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I. Introduction

Section 482 of the Internal Revenue Code¹ was enacted by Congress to place controlled taxpayers on a “tax parity” with uncontrolled taxpayers.² Such “tax parity” can not be achieved where related business enterprises are able to avoid imposition of United States Federal Income Tax by arbitrarily shifting income, expenses, or other deductions between controlling entities and their controlled affiliates. Therefore, section 482 allows the Commissioner of the Internal Revenue Service to allocate items of income or expenses among related businesses so that tax records will reflect true taxable income.³

¹ 26 U.S.C. § 482 (1988). The history of section 482 began with section 240 of the Revenue Act of 1918 requiring that affiliated corporations file consolidated returns. Revenue Act of 1918, ch. 18, § 240(a), 40 Stat. 1057, 1081 (1919). In 1921, section 240 of the Revenue Act of 1921 was provided “to prevent the arbitrary shifting of profits among related businesses.” S. REP. No. 275, 67th Cong., 1st Sess. 20 (1921). Section 45 of the Revenue Act of 1928, ch. 852, § 45, 45 Stat. 806, was enacted to “prevent tax evasion by the shifting of profits, the making of fictitious sales, and other methods frequently adopted for the purpose of ‘milking.’” H.R. REP. No. 2, 70th Cong., 1st Sess. 16-17 (1928). Section 482 has undergone little change since the Revenue Act of 1928, although Congress did amend section 482 in 1986 to provide that the income from a transfer of an interest in intangible property shall be “commensurate with the income attributable to the intangible.” 26 U.S.C. § 482.

² Treas. Reg. 1.482-1(b) (as amended in 1986). *Commissioner v. First Security Bank of Utah*, 405 U.S. 394, 400 (1972); *Simon J. Murphy Co. v. Commissioner*, 231 F.2d 639, 644 (6th Cir. 1956); *Bausch & Lomb, Inc. v. Commissioner*, 92 T.C. 525, 581 (1989), *aff’d* 933 F.2d 1084 (2d Cir. 1991). The distinction between “controlled” and “uncontrolled” taxpayers refers to the corporate structure in which business entities operate. Section 482 ensures equal tax treatment of business enterprises regardless of their autonomy or membership in a family of affiliated companies. In the absence of section 482, controlling corporations could structure transactions with their affiliates to achieve favorable tax treatment otherwise unavailable if the controlling corporations had dealt with unrelated third parties. See *infra* notes 11-19 and accompanying text.

³ When tax records of controlled taxpayers do not accurately reflect true taxable income, the regulations of section 482 allow the district director to make “such distributions, apportionments, or allocations as he may deem necessary of gross income, deductions, credits, or allowances, or of any item or element affecting taxable income . . . [to] determine the true taxable income of [such] controlled taxpayer.” Treas. Reg. 1.482-1(b)(1).

The Commissioner's power to allocate items of income and deductions under section 482 is particularly important in the taxation of international business transactions where a United States taxpayer controls or is controlled by a foreign affiliate.⁴ Recently, however, the Treasury's ability to maintain "tax parity" under section 482 has been severely limited by the Tax Court's decision in *Procter & Gamble Co. v. Commissioner*.⁵ In *Procter & Gamble*, a Spanish subsidiary corporation was controlled by a wholly owned Swiss subsidiary of Procter & Gamble Co. (P&G), a United States corporate taxpayer.⁶ Under Spanish law, the Spanish corporation was prohibited from making any royalty payments to the Swiss subsidiary for use of the P&G Co.'s intangible property.⁷ Because the Spanish government's prohibition on royalty payments caused the shifting of income from the U.S. parent to the Spanish subsidiary, the Commissioner of the Internal Revenue Service determined that a section 482 adjustment was required to clearly reflect the income of the parent.⁸ The Tax Court held, however, that because Spanish law prohibited the Spanish subsidiary from making royalty payments, no section 482 allocation was warranted.⁹

II. An Overview of Section 482

The Commissioner's authority to allocate items of income among related businesses is governed by section 482 of the Internal Revenue Code. Section 482 states:

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 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.

In the case of any transfer (or license) of intangible property . . . the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible.¹⁰

The regulations of section 482 broadly define the terms "controlled

⁴ See Comment, *First Security Bank of Utah-Its Effect Upon The Expanded Scope of Section 482*, 61 Ky. L.J. 845 (1973) [hereinafter *The Expanded Scope of Section 482*] (stating that the Commissioner's use of section 482 is "most notorious" in the "international business scene").

