred in two ways. First, the Tax Court compounded the Supreme Court's mistake in *First Security* by perpetuating the fallacy that application of section 482 is contingent upon the taxpayer's ability to receive the income in question. Second, and of paramount concern, by

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6. *Procter & Gamble*, 95 T.C. at 324.

7. The years at issue were 1978 and 1979. *Id.* at 330.

8. *Id.* at 330-31. The Treasury Regulations define "true taxable income," with regard to a controlled taxpayer, as

> the taxable income (or, as the case may be, any item or element affecting taxable income) which would have resulted to the controlled taxpayer, had it in the conduct of its affairs (or, as the case may be, in a particular contract, transaction, arrangement, or other act) dealt with the other member or members of the group at arm's length.

Treas. Reg. § 1.482-1(a)(6) (1986).

9. *See infra* notes 38-46 and accompanying text (discussing Subpart F). Subpart F, entitled Controlled Foreign Corporations, encompasses §§ 951-964 of the IRC. I.R.C. §§ 951-964 (1988 & Supp. 1989). It imposes a tax on U.S. shareholders that receive specified classes of income and conduct specified types of operations. *Id.*

10. *Procter & Gamble*, 95 T.C. at 330.

11. *Id.* at 323 (relying on Commissioner v. First Security Bank of Utah, 405 U.S. 394 (1972)).

12. Procter & Gamble Co. v. Commissioner, 60 T.C.M. (CCH) 1463 (1990).

13. *Id.* at 1466.

extending *First Security*'s holding into the international arena, the Tax Court has improperly ceded U.S. taxing authority to foreign nations.

II. BACKGROUND

A basic principle of U.S. tax law states that income is taxable to the person who earns it, regardless of anticipatory agreements or arrangements intended to relieve the earner of taxable income and make the income taxable to another.[14] This premise holds equally true when the taxpayer is a U.S. corporation that owns all of the stock in a foreign subsidiary.[15] The corporation's status as a legal person places U.S. corporations within the purview of U.S. taxation.[16] A foreign corporation, however, although wholly owned by an American parent, may be beyond the reach of U.S. taxation. This is because the foreign corporation is a separate corporate entity governed by foreign law.[17]

Section 482 of the IRC authorizes the Commissioner to allocate gross income, deductions, credits, or allowances among two or more organizations, trades, or businesses under common-control ownership whenever the IRS determines that an allocation "is necessary in order to prevent evasion of taxes or clearly to reflect income of any such organizations, trades, or businesses."[18] Its primary purpose is "to place a controlled taxpayer on tax parity with an uncontrolled

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14. Lucas v. Earl, 281 U.S. 111 (1930). In *Lucas*, the taxpayer, Earl, made a contract with his wife whereby she would be entitled to half of his earnings. *Id.* at 113-14. The Court held that the income was to be taxed to Earl, not his wife, stating:

> There is no doubt that the statute could tax salaries to those who earned them and provide that the tax could not be escaped by anticipatory arrangements and contracts however skilfully devised to prevent the salary when paid from vesting even for a second to the man who earned it.

Id. at 114-15. *See* National Carbide Corp. v. Commissioner, 336 U.S. 422 (1949) (holding that income earned by a subsidiary was taxable to the subsidiary and not the parent).

15. I.R.C. §§ 951-952 (1988 & Supp. 1989). Section 951 requires every person (including corporations) who is a United States shareholder of a foreign corporation to "include in his gross income . . . the sum of . . . subpart F income." *Id.* § 951(a)(1)(A)(i). *See infra* text accompanying notes 38-46 (discussing Subpart F income).

16. 2 JOSEPH ISENBERGH, INTERNATIONAL TAXATION ¶ 24.1 (1990).

17. *Id.*

18. I.R.C. § 482 (1988).

taxpayer."[19] Section 482 grants the Commissioner broad discretion to make allocations as he deems necessary.[20] His allocation is presumed to be correct, absent a showing that the allocation was arbitrary, capricious, or unreasonable.[21]

The IRS has invoked section 482 primarily in situations that involve transactions between a domestic parent corporation and a foreign subsidiary, where the foreign subsidiary is not subject to U.S. taxation on income derived from the parent.[22] For example, a U.S. corporation could sell its product to a foreign subsidiary at cost. As a result, upon retail sale, the subsidiary would generate greater profits.[23] The increased profit could not be taxed in the U.S. until the income was repatriated as dividends.[24] Accordingly, parent corporations can gain the benefits of greater profits, through deferral of taxes. However, when the arm's-length standard of section 482, in conjunction with Subpart F,[25] is applied to the transaction, the

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19. Treasury Regulation § 1.482-1(b)(1) states:.

> The purpose of section 482 is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer, by determining, according to the standard of an uncontrolled taxpayer, the true taxable income from the property and business of a controlled taxpayer. . . . The standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer.

Treas. Reg. § 1.482-1(b)(1) (1986).

20. I.R.C. § 482 (1988).

21. Foster v. Commissioner, 756 F.2d 1430, 1432 (9th Cir. 1985), *cert. denied*, 474 U.S. 1055 (1986) (quoting Erickson v. Commissioner, 598 F.2d 525, 528 (9th Cir. 1971)). *See* G.D. Searle & Co. v. Commissioner, 88 T.C. 252, 358 (1987) (holding that taxpayers have a much heavier burden of proof than normal and must prove that the Commissioner abused his discretion). *See also* Bausch & Lomb, Inc. v. Commissioner, 92 T.C. 525, 582 (1989), *aff'd*, 933 F.2d 1084 (2d Cir. 1991) (holding that the Commissioner's determination must be sustained absent an abuse of discretion).

22. *See* E.I. du Pont de Nemours & Co. v. United States, 608 F.2d 445 (Ct. Cl. 1979), *cert. denied*, 445 U.S. 962 (1980) (holding that where the Commissioner found a subsidiary's profits to be economically unrealistic and allocated profits to the parent, the allocation was reasonable given the Commissioner's general discretion and the inexactness of such allocations). *See generally* Eli Lilly & Co. v. United States, 372 F.2d 990 (Ct. Cl. 1967) (using § 482 to allocate income between parent and subsidiary corporations).

23. By selling the product at cost to the foreign subsidiary, the parent has effectively lowered the subsidiary's cost of goods sold. With a reduced cost, the difference between cost of goods sold and retail sales price (gross margin) increases. BELVERED E. NEEDLES, FINANCIAL ACCOUNTING 193-95 (1989).

24. I.R.C. § 61 (1988). Section 61(a) states, "Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items: . . . (7) Dividends . . . ." *Id.*

25. *See infra* notes 38-46 and accompanying text (discussing Subpart F).

price charged by the parent to the subsidiary must be adjusted to reflect a reasonable profit to the parent.[26] The profit is then allocated as income to the parent.[27] However, in order to fully understand the enactment of section 482, it is necessary to discuss the use of tax avoidance schemes by corporations and the governmental response to such schemes.[28]

A. *Early Tax Avoidance Schemes; The Foreign Personal Holding Company*

An early type of tax avoidance scheme utilized by corporations was the "foreign personal holding company."[29] Initially, an individual would set up a personal holding company in a foreign jurisdiction that had a low marginal tax rate. The individual would then transfer income producing assets to the holding company, placing these assets beyond the reach of U.S. taxation.[30]

In response to these schemes, the Revenue Act of 1937[31] enacted provisions allowing for taxation of personal holding companies. Today, provisions governing foreign personal holding companies are codified under IRC sections 551 through 558.[32] Under these provisions, income derived from any foreign personal holding company is taxed directly to its U.S. shareholder as a constructive dividend.[33] Therefore, the U.S. shareholder must include in its gross income,

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26. *See* Treas. Reg. § 1.482-1(b)(1) (1986) (stating that § 482 allows the Commissioner to determine, "according to the standard of an uncontrolled taxpayer, the true taxable income from the property and business of the controlled taxpayer").

27. I.R.C. §§ 951-964 (1988 & Supp. 1989).

28. *See infra* text accompanying notes 29-60.

29. A foreign personal holding company is defined under I.R.C. § 552 as:

> (1) a foreign corporation where more than 50% of the total combined voting power of all classes of stock or the total value is owned directly or indirectly, at any time during the taxable year, by five or fewer individuals, and (2) which derives at least 60% of its gross income in the form of "foreign personal holding income."

I.R.C. § 552 (1988 & Supp. 1989).