⁵ 95 T.C. 323 (1990).

⁶ *Id.* at 324.

⁷ *Id.* at 324-26.

⁸ *Id.* at 330-31.

⁹ *Id.* at 337-38.

¹⁰ 26 U.S.C. § 482 (1988).

taxpayer"¹¹ and "true taxable income"¹² to ensure that the taxable income of the controlling taxpayer is commensurate with the taxable income that would have been reported had the controlling taxpayer dealt at arm's length with an uncontrolled entity.¹³ Detailed regulations are provided to guide tax reporting where one member of a controlled group: 1) performs services for another member,¹⁴ 2) transfers intangible property,¹⁵ or 3) makes sales of tangible property to an affiliate.¹⁶

A simple illustration will demonstrate the potential for tax avoidance that would exist were the Treasury not armed with the authority to reallocate items of income via section 482. Suppose that Corp-America, organized and domiciled in the United States, operates a wholly owned subsidiary, Sub-Italia, in Italy. Sub-Italia was organized by Corp-America as a European distributor of products manufactured by Corp-America in the United States. Assuming that Corp-America is subject to a higher U.S. corporate tax rate than Italy imposes upon Sub-Italia, Corp-America would desire to set, as low

¹¹ "The term 'controlled' includes any kind of control, direct or indirect, whether legally enforceable, and however exercisable or exercised." Treas. Reg. 1.482-1(a)(3). The regulations further state that "[a] presumption of control arises if income or deductions have been arbitrarily shifted." *Id.* Unlike other Code sections that define "control," the definition of "control" provided in the regulations to section 482 is broad and contains no cross reference to other sections of the Code. *The Expanded Scope of Section 482, supra* note 4, at 854.

¹² The regulations define "true taxable income" as "the taxable income (or . . . any item or element affecting taxable income) which would have resulted to the controlled taxpayer, had it . . . dealt with the other member . . . of the group at arm's length." Treas. Reg. 1.482-1(a)(6).

¹³ Treas. Reg. 1.482-1(b)(1). See *Baldwin Bros. v. Commissioner*, 361 F.2d 668, 670 (3d Cir. 1966); *Spicer Theatre, Inc. v. Commissioner*, 346 F.2d 704, 706 (6th Cir. 1965); *Commissioner v. Chelsea Products*, 197 F.2d 620, 623 (3d Cir. 1952).

¹⁴ See Treas. Reg. 1.482-2(b)(as amended in 1988).

¹⁵ See Treas. Reg. 1.482-2(d). The proper pricing of intercompany transfers of intangible property under section 482 has proved to be very difficult for both taxpayers and the Tax Court. See *Hospital Corp. of America v. Commissioner*, 81 T.C. 520 (1983); *Eli Lilly, & Co. v. Commissioner*, 84 T.C. 996 (1985), *rev'd in part, aff'd in part and remanded*, 856 F.2d 855 (7th Cir. 1988); *Ciba-Geigy Corp. v. Commissioner*, 85 T.C. 172 (1985); *G.D. Searle & Co. v. Commissioner*, 88 T.C. 252 (1987). In 1986, Congress sought to relieve some of the confusion that has plagued the tax community by amending section 482 by adding a provision requiring that payments to a related entity with respect to an intangible be "commensurate with the income attributable to the intangible." 26 U.S.C. 482 (1986). The Treasury Department and the Internal Revenue Service then engaged in a study of the history and theory of the administration of section 482 and issued "A Study of Intercompany Pricing." Internal Revenue Service, Treasury Department, "A Study of Intercompany Pricing" (Discussion Draft, Oct. 18, 1988). This report, known as the section 482 "White Paper," presented a series of recommendations to Congress that would allow a more uniform approach to the intangible transfer problem inherent in the regulations to section 482. For a discussion of issues surrounding the arm's length price standard for intercompany transfers of intangible property, see Ungerman, *The White Paper: The Stealth Bomber of the Section 482 Arsenal*, 42 Sw. L.J. 1107 (1989); Durando, *Prices on Transfers of Intangible Property Between Related Taxpayers: Can the Section 482 White Paper's Arm's Length Return Method Work?*, 41 FLA. L. REV. 813 (1989).

¹⁶ See Treas. Reg. 1.482-2(e). See *infra* note 19.

as possible, its transfer price to Sub-Italia to minimize taxable income.¹⁷ By arbitrarily setting its transfer price, Corp-America could shift much of its income to Sub-Italia, and thereby avoid the higher United States income tax liability. Clearly, the Treasury's ability to generate revenue would be impeded without the aid of section 482.¹⁸ Section 482 allows the Commissioner to reallocate income back to Corp-America where examination reveals that the tax records of Corp-America have been understated due to arbitrary transfer pricing. In our example, under section 482 the district director is authorized to redetermine the taxable income that Corp-America would have recognized if the transfer price charged to Sub-Italia were equal to the transfer price Corp-America would have charged to an uncontrolled foreign buyer at arm's length.¹⁹

III. *Procter & Gamble, Co. v. Comm'r*²⁰

The dispute in *Procter & Gamble* concerned the allocation of royalty payments from Procter and Gamble Espana, S.A. (P&G Espana), to its parent corporation, Procter and Gamble A.G. (AG Swiss), a wholly owned Swiss subsidiary of Procter & Gamble, Co. (P&G).²¹ Although Spanish law prohibited a wholly owned Spanish subsidiary from making any royalty or technical assistance payments to its foreign parent company,²² the Commissioner of the Internal Revenue Service contended that a section 482 allocation of income from P&G Espana to AG Swiss was necessary to clearly reflect income recognized by P&G.²³ The Tax Court held that the deflection of income from AG Swiss to P&G Espana was caused by operation of Spanish law and not by P&G's exercise of control over AG Swiss and P&G Espana so as to improperly shift income.²⁴ Therefore, according

¹⁷ Conversely, if Sub-Italia were subject to a higher tax rate in Italy, Corp-America would attempt to sell to Sub-Italia at an inflated price to minimize income recognized by the subsidiary.

¹⁸ See Case Comment, *Income Tax-Section 482 Of The Internal Revenue Act: Commissioner's Authority to Allocate Income Is Limited by Taxpayer Legal Disability*-Commissioner of Internal Revenue Service v. First Security Bank of Utah, N.A., 405 U.S. 394 (1972), 48 WASH. L. REV. 492 (1973) (warning that "without the flexibility added to the Code by Section 482, businesses would have considerable discretion to restructure their activities and thus alter their true taxable income so as to defeat the purposes of the Code." *Id.* at 494).

¹⁹ Treas. Reg. 1.482-1(b)(1). Specifically, Treas. Reg. 1.482-2(e) provides a rather complicated outline as to how the Treasury will determine true taxable income where one controlled taxpayer sells tangible property to another. The regulations prescribe three methods for determining an arm's length price: the comparable uncontrolled price method, the resale price method, and the cost plus method. Treas. Reg. 1.482-2(e)(1)(ii). In addition, Treas. Reg. 1.482-2(e)(1)(iii) states that "some appropriate method of pricing other than those described" may be used where none of these methods can be applied under the circumstances.

²⁰ 95 T.C. 323 (1990).

²¹ *Id.* at 324.

²² *Id.* at 326.

²³ *Id.* at 330-31.

²⁴ *Id.* at 336.

to the court, the Commissioner's section 482 allocation was unwarranted.²⁵

During the years at issue, P&G was an Ohio corporation engaged in manufacturing and marketing consumer and industrial products through domestic and foreign subsidiaries.²⁶ AG Swiss, a wholly owned Swiss subsidiary of P&G, marketed P&G's products in countries where P&G did not already have a marketing affiliate.²⁷ In September 1967, P&G applied to the Presidency of the Spanish Government requesting permission to organize a wholly owned subsidiary, P&G Espana, to manufacture consumer and industrial products in Spain.²⁸ Under Spanish law, prior approval from the Spanish Council of Ministers was required in order for foreign ownership of a Spanish corporation to exceed fifty percent.²⁹ The Spanish government approved P&G's application for one hundred percent ownership in P&G Espana, but prohibited P&G Espana from making any royalty payments to P&G.³⁰ Spanish counsel advised P&G that it was useless to protest the government's prohibition of royalty payments by P&G Espana if P&G insisted upon one hundred percent ownership.³¹ Consequently, P&G did not formally appeal the Spanish government's decision.³²

²⁵ *Id.* at 337.

²⁶ *Id.* at 324.