30. ISENBERGH, *supra* note 16, ¶ 24.2, at 2.

31. The Revenue Act of 1937, ch. 815, 50 Stat. 813 (1937).

32. I.R.C. §§ 551-558 (1988 & Supp. 1989).

33. Foreign personal holding company income includes: dividends, stock and securities transactions, transactions in commodities, estate and trust income, personal service contracts, compensation for the use of corporate property, and rents. I.R.C. § 553(a)(1)-(7) (1988). Section 551(a) states that "undistributed foreign personal holding company income of a foreign personal holding company shall be included in the gross income of the citizens or residents of the United States . . . ." *Id.* § 551(a).

as a constructive dividend, an amount equal to the sum that would have been received had a distribution been made.[34] Section 551(e), however, permits a basis adjustment to the extent the constructive dividend is not actually distributed.[35]

Although the foreign personal holding company rules deterred U.S. citizens from shifting passive U.S. income to a foreign personal holding company, the rules were limited in scope. Where the foreign personal holding company was owned by foreigners, as well as U.S. citizens, or where the corporation earned active business income, the foreign personal holding company rules did not apply.[36] Thus, foreign corporate subsidiaries that engaged in active business were unaffected by the personal holding company rules. U.S. companies took advantage of this loophole by setting up subsidiaries in foreign countries with low marginal tax rates, and foreign subsidiaries flourished.[37]

B. Enactment of Subpart F

In response to the growing popularity of tax avoidance schemes through the use of foreign subsidiaries, Congress enacted Subpart F, Controlled Foreign Corporations, to the IRC in 1962.[38] Its adop-

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34. ISENBERGH, *supra* note 16, ¶ 24.6, at 7. Undistributed foreign personal holding company income is defined under § 556(a) as the taxable income of the foreign personal holding company. I.R.C. § 556(a) (1988). When the foreign corporation falls within the scope of §§ 551-558 and is found to be a foreign personal holding company, its entire income is currently taxable. ISENBERGH, *supra* note 16, ¶ 24.6, at 7. Therefore, the corporation's passive, as well as active, business income becomes currently taxable. *Id.*

Passive income is essentially synonymous with "foreign personal holding company income." *See supra* note 33. In contrast, active business income can be defined as income that is excluded from the foreign personal holding company rules. I.R.C. § 552(b)(2) excludes from the foreign personal holding company rules "corporations organized and doing business under banking and credit laws of a foreign country if it is established . . . to the satisfaction of the secretary that such corporation is not formed or availed of for the purpose of evading or avoiding United States income taxes . . . ." I.R.C. § 552(b)(2) (1988 & Supp. 1989).

35. I.R.C. § 551(e) states:

> The amount required to be included in the gross income of a United States shareholder under subsection (b) shall, for the purpose of adjusting the basis of his stock with respect to which the distribution would have been made (if it had been made), be treated as having been reinvested by the shareholder as a contribution to the capital of the corporation . . . .

I.R.C. § 551(e) (1988 & Supp. 1989).

36. ISENBERGH, *supra* note 16, ¶ 25.1, at 15.

37. *Id.*

38. I.R.C. §§ 951-964 (1988 & Supp. 1989).

tion was meant to eliminate the tax benefits accrued by U.S. corporations engaged in foreign operations.[39] Subpart F imposes current taxation on U.S. shareholders of controlled foreign corporations that receive certain classes of income or engage in certain types of activities.[40] Thus, Subpart F, like the foreign personal holding company rules, treats foreign corporate earnings as though they had been repatriated to the U.S. shareholder.

Subpart F is invoked when U.S. ownership or control of the foreign subsidiary exceeds a certain threshold of control, and then the subsidiary is classified as a controlled foreign corporation or "CFC."[41] Once the foreign corporation is classified as a CFC, the U.S. corporation is subject to U.S. taxation on all income found to be Subpart F income.[42] Accordingly, when it is determined that the

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39. ISENBERGH, *supra* note 16, ¶ 25.5, at 20-21.

40. I.R.C. §§ 951-964 (1988 & Supp. 1989).

41. ISENBERGH, *supra* note 16, ¶ 26.2, at 26. Section 957(a) defines a controlled foreign corporation as "any foreign corporation if more than 50 percent of . . . (1) the total voting power of all classes of stock . . . entitled to vote, or (2) the total value of stock, . . . is owned . . . by United States shareholders on any day during the taxable year of such foreign corporation." I.R.C. § 957(a) (1988).

Under the 1962 Act, the control test was met where the U.S. shareholder held more than half of the voting power. ISENBERGH, *supra* note 16, ¶ 26.1, at 25-26. The 1986 Act enlarged the class of foreign corporations subject to Subpart F taxation to include those U.S. shareholders that own more than half of the value of stock, regardless of whether they had voting control. *Id.*

Section 951(b) defines a United States shareholder as "a United States person . . . who owns . . . 10 percent or more of the total combined voting power of all classes of stock entitled to vote of such foreign corporation." I.R.C. § 951(b) (1988 & Supp. 1989).

42. I.R.C. § 952(a) defines Subpart F income as:

> [I]n the case of any controlled foreign corporation, the sum of—
> (1) insurance income,
> (2) the foreign base company income . . . ,
> (3) an amount equal to the product of—
> (A) the income of such corporation other than income which . . . is attributable to earnings and profits of the foreign corporation included in the gross income of a United States person under section 951 . . . ,
> multiplied by
> (B) the international boycott factor . . . ,
> (4) the sum of the amounts of any illegal bribes, kickbacks, or other payments . . . , and
> (5) the income of such corporation derived from any foreign country during any period during which section 901(j) applies to such foreign country.

I.R.C. § 952(a) (1988 & Supp. 1989).

Once it is determined that the foreign corporation is a CFC, § 951(a) includes in the gross income of the shareholder the sum of the pro rata portion of Subpart

foreign subsidiary is a CFC and the income falls within one of the categories of Subpart F income, the foreign earnings are treated as a constructive dividend to the U.S. shareholder.[43]

Although it was designed to deter tax avoidance schemes, Subpart F suffers from two limitations. First, if the subsidiary is a CFC, only the income deemed to be Subpart F income is treated as a constructive dividend.[44] Therefore, income that does not qualify as Subpart F income still remains eligible for indefinite tax deferral. Second, income is not Subpart F income if it is derived in the foreign country in which the CFC is organized.[45] For example, where the product is produced and sold within the foreign country, income derived from the sale is not Subpart F income. The income is automatically attributed to the U.S. parent only to the extent that the foreign subsidiary's income has no real business connection to the foreign country.[46] In response to the loopholes in the Subpart F rules, section 482 evolved as another means of deterring tax avoidance schemes.

C. *The Evolution of Section 482*

Section 482 originated from section 45 of the Revenue Act of 1928,[47] which had modified Regulation 41, articles 77 and 78 of the War Revenue Act of 1917.[48] Section 45 granted the Commissioner power to allocate income or deductions of corporations controlled by the same interest.[49] Early cases suggest that section 45 was imple-

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F income, previously excluded Subpart F income withdrawn from investment in less developed countries, previously excluded Subpart F income withdrawn from foreign base company operations, and increases in earnings invested in United States operations. *Id.* § 951(a).

43. *Id.* § 951.

44. *Id.* §§ 951(a)(1)(A)(i), 952(a).

45. Treas. Reg. § 1.954-1(b) (1985).

46. ISENBERGH, *supra* note 16, ¶ 25.6.1, at 22. Generally, the present form of Subpart F attempts to distinguish between active business income, for which deferral is allowed, and tax haven income, which is taxed directly to U.S. shareholders. *Id.* Today, Subpart F reaches some active business operations, however, these are felt to have tax shelter potential. *Id.*

47. Revenue Act of 1928, ch. 852, 45 Stat. 791, 806 (1928).

48. War Revenue Act of 1917, ch. 63, 40 Stat. 300, 303 (1917).

49. The legislative history of § 45 indicated that this section was originally drafted to prevent intentional evasion of taxes:

> Section 45 is based upon section 240(f) of the 1926 Act, broadened considerably in order to afford adequate protection to the Government . . . . The section of the new bill provides that the Commissioner may, in the

mented to correct manipulative acts of controlled entities attempting to avoid taxes.[50] Section 482 was also intended to deter tax avoidance schemes.[51] However, the drafters of section 482 declared a more encompassing purpose. The legislative history states that the Commissioner may make allocations "in order to reflect . . . true tax liability."[52] Accordingly, the IRS's allocation power under section 482 was not intended to be limited to transactions with tax avoidance motives. Section 482 was also intended to address inadvertent distortions of income.[53]

Section 482 vests the Commissioner with broad authority to allocate gross income, deductions, credits, or allowances between or among commonly controlled corporations on two alternate bases: (1) to prevent evasion of taxes or (2) to clearly reflect the income of

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> case of two or more trades or businesses owned or controlled by the same interests, apportion, allocate, or distribute the income or deductions between or among them, as may be necessary in order to prevent evasion (by shifting of profits, the making of fictitious sales, and other methods frequently adopted for the purpose of "milking"), *and in order to clearly reflect their true tax liability.*

H.R. 2, 70th Cong., 1st Sess. (1927) (emphasis added); S. 960, 70th Cong., 1st Sess. (1928).

50. Central Cuba Sugar Co. v. Commissioner, 198 F.2d 214, 216 (2d Cir. 1952) (holding that § 45 was "designed to deny the power to shift income or deductions arbitrarily among controlled corporations"); Asiatic Petroleum Co. v. Commissioner, 79 F.2d 234, 236 (2d Cir. 1935) (stating that § 45 was designed to frustrate an evasion or avoidance of taxes).

51. Your Host, Inc. v. Commissioner, 58 T.C. 10, 23-24 (1972), *aff'd*, 489 F.2d 957 (2d Cir. 1973) (stating that the "legislative and judicial history indicates that section 482 is designed to remedy only one abuse: the shifting of income from one commonly controlled entity to another").

52. *See supra* note 49.

53. *See Your Host*, 58 T.C. at 24. The Tax Court in *Your Host* stated, "[I]f there has been an actual shifting of income, purity of purpose and the presence of sound business reasons for forming multiple corporations are no defense under section 482." *Id.* See also Treasury Regulation § 1.482-1(c), which states:

> In determining the true taxable income of a controlled taxpayer, the district director is not restricted to the case of improper accounting, to the case of fraudulent, colorable, or sham transaction, or to the case of a device designed to reduce or avoid tax by shifting or distorting income, deductions, credits, or allowances. The authority to determine true taxable income extends to any case in which either by inadvertence or design the taxable income, in whole or part, of a controlled taxpayer, is other than it would have been had the taxpayer in the conduct of his affairs been an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer.

Treas. Reg. § 1.482-1(c) (1986).

controlled corporations.[54] It permits the IRS to tax related parties as though they had dealt at arm's length.[55] Accordingly, if a U.S. corporation charges a foreign affiliate less than market value for goods or services, the Commissioner has the power to impose an arm's-length price upon the initial sale from the U.S. corporation to the related foreign subsidiary.[56]

Where the sale is between related foreign entities, however, the transaction is beyond the grasp of section 482.[57] For example, a U.S. corporation selling goods in a foreign country would sell them in bulk to a foreign subsidiary in a tax haven country. The subsidiary (subsidiary one) would then sell the goods to a second subsidiary (subsidiary two) at a high price. Subsidiary two would sell the goods in their market destination. Subsidiary one would set the highest price possible so as to achieve the greatest profit in a low tax environment.[58] Subsidiary two, normally operating in a high tax jurisdiction, would have a high cost basis (cost of goods sold), resulting in a low profit margin. Through artificial shifting of income, it appears that subsidiary two is operating at a loss. Under this tax avoidance scheme, the parent company accrues a twofold benefit: (1) initially, high profits from subsidiary one and (2) tax benefits derived from losses incurred by subsidiary two.[59] Under section 482, the IRS could correct the insufficient price charged by the U.S. corporation to subsidiary one, but could not affect the prices charged

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54. Spicer Theatre, Inc. v. Commissioner, 346 F.2d 704, 706 (6th Cir. 1965), *aff'g*, 44 T.C. 198 (1964) (stating that the purpose of § 482 is to prevent tax avoidance or distortion of income due to shifting income from one entity to another); Paccar, Inc. v. Commissioner, 85 T.C. 754, 787 (1985), *aff'd*, 849 F.2d 393 (9th Cir. 1988) (holding that the purpose of § 482 is to place controlled and uncontrolled taxpayers on parity with one another); Foster v. Commissioner, 80 T.C. 34, 142 (1983), *aff'd on this issue*, 756 F.2d 1430, 1432 (9th Cir. 1985), *cert. denied*, 474 U.S. 1055 (1986) (citing the purposes of § 482 to be prevention of tax evasion and reflection of true income).

55. *See supra* note 53 (excerpting Treas. Reg. § 1.482-1(c) (1986)).

56. ISENBERGH, *supra* note 16, ¶ 25.3.1, at 17.

57. *Id.* at 18. This problem was, for the most part, eliminated with the enactment of Subpart F. *See infra* text accompanying notes 59-60. *See also infra* text accompanying notes 38-46 (discussing Subpart F).

58. *See supra* text accompanying notes 23-24.

59. By shifting profits to the tax haven, the U.S. corporation would not be currently taxed on the income and would be able to suspend payment of taxes until the profits were repatriated as dividends. I.R.C. § 61(a)(7) (1988). The greatest benefit of deferral of U.S. taxation is the time value of the difference between the U.S. income tax rate and the foreign rate in foreign earnings. Essentially, the longer a corporation can defer the tax, the less the amount of the tax becomes.

between the foreign subsidiaries (subsidiaries one and two) because they would be beyond section 482's reach.[60] If Subpart F, however, was applied in conjunction with section 482, the income would be taxable to the U.S. parent. The income of subsidiary two would be allocated to subsidiary one by section 482. The allocated income would then be within the grasp of Subpart F and would be taxable to the U.S. parent.

D. *Analysis of Section 482*

Section 482 has three statutory requirements: (1) two or more organizations, trades, or businesses;[61] (2) common ownership or control;[62] and (3) an IRS determination that reallocation is necessary to prevent tax evasion.[63] Once the three statutory prerequisites have been met, the IRS will apply the relevant standard to determine the taxpayer's proper tax liability.[64] The regulations for section 482 prescribe that "[t]he standard to be applied in every case is that of

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60. ISENBERGH, *supra* note 16, ¶ 25.3.1, at 18. While § 482 permits reallocation between controlled foreign entities, there is no immediate effect without the Subpart F rules, because both entities are beyond the reach of U.S. taxation. *Id.*

61. Section 482's threshold condition is the existence of "two or more organizations, trades, or businesses (whether or not incorporated, whether or not incorporated in the United States, and whether or not affiliated) . . . ." I.R.C. § 482 (1988).

The term "organization" is defined under Treasury Regulation § 1.482-1(a)(1) to encompass "any organization of any kind, whether it be a sole proprietorship, a partnership, a trust, an estate, an association, or a corporation," and the terms "trade" and "business" are defined under Treasury Regulation 1.482-1(a)(2) as "any trade or business of any kind, regardless of whether or where organized, whether owned individually or otherwise, and regardless of the place where carried on." Treas. Reg. § 1.482(a)(1)-(2) (1986). These terms are broadly defined under the regulations to afford the Commissioner the widest possible scope in the application of section 482. *See id.* § 1.482-1(c).

62. The second statutory prerequisite is common ownership or control. This requirement was also drafted broadly to permit a wide scope. *See* Treas. Reg. § 1.482-1(c) (1986). Treasury Regulation § 1.482-1(a)(3) defines "controlled" as "any kind of control, direct or indirect, whether legally enforceable, and however . . . exercised." *Id.* § 1.482-1(a)(3). A presumption of control arises if income or deductions have been arbitrarily shifted. *Id.* Therefore, the reality of control is decisive, not its form or its exercise. *Id.*

63. The last prerequisite of section 482 is an IRS determination that reallocation is "necessary" to prevent evasion of taxes or clearly reflect income of any member of the group. I.R.C. § 482 (1988). The regulations do not define "necessary"; but for practical purposes, it means "helpful" or "appropriate." BORIS I. BITTKER & LAWRENCE LOKKER, FUNDAMENTALS OF INTERNATIONAL TAX ¶ 79.2 (1990).

64. Treas. Reg. § 1.482-1(b)(1) (1986).

an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer."[65] Thus, the IRS attempts to achieve tax parity between controlled and uncontrolled taxpayers.

In determining an arm's-length price, the issue is what the uncontrolled taxpayer would pay for the good, service, or intangible.[66] Determining the arm's-length price is relatively simple where there is a comparable good, service, or intangible readily available.[67] The uncontrolled price is assumed to reflect an arm's-length price.[68] Accordingly, the IRS adjusts the price to reflect the arm's-length price.[69] Where there is no readily available substitute good, service, or intangible, however, determination of the arm's-length price becomes much more complex. To resolve arm's-length pricing problems, the treasury regulations provide guidelines for determining an arm's-length price.[70] There are five areas the treasury regulations address: (1) the terms of loans and advances,[71] (2) the performance of services,[72] (3) the use of tangible property,[73] (4) the sale of tangible

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65. *Id.*

66. *Id.*

67. Notice 88-123, 1988-2 C.B. 458, 466 (1988).

68. *Id.*

69. Treas. Reg. § 1.482-1(c) (1986).

70. Treas. Reg. § 1.482-2 (1986). However, should none of the given methods appropriately reflect an arm's-length price, the given price of the good, service or intangible is generally regarded as a "safe harbor" even if a more appropriate price could be determined. *See id.* § 1.482-2(a)(2)(iii).

71. Treas. Reg. § 1.482-2(a) (1986). Treasury Regulation § 1.482-2(a) governs loans and advances. When a loan or advance is made from one controlled party to another and the lender does not charge an arm's-length interest rate, § 482 permits allocation of income to reflect an arm's-length interest rate. *Id.* § 1.482-2(a)(1). Generally, the regulations require that a loan or advance between commonly controlled organizations, trades, or businesses must bear an interest rate that would be "charged at the time the indebtedness arose, in independent transactions with or between unrelated parties under similar circumstances." *Id.* § 1.482-2(a)(2)(i).