²⁷ *Id.* Under a License and Service Agreement, known as a "package fee agreement," between P&G and AG Swiss, AG Swiss paid royalties to P&G for its non-exclusive right to use P&G's intangible property. *Id.* Royalties paid by AG Swiss were based upon net sales of P&G's products by AG Swiss and its subsidiaries. *Id.* AG Swiss entered into similar technical assistance and other service agreements with its wholly owned subsidiaries. *Id.*

²⁸ *Id.* at 325. In the application letter addressed to the "Presidency of the Spanish Government," P&G requested authorization to organize P&G Espana. The letter stated that P&G intended to own all of the capital stock of P&G Espana either directly or through a wholly owned subsidiary. *Id.* According to the letter, P&G Espana would manufacture and sell consumer and industrial products such as synthetic detergents, soaps, and toiletries. *Id.*

²⁹ *Id.* Article First of the First Title of the Spanish Law of Monetary Crimes of November 24, 1938, provided authority for regulating payments from Spanish corporations to residents of foreign countries. *Id.* Paragraphs 14 through 17 required prior governmental approval for payments to foreign residents. *Id.* Making such payments without prior governmental authorization constituted a crime. *Id.* In September 1973, the Spanish government issued Decree 2343/1973 which provided specific regulations for technology agreements. *Id.* at 327. In December of that year, the Ministry of Industry issued an order outlining rules for technology agreements under Decree 2343. *Id.* at 328. Paragraph 12 of article 3 stated that the Ministry of Industry should not give favorable treatment to technology agreements between a Spanish subsidiary and a foreign parent that provided for royalty payments to the parent for the subsidiary's use of the parent's technology where the parent's capital investment in the subsidiary exceeded fifty percent. *Id.* Royalty payments were authorized, however, where foreign ownership was less than fifty percent. *Id.*

³⁰ *Id.* at 326.

³¹ *Id.* When P&G Espana was organized, several of its competitors likewise could not make royalty payments abroad. *Id.*

³² *Id.* After incorporating P&G Espana through P&G Swiss, P&G Espana made several requests to increase P&G's capital investment. *Id.* at 326-27. Although granting P&G Espana's requests, the Spanish government conditioned each approval subject to the pro-

In 1968 P&G incorporated P&G Espana through AG Swiss. From the date of incorporation until 1985, AG Swiss paid royalties to P&G based on a percentage of P&G Espana's net sales and reduced its income accordingly.³³ During these years, however, P&G Espana never made any payments to AG Swiss for the use of P&G's technology.³⁴ In 1985, the Spanish government changed its system for authorizing foreign investment and in 1987, the Spanish government approved P&G Espana's application for removal of the prohibition against the payment of royalties.³⁵ The Internal Revenue Service then sought to increase AG Swiss's taxable income for the years 1978 and 1979 by allocating income from P&G Espana to AG Swiss under section 482.³⁶ The Commissioner determined that income in the amounts of \$1,232,653 and \$1,795,005 for the years 1978 and 1979 should be allocated to AG Swiss which in turn increased P&G's subpart F income under section 951(a)(1)(A).³⁷

Relying upon the Supreme Court's decision in *Commissioner v. First Security Bank of Utah*,³⁸ which held that the Commissioner's section 482 allocation of insurance premium income was improper where federal law prohibited the taxpayer from receiving such income,³⁹ P&G contended that it did not improperly exercise its control over AG Swiss and P&G Espana to shift income it could not legally receive under Spanish law.⁴⁰ According to P&G, section 482

hibition of any royalty payments to AG Swiss or P&G. *Id.* at 327. On May 19, 1970, counsel for P&G Espana met with an official from the Spanish Ministry of Industry to discuss the possibility that P&G Espana could make technical assistance payments to AG Swiss. *Id.* However, the Spanish Government refused to grant permission for such payments. *Id.* The Spanish Government discouraged these appeals due to concerns that companies situated similar to P&G Espana would abuse technical assistance payments and thereby remove profits from Spanish taxation. *Id.*

³³ *Id.* at 330.

³⁴ *Id.*

³⁵ *Id.*

³⁶ *Id.* at 330-31. The Commissioner's allocation was based on a royalty of two percent of P&G Espana's net sales of P&G's products. P&G did not contest the amount of the allocations but contended that no allocations from P&G Espana were proper under section 482. *Id.* at 331.