72. *Id.* § 1.482-2(b). Treasury Regulation § 1.482-2(b) governs performance of services. Where one member of a controlled entity performs marketing, managerial, administrative, technical, or other services for another member of the controlled entity, either without charge or for less than an arm's-length fee, the IRS may make a § 482 allocation. BITTKER & LOKKER, *supra* note 63, ¶ 79.3.3, at 14; Treas. Reg. § 1.482-2(b)(1) (1986). The IRS may make the allocation whether the service is performed for the joint benefit of all the members of the group or by one of the members for the exclusive benefit of the group. *Id.* § 1.482-2(b)(2).

73. *Id.* § 1.482-2(c). Treasury Regulation § 1.482-2(c) prescribes, "Where possession, use, or occupancy of tangible property owned or leased" by another member of the controlled group, without charge or at less than an arm's-length charge, an allocation of arm's-length price is required. *Id.* In general, the arm's-length rental charge is the amount of rent "which was charged, or would have

property,[74] and (5) the transfer of intangibles.[75] This last area, covering the transfer of intangibles, will be discussed in detail, as it becomes important in the analysis of *Procter & Gamble*, the focus of this comment.

Treasury Regulation section 1.482-2(d) governs the transfer or use of intangible property.[76] This section dictates that where intangible property is transferred, sold, assigned, loaned, or otherwise made available by one member of a controlled entity to another member of the controlled entity for other than arm's-length consideration, the IRS may make an allocation to reflect arm's-length consideration.[77]

In 1986, Congress added the following sentence to section 482: "In the case of any transfer (or license) of intangible property (within

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been charged for the use of the same or similar property, during the time it was in use, in independent transactions with or between unrelated parties under similar circumstances . . . ." *Id.*

74. *Id.* § 1.482-2(e). Treasury Regulation § 1.482-2(e) governs sales of tangible property. Where the transaction involves the sale of tangible property between related parties, the regulations subscribe allocation to reflect the arm's-length price that an unrelated party would have paid under the same circumstances. *Id.* § 1.482-2(e)(1)(i). Unrelated parties normally sell products at a profit. Accordingly, the arm's-length price will be imposed to reflect reasonable profit to the seller. *Id.* There are three methods for determining an arm's-length price on the sale of tangible property: (1) the comparable uncontrolled sales price method, (2) the resale price method, and (3) the cost plus method. *Id.* § 1.482-2(e)(2)-(4); BITTKER & LOKKER, *supra* note 63, ¶ 79.3.6, at 27. The comparable uncontrolled sales price method is the price charged with respect to identical or nearly identical goods in similar circumstance to a party that is not a member of the controlled group. Treas. Reg. § 1.482-2(e)(2)(ii) (1986). The resale price method entails the use of resale price reduced by an appropriate markup and adjusted for reasonable ascertainable difference in the product or terms of sale. *Id.* § 1.482-2(e)(2). The cost plus method provides that the arm's-length price for the controlled sale is calculated by adding the cost of producing the property, multiplied by the gross profit, plus or minus any adjustments. *Id.* § 1.482-2(e)(3)(i).

75. Treas. Reg. § 1.482-2(d) (1986).

76. *Id.*

77. *Id.* Intangible property is defined under Treas. Reg. § 1.482-2(d)(3)(ii) as:

> (a) Patents, inventions, formulas, processes, designs, patterns, and other similar items;
> (b) Copyrights, literary, musical, or artistic compositions, and other similar items;
> (c) Trademarks, tradenames, brand names, and other similar items;
> (d) Franchises, licenses, contracts, and other similar items;
> (e) Methods, programs, systems, procedures, campaigns, surveys, studies, forecasts, estimates, customer lists, technical data, and other similar items.

Treas. Reg. § 1.482-2(d)(3)(ii) (1986).

the meaning of section 936(h)(3)(B)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible."[78]

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78. Tax Reform Act of 1986, Pub. L. No. 99-514, § 1231(e)(1), 100 Stat. 2085, 2562-63 (1986). I.R.C. § 936 defines intangible property. I.R.C. § 936(h)(3)(B) (1990). Its definition of intangible property is essentially identical to the definition of intangible property under Treas. Reg. § 1.482-2(d)(3)(ii) (1986). *See supra* note 77.

The staff of the Joint Committee on Taxation explained the reasons for the addition as follows:

> The problems [with section 482] have been particularly acute in the case of transfers of high-profit potential intangibles. Taxpayers may have transferred such intangibles to foreign related corporations or to possessions corporations at an early stage, for a relatively low royalty, and taken the position that it was not possible at the time of the transfers to predict the subsequent success of the product. Even in the case of a proven high-profit intangible, taxpayers frequently have taken the position that intercompany royalty rates may appropriately be set on the basis of industry norms for transfers of much less profitable items.
>
> . . . .
>
> In many cases firms that develop high profit-potential intangibles tend to retain their rights or transfer them to related parties in which they retain an equity interest in order to maximize their profits. The transferor may well be looking in part to the value of its direct or indirect equity interest in the related party transferee as part of the value to be received for the transfer, rather than to "arm's length" factors. Industry norms for transfers to unrelated parties of less profitable intangibles frequently are not realistic comparables in these cases.
>
> Transfers between related parties do not involve the same risks as transfers to unrelated parties. There is thus a powerful incentive to establish a relatively low royalty without adequate provisions for adjustment as the revenues of the intangible vary. There are extreme difficulties in determining whether the arm's length transfers between unrelated parties are comparable. Congress thus concluded that it is appropriate to assure that the division of income between related parties reasonably reflect the relative economic activities undertaken by each. Congress believed that payments made on a transfer of intangibles to a related [person] should be commensurate with the income attributable to the intangible.
>
> . . . .
>
> This requirement is established to fulfill the objective that the division of income between related parties reasonably reflect the relative economic activity undertaken by each.

Staff of the Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986*, at 1014-15 (1987) [hereinafter *General Explanation*]. *See* Notice 88-123, 1988-2 C.B. 458, 472 ("The primary difficulty addressed by the legislation was the selective transfer of high profit intangibles to tax havens."). Notice 88-123 is entitled "A Study of Intercompany Pricing under Section 482 of the Code" and is sometimes referred to as the section 482 White Paper. *See generally* George V. Carlson et al., *The Section 482 White Paper: Highlights and Implications*, 41 TAX NOTES 547 (1988) (providing a review of the principal features of the White Paper as well as an

The "commensurate with income" standard extends the arm's-length standard. It seeks to insure that the income of the United States parent and its foreign subsidiary "reasonably reflect the relative economic activity undertaken by each."[79] This standard, however, deviates from the arm's-length standard in that it rejects "industry norms or other unrelated party transactions" for use as guideposts.[80] Because compensation for intangibles was "greater than industry averages" or other commercial standards,[81] the provision has taken

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outline of the major changes in taxpayer practices which would be required by implementation of the White Paper).

79. *General Explanation*, *supra* note 78, at 1015-16. The IRS has outlined three approaches that may be used when applying the "commensurate with income" standard: (1) evaluation based on comparable transactions between unrelated persons, (2) methods based on market rates of return, and (3) cost sharing. Notice 88-123, 1988-2 C.B. 458, 485-493.

In evaluating comparable transactions, there are two types of comparables—"exact" and "inexact." *Id.* at 485-88. Exact comparables are those that involve the same type of patent, product design, process, trademark, "substantially similar economic environment," or "substantially similar contractual features." *Id.* at 486. Exact comparables are very rare, but when available provide a good yardstick for measuring an arm's-length charge. BITTKER & LOKKER, *supra* note 63, ¶ 79.3.5, at 24. Inexact comparables are those transactions between unrelated parties that resemble the related party transfer, but do not meet all of the requirements for exact comparables. *Id.* Generally, "an unrelated party arrangement should be used as an inexact comparable if the differences between it and the related party transaction can be reflected by a reasonable number of adjustments that have definite and ascertainable effects on the terms of the arrangement." *Id.*

The second method for determining the "commensurate with income" value is the basic arm's-length return method (BALRM). *Id.* The BALRM provides a functional analysis. It determines what the firm does and derives an appropriate rate of return that is similar to that earned by an uncontrolled firm performing a comparable activity. *Id.* Under BALRM, each type of business of the taxpayer is broken down into its component parts. *Id.* The factors of production are then identified, and a market rate of return is determined for each function. *Id.* These figures are deemed the appropriate earnings of the subsidiary, and any excess profit is allocated to the U.S. parent. *Id.* ¶ 79.3.5, at 25. BALRM should be used only when there is no comparable product.

The last method for determining "commensurate with income" value is the cost sharing method. "In general, a cost sharing arrangement is an agreement between two or more persons to share the costs and risks of research and development as they are incurred in exchange for a specified interest in any property that is developed." Notice 88-123, 1988-2 C.B. 458, 493. When controlled entities seek to share costs in the development of intangible property, the IRS will not make an allocation except as is necessary to reflect each entity's arm's-length share of costs and risks in developing the property. Treas. Reg. § 1.482-2(d)(4) (1986). Accordingly, the "commensurate with income" standard seeks to estimate the income associated with the costs and risks of developing the intangible.

80. *General Explanation*, *supra* note 78, at 1015.

81. *Id.* at 1016.

on the colloquialism "Super Royalty."[82] By adding the "commensurate with income" provision to section 482, Congress made it clear that industry norms would no longer provide a safe harbor for related parties transferring intangible property within their control group.[83] In addition, Congress adopted a provision that allowed for periodic adjustment of the royalty paid for the intangible property.[84] Accordingly, a royalty payment in year one that is determined to be commensurate with income does not prevent the service from adjusting the royalty in year two to reflect "actual profit experience."[85]

E. Present Limits of Section 482: Commissioner v. First Security Bank of Utah

The first United States Supreme Court decision to address section 482 was *Commissioner v. First Security Bank of Utah*.[86] A majority of the Court held that the Commissioner's use of section 482 was not warranted where a holding company did not utilize its control over two national banks to distort their taxable income.[87]

First Security Corporation was a holding company for two large national banks, First Security Bank of Utah and First Security Bank of Idaho.[88] The banks regularly encouraged customers to purchase credit life, health, and accident insurance and offered to arrange the financing of these contracts through the bank.[89] The banks would then forward the completed applications to an independent insurer.[90] The independent insurer would reinsure the policies with Security Life, another wholly owned subsidiary of First Security Corporation.[91] The arrangement was designed so that First Security retained eighty-five percent of the insurance premiums, and the independent insurer was paid the remaining fifteen percent.[92] Security Life reported the entire amount of eighty-five percent of the reinsurance premiums on

82. A.W. Granwell & Bobbe Hirsh, *The Super Royalty: A New International Tax Concept*, 33 TAX NOTES 1037 (1986).
83. *General Explanation*, *supra* note 78, at 1015-16.
84. *Id.* at 1016.
85. *Id.*
86. 405 U.S. 394 (1972).
87. *Id.* at 407.
88. *Id.* at 396.
89. *Id.*
90. *Id.*
91. *Id.* at 398.
92. *Id.*

its income for the years at issue.[93] Since Security Life received the income instead of the banks, Security Life took advantage of the preferential tax treatment afforded to insurance companies.[94] Pursuant to section 482, the Commissioner allocated forty percent of the reinsurance premiums earned by Security Life to the banks as compensation for the processing and forwarding of the insurance forms.[95]

The Tax Court affirmed the Commissioner's determination, relying on a then-recent Seventh Circuit case with similar facts, *Local Finance Corp. v. Commissioner*.[96] In *Local Finance*, a holding company controlled several finance companies and an insurance company.[97] The Seventh Circuit held that where finance companies induced most of their borrowers to take out credit life insurance with the commonly controlled insurance company, and the finance company did nearly all the paper work, the Commissioner properly allocated fifty percent of the net premiums, pursuant to section 482, even though the finance companies did not receive the premiums and were prohibited by law from receiving them.[98] The Seventh Circuit applied the "generation of income" theory, reasoning that because the finance companies generated the income, they should be taxed on it.[99]

On appeal, the Tenth Circuit rejected the "generation of income" theory relied on in *Local Finance*.[100] It reversed the Tax Court's decision, holding that

> [t]he banks have not received, and in all probability never can receive, the income because of the present diverse public

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93. *Id.* at 399.

94. *Id.* At the time in issue, the Life Insurance Company Tax Act for 1955, Pub. L. No. 429, ch. 83, 70 Stat. 36 (1955), applicable to the years 1955-1957, and the Life Insurance Company Tax Act of 1959, Pub. L. No. 86-69, ch. 83, 73 Stat. 112 (1959), applicable to later years, afforded preferential tax treatment to life insurance companies.

95. *First Sec.*, 405 U.S. at 399-400.

96. 407 F.2d 629 (7th Cir.), *cert. denied*, 396 U.S. 956 (1969).

97. *Id.* at 630.

98. *Id.* at 633.

99. *Id.* at 632. In applying the "generation of income" theory, the Seventh Circuit considered which party actually caused the insurance policies to be issued. *Id.* The record demonstrated that the finance companies had performed nearly all of the integral services and that the function of the latter companies was merely clerical. *Id.* Thus, the Commissioner's allocation had the effect of compensating the finance companies for their efforts in generating the income. *Id.*

100. First Sec. Bank of Utah v. Commissioner, 436 F.2d 1192, 1196-97 (10th Cir. 1971).

> ownership of the parent of the banks and the parent of Security Life. We believe that the [section] 482 allocations made by the Commissioner are arbitrary and capricious and inconsonant with the basic concepts of federal income taxation.[101]

The Supreme Court granted certiorari to resolve the conflict between the Seventh and Tenth Circuits.[102] It framed the issue as "[w]hether there was a shifting or distorting of the Banks' true net income resulting from the receipt and retention by Security Life of the premiums . . . ."[103] The Court focused on whether the taxpayer exhibited "complete power" over the income and whether that power was used in such a way so as to understate the true income of the subsidiary.[104] The majority affirmed the Tenth Circuit, resting primarily on the fact that the bank "could never have received a share of these premiums."[105] The Court further stated, "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."[106] Thus, the Court concluded that the Seventh Circuit's decision in *Local Finance* was incorrect.[107]

The Supreme Court's holding in *First Security* stands for two propositions: (1) a taxpayer must have "complete dominion" over

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101. *Id.* at 1198.

102. Commissioner v. First Sec. Bank of Utah, 405 U.S. 394 (1972).

103. *Id.* at 400-01.

104. *Id.* at 404-05. With respect to the issue of control, Treasury Regulation § 1.482-1(b)(1) states in part, "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." Treas. Reg. § 1.482-1(b)(1) (1986) (emphasis added).

105. *First Sec.*, 405 U.S. at 401.

106. *Id.* at 403.

107. *Id.* at 406 n.22. The Supreme Court's decision was influenced by the Tax Court's holding in L.E. Shrunk Latex Products, Inc. v. Commissioner, 18 T.C. 940 (1952). In *L.E. Shrunk Latex Products*, the same company controlled both the manufacturing and distribution of latex condoms. *Id.* During the Second World War, the Office of Price Administration issued price regulations which prohibited the manufacturer from raising his price to the distributor. *Id.* at 950. However, the regulation did not prohibit the distributor from raising his price to retailers. *Id.* The Commissioner, acting pursuant to § 45, attempted to allocate income from the distributor to the manufacturer on the ground that some of the distributor's profits were in fact earned by the manufacturer, despite the fact that the manufacturer was prohibited from receiving such funds. *Id.* at 952. The Tax Court held that the Commissioner had "no authority to attribute to petitioners income which they could not have received." *Id.* at 961.

the income to be taxable on that income,[108] and (2) section 482 does not apply where the controlling party has not exercised control to shift income among the controlled group.[109] Accordingly, the IRS is powerless to allocate income among controlled parties where another authority, such as the federal banking law in *First Security*, has distorted the income.

III. ANALYSIS

In *Procter & Gamble*, the Tax Court addressed whether an allocation by the Commissioner under section 482 was permitted where the taxpayer's receipt of income was barred by a foreign law.[110] Procter & Gamble Corporation (P&G) is a multinational corporation primarily engaged in manufacturing and producing consumer and industrial products.[111] Procter & Gamble AG (AG), a Swiss corporation and a wholly owned subsidiary of P&G, was also a party to the litigation.[112] AG owned 100% of Espana, a foreign subsidiary organized in Spain.[113] The Commissioner determined that an allocation of income from Espana to AG, pursuant to section 482, was necessary to clearly reflect the income of AG.[114] This allocation in turn increased P&G's Subpart F income.[115] The Commissioner subsequently issued a notice of deficiency to P&G for the years 1978 and 1979 for $1,232,653 and $1,795,005 respectively.[116] P&G petitioned the Tax Court to reverse the Commissioner's decision. P&G did not contest the amount of the allocation or the method of calculating the determination, but contended that section 482 should not have been applied at all.[117] The sole issue addressed by the Tax Court was whether the Commissioner's allocation of gross income

108. *First Sec.*, 405 U.S. at 404.
109. *Id.* at 407.
110. *Procter & Gamble*, 95 T.C. at 323.
111. *Id.* at 324.
112. *Id.*
113. *Id.* at 326.
114. *Id.* at 330-31.
115. *Id.* at 331. *See supra* notes 38-46 and accompanying text (analyzing Subpart F).
116. *Procter & Gamble*, 95 T.C. at 330. The Commissioner's determination of deficiency was based on two percent of Espana's net sales of P&G's products for the taxable years in question. *Id.* at 331.
117. *Id.* at 331.