³⁷ *Id.* at 330-31. Subpart F of the Internal Revenue Code was enacted by Congress to prevent U.S. taxpayers from using foreign corporations to accumulate certain types of income in low-tax jurisdictions. R. DOERNBERG, *INTERNATIONAL TAXATION* 172 (1989) [hereinafter DOERNBERG]; R. HELLOWELL & R. PUGH, *TAXATION OF TRANSNATIONAL TRANSACTIONS 1987-1988* at 252 (1987). Under section 951 (a)(1)(A)(i) of the Internal Revenue Code, a U.S. shareholder of a controlled foreign corporation is treated as having received a current distribution of his pro rata share of the controlled foreign corporation's subpart F income. The subpart F income of a controlled foreign corporation includes "foreign base company income." 26 U.S.C. § 952(a)(2). In turn, "foreign base company income" is composed of several categories of income that otherwise could be isolated by a U.S. taxpayer in the controlled foreign corporation's low-tax jurisdiction. DOERNBERG, *supra*, at 176. See 26 U.S.C. § 954 (1988).

³⁸ 405 U.S. 394 (1972). See *infra* notes 59-85 and accompanying text.

³⁹ *First Security Bank*, 405 U.S. at 404-05.

⁴⁰ *Procter & Gamble*, 95 T.C. at 332.

did not apply and AG Swiss' income should not be increased.⁴¹

The Commissioner advanced two theories supporting the position that section 482 should apply. First, the Commissioner argued that the prohibition of royalty payments from P&G Espana was "merely an administrative decision" by the Spanish government.⁴² Because P&G Espana "voluntarily waived" this decision by failing to formally appeal the prohibition of royalty payments, *First Security Bank* did not apply.⁴³ Second, the Commissioner argued that even assuming that P&G Espana was bound by the Spanish government's decision, the facts of *First Security Bank* were distinguishable.⁴⁴ In *First Security Bank*, federal law prohibited the related taxpayer from receiving income from the affiliate.⁴⁵ In the present case, however, Spanish law only prohibited the wholly owned Spanish subsidiary from making the royalty payments to a foreign parent.⁴⁶ Because AG Swiss could have received royalty payments from an unrelated Spanish company at arm's length, the transactions between P&G Espana and AG Swiss effected an artificial shifting of income.⁴⁷ Therefore, the Commissioner argued that the tax consequences of the relationship between P&G Espana and AG Swiss did not "clearly reflect" the true taxable income of AG Swiss.⁴⁸

Contrary to the Commissioner's primary contention that *First Security Bank* did not apply to the case at hand, the Tax Court concluded that section 482 was not applicable where foreign law, and not the members of the controlled group, acted to distort income of a subsidiary; therefore, the sole issue before the court was whether Spanish law indeed prohibited payment of royalties by P&G Espana.⁴⁹ Finding that Spanish law only allowed royalty payments

⁴¹ *Id.*

⁴² *Id.* at 333. The Commissioner characterized the Spanish government's prohibition of royalty payments as "an administrative decision, arbitrarily determined and subject to appellate review" *Id.*

⁴³ *Id.*

⁴⁴ *Id.* The court recognized that the Supreme Court in *First Security Bank* did not decide whether section 482 would apply where foreign law, rather than domestic law, prohibited payments between companies subject to common ownership. *Id.*

⁴⁵ See *First Security Bank*, 405 U.S. at 400-02.

⁴⁶ *Procter & Gamble*, 95 T.C. at 333.

⁴⁷ *Id.* The court rephrased the Commissioner's argument: "because AG [Swiss] could have received royalty payments from an unrelated Spanish company, and would have demanded royalties if bargaining at arm's length . . . [t]he transaction, albeit a product of Spanish law, effects an artificial shifting of income and does not clearly reflect income."

⁴⁸ *Id.*

⁴⁹ *Id.* at 336.

[S]ection 482 simply does not apply where restrictions imposed by law, and not the actions of the controlling interest, serve to distort income among the controlled group. Accordingly, in order to decide whether [the Commissioner's] allocation is appropriate . . . we must determine whether Spanish law prohibited or blocked [P&G] Espana from making royalty payments to AG [Swiss]. *Id.*

where companies comparable to AG Swiss held less than fifty percent ownership in a Spanish subsidiary, the court concluded that the Spanish government's prohibition of royalty payments by P&G Espana was not arbitrary.⁵⁰ Moreover, the court stated that P&G Espana's failure to file a formal appeal with the Spanish government did not affect its determination that a section 482 allocation was inappropriate.⁵¹

The Tax Court emphasized that P&G had valid business reasons for one hundred percent ownership of P&G Espana.⁵² The court noted that like the taxpayer in *First Security Bank*, P&G did not utilize its control over P&G Espana to arbitrarily shift income nor did it structure its capitalization of P&G Espana to avoid taxes.⁵³ Although P&G could have structured its ownership of P&G Espana through less than fifty percent ownership so as to circumvent the Spanish prohibition of royalty payments to a majority owner, P&G was not required to capitalize P&G Espana to maximize its tax liability "as long as the transaction in question ha[d] substance."⁵⁴

The court also refused to agree with the Commissioner's attempt to distinguish *First Security Bank* on the grounds that federal law in *First Security Bank* prohibited receipt of income whereas Spanish law only prohibited payment of income.⁵⁵ Although the Supreme

⁵⁰ *Id.* at 337. In determining that Spanish law indeed prohibited P&G Espana from making royalty payments, the court found compelling the express prohibition against royalty payments contained in the approval letters granting permission to organize P&G Espana and permitting capital increases. *Id.* at 336. The court also emphasized that companies comparable to P&G Espana were likewise barred from making royalty payments to their foreign parents. *Id.*

⁵¹ *Id.* at 337. Although P&G Espana did prepare a formal application requesting that the prohibition against royalty payments be lifted, P&G Espana abandoned its efforts after informal communications with Spanish officials. *Id.* In addition, testimony revealed that although appeal of the royalty prohibition was possible, "an appeal always puts you in a very difficult position vis-a-vis of the public administration and you could in the future be blackmailed by the official who has to approve afterwards all the dossiers in the exchange control authority." *Id.*

⁵² *Id.* at 338. Through 100 percent ownership in P&G Espana, P&G could ensure confidentiality of its technology, and P&G Espana would be able to obtain access to additional investment capital from P&G. *Id.* at 338. In addition, P&G contended that 100 percent ownership was necessary due to the risks in mass-producing P&G consumer products. *Id.* at 326.

⁵³ *Id.* at 338. In fact, on three occasions, P&G sought for and received authorization from the Spanish government to receive compensation for engineering services provided to P&G Espana notwithstanding the government's similar prohibition against such payments. *Id.*

⁵⁴ *Id.*

⁵⁵ *Id.* at 339.

As we see it, this is a distinction without a difference. If [P&G] Espana could not by law make royalty payments to AG [Swiss] . . . AG [Swiss] could not receive them. In this light [the Commissioner's] contention is illogical, a non sequitur. To the extent that AG [Swiss] did not and could not receive payment, *First Security Bank* controls. *Id.*

The court also stated that their decision did not allow "section 482 to be abrogated" by foreign law. *Id.* "[W]e fail to see how the *First Security Bank* analysis differs whether considering the effect of foreign law as opposed to domestic law." *Id.*

Court did not address whether section 482 was equally applicable whether the payment or the receipt of income was prohibited, the Tax Court concluded that the proper focus in either event was whether the taxpayer utilized its control to shift income.⁵⁶ Because the shifting of income was the result of Spanish law and not P&G's improper exercise of control over P&G Espana, the "threshold for application of section 482" was absent.⁵⁷ The court did not address whether a section 482 allocation would be appropriate where the transaction between the related taxpayers lacked a legitimate business purpose.⁵⁸

IV. *Commissioner v. First Security Bank of Utah* and the Legal Disability Doctrine

Any analysis of the Tax Court's decision in *Procter & Gamble* must begin with an examination of *Commissioner v. First Security Bank of Utah*.⁵⁹ In *First Security Bank*, two banks, First Security Bank of Utah and First Security Bank of Idaho ("the Banks"), and Security Life, an insurance company, were wholly owned subsidiaries of First Security Corp. ("the Holding Company").⁶⁰ In 1948 the Banks began offering to arrange credit life and health insurance for borrowers.⁶¹ Borrowers were referred by the Banks to an independent insurance company to underwrite the insurance.⁶² The insurance company would then reinsure the policies with Security Life.⁶³ Security Life, licensed to engage in the insurance business, would retain eighty five percent of the premiums from the independent insurance companies.⁶⁴ Security life paid no sales commissions to the Banks for gen-

⁵⁶ *Id.* at 340.