from Espana to AG, pursuant to section 482, was arbitrary, capricious, or unreasonable.[118]

A. *Facts*

P&G, an Ohio corporation whose principal place of business was Cincinnati, Ohio,[119] was principally engaged in the manufacturing and marketing of consumer and industrial products.[120] During the years at issue, P&G and AG were parties to a license and services agreement known as a "package fee agreement."[121] Under this agreement, AG marketed P&G's products and paid P&G a royalty fee.[122] The royalty fee was based principally on the net sales of P&G's products by AG and its subsidiaries.[123]

In 1967, P&G sought to organize a wholly owned subsidiary in Spain that would manufacture and sell P&G's consumer and industrial products in that country.[124] On September 23, 1967, P&G submitted an application to the Spanish government requesting authorization to organize a Spanish company, Espana.[125] The application stipulated that Espana would be wholly owned by P&G through AG.[126] The Spanish government approved 100% ownership of the subsidiary with the provision that Espana could not pay any amount for royalties or technical assistance.[127] From 1969 through the years at issue, Espana filed several applications with the Spanish government requesting to increase its capital investment.[128] The capital requests were approved with the stipulation that Espana "will not pay any amount whatsoever in the concept of fees, patents, royalties, and/or technical assistance to the investing firm nor to any of its

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118. *Id. See supra* note 21 and accompanying text (discussing the standard for reversal of the Commissioner's allocation).

119. *Procter & Gamble*, 95 T.C. at 324.

120. *Id.*

121. *Id.*

122. *Id.* The agreement provided non-exclusive use by AG and its subsidiaries of P&G's patents, trademarks, tradenames, knowledge, research, and assistance in the fields of manufacturing, general administration, finance, buying, marketing, and distribution. *Id.*

123. *Id.*

124. *Id.*

125. *Id.* at 325.

126. *Id.* Having the subsidiary wholly owned was imperative for P&G to preserve the confidentiality of its technology and provide confidence for foreign investors in Espana. *Id.* at 326.

127. *Id.* at 326.

128. *Id.* at 327.

affiliates, unless with the approval of the [Spanish] Administration."[129] At the time, Spanish law strictly regulated payment by companies in Spain to foreign countries.[130]

In September of 1973, the Spanish government eased the ban on payment to foreign organizations.[131] It issued several decrees providing for regulation of technology agreements.[132] Later that year, P&G entered into an engineering services contract with Espana.[133] P&G sought the Spanish government's approval for payments to P&G for actual costs under the contract.[134] In 1974, the Spanish government approved payments by Espana for actual costs incurred by P&G under the contract, whenever it found that the services could not be provided by a Spanish company.[135] In 1977, Espana was again permitted to make payments to P&G for actual costs arising under a second engineering contract.[136]

In 1976, in an effort to encourage foreign investment, the Spanish government adopted measures designed to facilitate foreign investment of capital in Spain by providing automatic authorization for foreign investment that complied with certain requirements.[137] This automatic authorization, however, was conditioned on the Spanish company's not making payments to the foreign investor, its subsidiaries, or its affiliates for the transfer of technology.[138]

Although the officers of P&G, AG, and Espana made informal inquiries into whether the decree was subject to appeal, an appeal

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129. *Id.* The ban on royalties was completely within the discretion of the Spanish government and was a common practice at the time. *Id.* at 324. The Spanish government prohibited royalty payments to foreign investors out of fear that companies would abuse technical assistance payments to remove profits from Spain untaxed. *Id.* at 327. However, royalty payments were not barred where less than 50% of the Spanish company was owned by foreigners or where a clear and obvious benefit to Spain was demonstrated in terms of substantial exports, use of Spanish raw materials, and enhancement of Spanish technology. *Id.*

130. The first title of Spanish Law of Monetary Crimes of November 24, 1938, granted the Spanish government broad authority to regulate payments from Spanish entities to residents of foreign countries. *Id.* at 325. The law was repealed December 10, 1979. *Id.*

131. *Id.* at 327.

132. *Id.*

133. *Id.* at 328.

134. *Id.* at 328-29.

135. *Id.* at 329.

136. *Id.*

137. *Id.*

138. *Id.*

of the prohibition was never filed.[139] AG never had an agreement with Espana during the years at issue to make payments to AG for the use of P&G's technology.[140] AG did, however, pay royalties to P&G based in part on sales by Espana.[141] In 1987, the Spanish government issued decrees liberalizing the Spanish system of authorization of foreign investment.[142] In response to these decrees, Espana filed an application for the removal of the prohibition against royalty payments.[143] The application was subsequently approved.[144]

The Commissioner issued a notice of deficiency, in which he allocated income in the amounts of $1,232,653 for the year 1978 and $1,795,005 for the year 1979 from Espana to AG, pursuant to section 482.[145] This allocation increased P&G's Subpart F income under section 951(a)(1)(A).[146] P&G appealed to the Tax Court.[147]

B. Procedural Posture

1. The Tax Court Decision

The fundamental issue addressed by the Tax Court in *Procter & Gamble* was whether the section 482 allocation was warranted where foreign law barred the payment of the amounts that the IRS sought to allocate.[148] Section 482 authorizes the Commissioner to allocate income between controlled enterprises when he determines that such allocations are necessary to prevent evasion of taxes or to clearly reflect the true income of the controlled party.[149] The IRS's

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139. *Id.* at 326. P&G's Spanish counsel advised P&G that the decree prohibiting payment and the transfer of technology was well within the power of the Spanish government and reflected normal practice. *Id.*

140. *Id.* at 330.

141. *Id.*

142. *Id.* This action was consistent with Spain's membership in the European Economic Community, and Spain liberalized its system of authorization in an attempt to attract more foreign investment. *Id.*

143. *Id.* at 330.

144. *Id.*

145. *Id.*

146. *Id.* at 331.

147. *Id.*

148. *Id.* at 336.

149. I.R.C. § 482 (1988). *See generally* Eli Lilly & Co. v. United States, 372 F.2d 990 (Ct. Cl. 1967) (holding that the Commissioner was not precluded from a § 482 allocation even where parent sold its subsidiary); G.D. Searle & Co. v. Commissioner, 88 T.C. 252 (1987) (upholding an allocation of income from subsidiary to parent).

authority to make allocations under section 482 is broad, and such allocations must be sustained absent a showing of abuse of discretion.[150] In order to refute such a determination, a taxpayer must meet a greater than normal burden of proof, demonstrating that the IRS's allocation was arbitrary, capricious, or unreasonable.[151]

P&G asserted that, because Spanish law prohibited royalty payments from Espana to AG, it did not improperly utilize control over the subsidiary and, therefore, section 482 was inapplicable.[152] In support of this contention, P&G relied on *First Security* for the proposition that where receipt of income is barred by law, the IRS is powerless to allocate income pursuant to section 482.[153] P&G, however, conceded that, in *First Security*, the Supreme Court did not consider whether section 482 would be applicable in a situation where foreign law prohibited payments between controlled entities.[154]

The Tax Court began its analysis with a summary interpretation of section 482. It stated that "section 482 is designed to prevent the artificial shifting of the true net incomes of controlled taxpayers by placing controlled taxpayers on a parity with uncontrolled, unrelated taxpayers."[155] In deciding whether there has been an artificial shifting of income, the court focused on two criteria: (1) whether P&G controlled the subsidiary and (2) whether there was an artificial shifting of income.[156] The regulations for section 482 prescribe that there is a presumption of control when income or deductions have been artificially shifted.[157] Therefore, the first issue as to control was no longer relevant. Accordingly, the Tax Court framed the paramount issue as "whether a section 482 allocation is appropriately applied under the circumstances to correct the 'shifting' of income associated with Spain's policy of prohibiting or blocking royalty payments from a Spanish subsidiary to its foreign parent."[158] To resolve this issue, the Tax Court turned to the test set out in *First Security*: whether there had been a shifting or distortion of income

150. *See supra* note 21 and accompanying text.
151. *Procter & Gamble*, 95 T.C. at 332.
152. *Id.*
153. *Id.*
154. *Id.* at 333.
155. *Id.* at 332.
156. *Id.* at 331-33.
157. Treas. Reg. § 1.482-1(a)(3) (1986).
158. *Procter & Gamble*, 95 T.C. at 333.

by the controlling entity.[159] The Tax Court interpreted *First Security* to mean that "section 482 simply does not apply where restrictions imposed by law, and not actions of the controlling interest, serve to distort income among the controlled group."[160]

The Tax Court concluded that, because Spanish law prohibited Espana from paying royalties to AG, this effectively precluded AG from receiving them.[161] There was no shifting of income by P&G from AG to Espana; therefore, the allocation of income from Espana to AG was not authorized under section 482.[162] As a result, the increase in P&G's Subpart F income was improper.[163]

2. Motion for Reconsideration

The IRS filed a motion for reconsideration, arguing that: (1) section 482 could be applied to allocate deductions from AG to Espana (as opposed to allocating income from Espana to AG)[164] and (2) foreign law was irrelevant with respect to the application of section 482.[165] The IRS cited *United States v. Goodyear Tire & Rubber Co.*[166] in support of its contention that foreign law was immaterial to the interpretation and application of U.S. tax law.[167] In *Goodyear*, the Supreme Court reaffirmed the statutory canon that "tax provisions should generally be read to incorporate domestic tax concepts absent clear congressional expression that foreign concepts control."[168]

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159. *Id.* at 334 (citing Commissioner v. First Sec. Bank of Utah, 405 U.S. 394 (1972)).