⁵⁷ *Id.*

⁵⁸ *Id.* at 341. "We do not have before us, and therefore do not address, whether a section 482 allocation may be appropriate where legitimate business purposes are lacking." *Id.*

The Commissioner also argued that the court's decision rendered Treasury Regulation 1.482-1(d)(6) meaningless. *Id.* at 340. Treasury Regulation 1.482-1(d)(6) provides that if payment for the rendition of services among members of a group of controlled entities is prevented because of foreign law, the taxpayer may elect to defer any section 482 allocations of income until the income is no longer deferrable, if the taxpayer also defers expenses related to that income. The court dismissed the Commissioner's contention stating that because section 482 does not apply, neither do the underlying regulations. *Procter & Gamble*, 95 T.C. at 341.

⁵⁹ 405 U.S. 394 (1972).

⁶⁰ *Id.* at 396.

⁶¹ *Id.*

⁶² *Id.* at 398.

⁶³ *Id.* Before 1954, borrowers were referred to independent insurance companies who paid sales commissions to an insurance agency, Ed. D. Smith & Sons, which was another wholly owned subsidiary of Holding Company. The sales commissions were reported as income by First Security Co., another wholly owned subsidiary of Holding Company, which maintained records of purchased insurance and forwarded premiums to the insurance companies. *Id.* at 396-97.

⁶⁴ *Id.* at 398.

erating credit insurance.⁶⁵

Between the years 1955 and 1959, Security Life reported the retained insurance premiums in its income.⁶⁶ Because Security Life was subject to a lower tax rate than the Holding Company, the total tax liability for the Holding Company and its subsidiaries was less than it would have been had First Security paid sales commissions to the Banks.⁶⁷ Pursuant to section 482, the Commissioner sought to allocate forty percent of Security Life's premium income to the Banks as compensation for processing the credit life insurance even though no commissions were ever received by the Banks.⁶⁸

In determining whether "a shifting or distorting of the Banks' true net income result[ed]"⁶⁹ from Security Life's receipt and retention of the premiums, the Court recognized that federal law prohibited the banks from acting as insurance agents and the banks therefore were unable to receive a share of the insurance premiums.⁷⁰ According to the Court, an underlying concept of taxable income is that a taxpayer must be free to receive and must have "complete dominion" over the income in question.⁷¹ Based upon Treasury Regulation 1.482-1(b)(1),⁷² the Court reasoned that section 482 only applies where the controlling interest has "complete power" to shift income between the controlled affiliates.⁷³ Because

⁶⁵ *Id.*

⁶⁶ *Id.* at 399.

⁶⁷ *Id.* Under the Life Insurance Company Tax Act of 1955, 70 Stat. 36 (1960), in effect during the years 1955 to 1957, and under the Life Insurance Company Income Tax Act of 1959, Pub. L. No. 86-69, 73 Stat. 112 (1959), insurance companies were subject to preferential tax treatment. *First Security Bank*, 405 U.S. at 399 n. 6.

⁶⁸ *Id.* at 400.

⁶⁹ *Id.* at 400-01.

⁷⁰ *Id.* at 402. Under section 92 of the National Bank Act of 1916, national banks could not act as insurance agents when located in places having a population not exceeding 5000 inhabitants. Federal Reserve Act, Pub. L. No. 270, 39 Stat. 752, 753 (1916), amended by Act of April 5, 1918, Pub. L. No. 121, 40 Stat. 506, 512 (1918) (prohibition limiting banks to act as insurance agents omitted and never placed in United States Code). Section 92 did not explicitly prohibit banks in cities of more than 5000 inhabitants from acting as insurance agents but courts have held that it implicitly does. *First Security Bank*, 405 U.S. at 401. See, e.g., *Saxon v. Georgia Ass'n of Indep. Ins. Agents*, 399 F.2d 1010, 1013 (5th Cir. 1968); *Commissioner v. Morris Trust*, 367 F.2d 794, 795 (4th Cir. 1966). Because the Banks in *First Security Bank* operated in a city with a population exceeding 5000 persons, the Court held that section 92 of the National Bank Act prohibited the Banks from acting as insurance agents by soliciting or collecting insurance premiums. 405 U.S. at 407. Section 92 was omitted from the National Banking Act of 1918 but was still considered to be in effect during the years of the transactions between the Banks and Security Life. *Id.* at 401 n. 12.