160. *Id.* at 336.

161. *Id.*

162. *Id.* at 337-38.

163. *Id.* at 341.

164. *Procter & Gamble*, 60 T.C.M. (CCH) at 1464.

165. *Id.* There were a total of eight grounds laid out in the IRS's motion for reconsideration: (1) foreign law was immaterial with respect to the application of § 482; (2) administrative remedies must be exhausted to prove foreign law with respect to the application of § 482; (3) AG did not deal with Espana as it would have dealt with an unrelated party; (4) foreign law may not override the laws of the United States; (5) § 482 may be applied to allocate deductions from AG to Espana; (6) Spanish law did not prevent Espana from paying AG for the use of P&G's intangible property; (7) AG's payments to P&G, for Espana's use of P&G's intangible property, were not deductible under § 162; and (8) the Court improperly invalidated the blocked income rules. *Id.*

166. 493 U.S. 132 (1989).

167. *Proctor & Gamble*, 60 T.C.M. (CCH) at 1466.

168. *Id.* (quoting United States v. Goodyear Tire & Rubber Co., 493 U.S. 132 (1989)).

The Tax Court denied the IRS's motion for reconsideration, holding that the first argument was a new matter and that the IRS had waived it by not raising it at trial.[169] With respect to the IRS's second argument, the Tax Court again relied on the Supreme Court's holding in *First Security* that an allocation under section 482 cannot be made when the taxpayer's receipt of the income is barred by law.[170] The Tax Court concluded that there was "no sound basis for refusing to apply the foregoing principle where receipt of the income in question is precluded by foreign law as opposed to domestic law."[171] Therefore, the holding did not conflict with *Goodyear.*

IV. EVALUATION

In *Procter & Gamble*, the Tax Court held that the IRS was powerless to allocate income among controlled foreign corporations where local law effectively precluded payment of the amount the Commissioner sought to allocate.[172] It relied heavily on the Supreme Court's decision in *First Security* for the proposition that a section 482 allocation cannot be made where the taxpayer's receipt of the income to be allocated would be illegal.[173] The Tax Court's reliance on *First Security* presents two significant issues that warrant further attention: (1) whether an allocation of income pursuant to section 482 was intended to be contingent upon the taxpayer's ability to receive the income in question; and (2) whether, as a general principle, it is prudent to permit U.S. taxing authority to be controlled by foreign law.

A. *Taxpayer's Ability to Receive the Income*

In *First Security*, the Supreme Court framed this issue to be "whether there was a shifting or distorting of the Banks' true net income."[174] The Court concluded that there was no shifting of income because the banks could not legally receive the income in question.[175] In arriving at this conclusion, the Court relied on Treasury Regu-

169. *Id.* at 1465-66.
170. *Id.* at 1466.
171. *Id.*
172. Procter & Gamble Co. v. Commissioner, 95 T.C. 323 (1990).
173. *Id.* at 339.
174. *First Sec.*, 405 U.S. at 400.
175. *Id.* at 407.

lation section 1.482-1(b)(1).[176] The Tax Court in *Procter & Gamble* followed the Supreme Court's interpretation of Treasury Regulation section 1.482-1(b)(1).[177] It concluded that, because Espana was barred by law from paying royalties to AG, P&G could not possess the requisite control to shift or distort AG's income.[178] However, the Supreme Court's interpretation of Treasury Regulation section 1.482-1(b)(1) contradicts the plain meaning of the regulation.

Treasury Regulation section 1.482-1(b)(1) states:

> [T]he purpose of section 482 is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer . . . . 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 . . . of each of the controlled taxpayers.[179]

Thus, under Treasury Regulation section 1.482-1(b)(1), there is a presumption that the controlling party has complete control. However, the Supreme Court did not acknowledge this presumption in *First Security*. It interpreted Treasury Regulation section 1.482-1(b)(1) to require that the controlling party must have complete power and exercise that power in order to shift income among its subsidiaries.[180]

This contradiction is important, as it places both the Supreme Court's holding in *First Security* and the Tax Court's decision in *Procter & Gamble* on tenuous ground. If the plain meaning of Treasury Regulation section 1.482-1(b)(1) is employed, it is irrelevant whether the controlling taxpayer could legally receive the income in question since the taxpayer is assumed to have complete control of all financial affairs. Thus, in *Procter & Gamble*, the Spanish law prohibition on royalty payments from Espana to AG would have no effect on the

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176. *Id.* at 400. "The standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer." Treas. Reg. § 1.482-1(b)(1) (1986).

177. *Procter & Gamble*, 95 T.C. at 332.

178. *Id.* at 336 (finding that Spanish law, not P&G, served to distort AG's income).

179. Treas. Reg. § 1.482-1(b)(1) (1986) (emphasis added).

180. *First Sec.*, 405 U.S. at 404-05. The Court concluded that the banks did not have complete power over the controlled taxpayer because they could not have complete power under federal banking law. *Id.* Justice Powell stated, "The 'complete power' referred to in the regulations hardly includes the power to force a subsidiary to violate the law." *Id.* at 405.

allocation of income. AG would be assumed to have complete control over the finances of Espana, regardless of outside influences such as foreign law.

The court in *Procter & Gamble* interpreted the holding in *First Security* to mean that section 482 does not apply where restrictions imposed by law, as opposed to the actions of controlling interests, act to distort income among the controlled group.[181] It concluded that P&G could not be taxed on income that AG could not legally receive and P&G could not distort.[182]

Taxation, despite non-receipt of the income, however, is common in our tax law.[183] Justice Blackmun stated in his dissent in *First Security*:

> As I read the Court's opinion, I gain the impression that it chooses to link legality with taxability or, to put it better oppositely, that it ties illegality to receive with inability to tax. I find in the Internal Revenue Code no authority for the concoction of a restrictive connection of that kind.[184]

Justice Blackmun concluded that if clear reflection is the goal, then legality or illegality is irrelevant.[185] This conclusion supports the IRS's position that, although P&G could not legally receive income from Espana, it could nevertheless be taxed on that income.

Justice Blackmun further recognized that the true purposes of section 482 were to properly reflect income and to put controlled taxpayers in tax parity with uncontrolled taxpayers.[186] In espousing these principles, he wrote: "It is no answer to say that generation of income does not necessarily lead to taxation of the generator; here the earnings themselves stayed within the corporate structure dominated by the Holding Company, and did not pass elsewhere with

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181. *Procter & Gamble*, 95 T.C. at 336.

182. *Id.* at 341.

183. *First Sec.*, 405 U.S. at 423 (Blackmun, J., dissenting) (taxpayer held taxable for earnings assigned to another and never received) (citing Harrison v. Shaffner, 312 U.S. 579 (1941)). A major purpose of tax laws is the taxation of income to those who earn or otherwise create the right to receive it. *See* Helvering v. Horst, 311 U.S. 112 (1940) (holding taxpayer taxable for income from bond coupons, maturing in the future, assigned to another and never received). *See also* Old Colony Trust v. Commissioner, 279 U.S. 716 (1929) (holding taxpayer taxable for employer's payment of income taxes in his employee's compensation).

184. *First Sec.*, 405 U.S. at 418 (Blackmun, J., dissenting).

185. *Id.* at 419.

186. *Id.*

consequent tax impact elsewhere."[187] Justice Blackmun asserted that the income was not purely rerouted by law, but by both law and the holding company, since the rerouting provided the holding company with less taxable income.

The majority in *First Security*, however, reasoned that only federal banking law, not the holding company, shifted the income. The Tax Court in *Procter & Gamble* followed the *First Security* majority, concluding that Spanish law shifted the income instead of P&G.[188] This conclusion overlooks the fact that the Spanish law that prohibited Espana from paying AG clearly benefitted P&G. By prohibiting Espana from paying AG, Spanish law effectively reduced P&G's taxable income and increased the controlled group's profits because the income was taxed at Spain's corporate tax rate as opposed to the higher U.S. corporate tax rate. AG was provided, as Justice Blackmun wrote in *First Security*, with "an additional source of income for the group irrespective of the particular pocket into which that income might initially be routed."[189] The Tax Court in *Procter & Gamble* should have followed this reasoning, making it irrelevant whether AG could have actually received the income because the income remained within the control group.

Justice Marshall also dissented in *First Security*.[190] He argued that if section 482 was to have any meaning at all, the majority's holding that illegality to tax leads to inability to tax must be rejected.[191] He stated:

> It makes absolutely no sense to examine this case with a technical eye as to whether respondents actually received or had a "right" to receive any commissions. This is not a case involving independent companies or private individuals where we must scrupulously avoid taxing someone on money he will never receive regardless of his will in the matter. This is a case involving related corporations, and § 482 recognizes that such corporations may be treated differently from natural persons or unrelated corporations for certain tax purposes.[192]

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187. *Id.* at 422.
188. *Procter & Gamble*, 75 T.C. at 336.
189. *First Sec.*, 405 U.S. at 420 (Blackmun, J., dissenting).
190. *Id.* at 407 (Marshall, J., dissenting).
191. *Id.* at 415.
192. *Id.* at 410 (citations omitted).

Justice Marshall's argument is clear and directly on point; the Commissioner should be free to allocate income among controlled parties provided the income remains within the control group.[193] Justice Marshall recognized the crucial distinction between controlled and uncontrolled taxpayers; when income remains within the controlled group, receipt of the income by one particular controlled party becomes irrelevant. In *Procter & Gamble*, Espana was wholly owned by AG, and AG was wholly owned by P&G.[194] Because AG was part of the group that P&G controlled, it was irrelevant whether it could have legally received the income from Espana. Therefore, the Tax Court erred in finding that the section 482 allocation was improper.

There is another basis for dispute with the Tax Court's decision in *Procter & Gamble*. In his dissent in *First Security*, Justice Marshall further criticized the majority for improperly interpreting the true issue.[195] He believed that the issue was not whether the controlled party could legally receive the income, but whether unrelated parties dealing at arm's length would have made the same deal.[196] In *Procter & Gamble*, if AG had been dealing at arm's length with an unrelated party in Spain, AG would have demanded royalty payments from the unrelated party. Thus, unrelated parties would not have permitted their contracts to be structured in this manner. By allocating income to P&G through AG, the Commissioner structured AG's income to reflect a transaction that would have occurred had the parties dealt at arm's length. The Tax Court in *Procter & Gamble*, however, did not address the question of how unrelated parties would have dealt with each other in the same transaction and summarily dismissed this relevant issue.[197] By relying on *First Security*'s mistaken rationale, the Tax Court in *Procter & Gamble* placed its holding on even more tenuous ground.

B. Foreign Law

The Tax Court in *Procter & Gamble* devoted a large portion of its opinion to analyzing Spanish law.[198] In contrast, negligible inquiry

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193. *Id.* at 415-17.

194. *Procter & Gamble*, 95 T.C. at 324-26.

195. *First Sec.*, 405 U.S. at 408 (Marshall, J., dissenting).

196. *Id. See* Borge v. Commissioner, 405 F.2d 673 (2d Cir. 1968), *cert. denied*, 395 U.S. 933 (1969) (holding that allocation was proper where funds were transferred to a controlled corporation for the purpose of tax avoidance).

197. *Procter & Gamble*, 95 T.C. at 333.

198. *Id.* at 336-38.

was given to the more important issue of whether Spanish law should matter at all.[199]

In its motion for reconsideration, the IRS cited *United States v. Goodyear Tire & Rubber Co.*[200] in support of its contention that foreign law was immaterial.[201] The issue in *Goodyear* was whether Goodyear's section 902 "accumulated profits" should be measured in accordance with United States or foreign tax principles.[202] The Supreme Court unanimously held that "'accumulated profits,' as that term appears in [section] 902's indirect tax credit, should be calculated in accordance with domestic tax principles."[203] Thus, the Supreme Court in *Goodyear* reaffirmed the statutory canon that "tax provisions should generally be read to incorporate domestic tax concepts absent a clear congressional expression that foreign concepts control."[204]

In contrast, the Tax Court in *Procter & Gamble* concluded that it had correctly applied domestic tax concepts regarding the use of section 482 as set forth in *First Security*.[205] The Tax Court concluded, "[W]e see no sound basis for refusing to apply the foregoing principle where receipt of the income in question is precluded by foreign as opposed to domestic law."[206] However, the Tax Court failed to recognize that allowing foreign law to dictate United States taxing authority ceded U.S. taxing power to foreign nations.

The ramifications of ceding U.S. tax authority to foreign governments is of much greater consequence than the Tax Court would have us believe. Allowing foreign governments to determine U.S. tax liability has numerous potential detrimental effects. A United States corporation could create controlled corporations in foreign countries and possibly avoid taxation on the revenues received from the subsidiary through a preferential arrangement with the foreign country. Where the United States government can prove that the taxpayer had a private arrangement with the foreign government, actual receipt would be immaterial.[207] However, if the government

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199. This issue was not decided on appeal because it was not properly raised by the IRS in its pleadings. *Procter & Gamble*, 60 T.C.M. (CCH) at 1465.

200. 493 U.S. 132 (1989).

201. *Procter & Gamble*, 60 T.C.M. (CCH) at 1466.

202. *Goodyear*, 493 U.S. at 134.

203. *Id.* at 145.

204. *Id.*

205. *Procter & Gamble*, 60 T.C.M. (CCH) at 1466.

206. *Id.*

207. *See, e.g.*, United States v. Basye, 410 U.S. 441, 449-50 (1973) (holding that a taxpayer who earns income cannot avoid taxation through anticipatory arrangements).

cannot prove that the taxpayer had a private arrangement with the foreign government, which often will be the case, U.S. taxation power would be at the mercy of the foreign government.

It would appear that the potential for collusion between foreign governments and private taxpayers is pervasive. In the wake of *First Security*, Revenue Ruling 82-45 was issued in an effort to limit *First Security* to its facts.[208] Revenue Ruling 82-45 states in part, "[W]hen the prohibition on the receipt of income is based not on the laws of the United States but rather on restrictions imposed by foreign governments, the decision in *First Security Bank of Utah* does not foreclose the Service from applying section 482 in order to clearly reflect income."[209] Revenue Ruling 82-45 concluded that the laws of a foreign country cannot limit the scope of the laws of the United States.[210] The Tax Court summarily rejected Revenue Ruling 82-45 despite the clear intent of the Commissioner to limit *First Security* to its facts and not to permit foreign law to control U.S. taxing authority.[211] The Tax Court stated that the respondent cited no authority to support this argument and concluded that it failed to see how the *First Security* analysis differed whether considering the effect of foreign or domestic law.[212] However, the Tax Court did not recognize that when foreign law governs taxation of United States taxpayers, there is no assurance that the law was adopted free from motivation to attract foreign investors. It is not difficult to imagine how countries that desire the vast capital of the United States would employ any means possible to attract that capital.

There is also a strong policy reason for not permitting foreign laws to affect United States taxation. If foreign laws were considered, the United States' taxing authority would then be subject to a multitude of foreign laws. It would be administratively impossible for the IRS to interpret every law of another country that affects taxation by the United States.

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208. Rev. Rul. 82-45, 1982-1 C.B. 89.

209. *Id.*

210. *Id.*

211. *Procter & Gamble*, 95 T.C. at 339-41. In *Procter & Gamble*, the Tax Court addressed Revenue Ruling 82-45. *Id.* at 339. It rejected the ruling in concluding that the allocation was improper under *First Security* because AG's business dealings subjected it to legal restrictions that blocked receipt of the income. *Id.* at 341. In doing so, the Tax Court stated that there was no authority to show "that the Supreme Court's analysis in *First Security Bank* is limited to instances in which the section 482 allocation is contrary to Federal law." *Id.* at 339.

212. *Id.* at 339.

Ceding U.S. taxing power would prove to be detrimental to both the U.S. Government and U.S. corporations. It would encourage U.S. corporations to set up businesses in other countries that provide preferential tax treatment. This would harm the government by diminishing the U.S. tax base. Further, the corporations that set up subsidiaries in foreign countries would enjoy unwarranted tax benefits and gain a competitive advantage over corporations operating solely within the borders of the United States. This would place domestic corporations at a distinct disadvantage to multinational corporations.

V. CONCLUSION

By holding that the IRS is powerless to allocate income among controlled foreign corporations where foreign law effectively precluded the payment of amounts sought to be allocated, the Tax Court has compounded the Supreme Court's error in *First Security*. Section 482 was intended to prevent artificial shifting of income between controlled entities. Permitting the *Procter & Gamble* decision to stand would seriously hinder the effectiveness of section 482.

The solution to the problem created by *Procter & Gamble* requires both judicial and legislative attention. If the Supreme Court was to address the issue in *Procter & Gamble*, the Court should reiterate the policies behind section 482 and reverse the bad precedent of *Proctor & Gamble*. Additionally, Congress should amend section 482 so that it clearly reflects true legislative intent, i.e., when the IRS allocates income between controlled entities pursuant to section 482, actual receipt of income by one particular controlled entity is irrelevant, and U.S. taxing authority must not be ceded to foreign countries.

Gaetano C. Lanciano