⁷¹ *First Security Bank*, 405 U.S. at 403. "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." *Id.*

⁷² "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).

⁷³ *First Security Bank*, 405 U.S. at 404.

the Holding Company would have violated federal law if it had exercised control over its subsidiaries to cause the Banks' receipt of insurance premiums, the Banks' legal disability to receive the premium income negated the Commissioner's authority to reallocate income under section 482.⁷⁴

The Court finally noted that a similar prohibition on the receipt of insurance premium income would exist even if the Holding Company had dealt at arm's length with an independent, uncontrolled bank.⁷⁵ Because federal law applied equally to all banks, the purpose of section 482 in placing controlled and uncontrolled taxpayers on a tax parity was satisfied by the Court's determination that a section 482 allocation was inappropriate.⁷⁶

In his dissenting opinion, Justice Blackmun argued that the majority erroneously concluded that illegality to receive income implicates inability to tax that income.⁷⁷ Instead, Blackmun argued the purpose of section 482 is to correct a distortion of income and effectuate a proper reflection of true income.⁷⁸ The specific wording of section 482 states that the statute is directed both to "prevent evasion of taxes" and to "clearly reflect income."⁷⁹ Blackmun felt that the Court's emphasis on the Banks' legal inability to receive insurance premium income placed "undue emphasis [on] the first alternative of [section] 482, and seem[ed] almost wholly to ignore the second."⁸⁰ Blackmun conceded that because section 482 is

⁷⁴ *Id.* at 405. "The 'complete power' referred to in the regulations hardly includes the power to force a subsidiary to violate the law." *Id.* The basis of the Supreme Court's decision is known as the "taxpayer disability" doctrine. In relying upon the "complete dominion" principle of section 61 of the Internal Revenue Code to formulate his disability argument, Mr. Justice Powell appears to have added a "complete power" condition to application of section 482. *The Expanded Scope of Section 482, supra* note 4, at 858. Under this interpretation of *First Security Bank*, the Commissioner's power to allocate income under section 482 is now limited to his power to tax income under section 70. *See id.*

⁷⁵ 405 U.S. at 407.

⁷⁶ *Id.* The Supreme Court's decision in *First Security Bank* was met with mixed reviews. Some commentators criticized the decision for "its exaltation of form over substance." Note, *Income Tax-Section 482 of The Internal Revenue Act: Commissioner's Authority To Allocate Income Is Limited By Taxpayer Legal Disability*, 48 WASH. L. REV. 492, 502 (1973). Other commentators were less critical of *First Security Bank*. *See* Teschner, *First Security Bank of Utah: Taxpayer Disability and the Supreme Court*, 50 TAXES 260 (1972).

Mr. Justice Powell's first opinion for the Court has infused tax law with a basic humanism-has, in short, treated taxpayers compassionately and as people. For the first time the Court has spoken directly and conclusively: yes, taxpayer volition is significant and, no, taxpayer disability may *not* be overlooked by the tax collector.

Id. at 260 (emphasis in original).

⁷⁷ *First Security Bank*, 405 U.S. at 418 (Blackmun, J., dissenting). Justice Blackmun stated that the language used by the Court to support its "complete dominion" theory is "language used to support the taxation of income, it is not language, as the Court would make it out to be, that supported the nontaxation of income." *Id.* at 424 (Blackmun, J., dissenting)(emphasis in original).

⁷⁸ *See id.* at 419.

⁷⁹ *Id.* at 419.

⁸⁰ *Id.*

"designed to produce for tax purposes . . . economic realities and to have the tax consequences follow those realities and not some structured nonreality," the Court should have focused on the controlling force generating the premium income.⁸¹

According to Justice Blackmun, the majority failed to properly recognize that it was the Banks, and not Security Life, that generated the premium income on behalf of Security Life.⁸² Had the Banks and Security Life dealt with each other at arm's length, the Banks would have been compensated for their services.⁸³ Clearly, the benefits of the transactions between the Banks and Security Life inured to the Holding Company regardless of "the particular pocket into which that [referral] income might initially be routed."⁸⁴ According to Blackmun, by ignoring the economic reality of the control exerted by Holding Company, the majority's holding "dull[ed] one edge of what ha[d] been a sharp two-edged tool fashioned and bestowed by the Congress upon the Internal Revenue Service for the effective enforcement of our federal tax laws."⁸⁵

The Court's decision that section 482 did not apply to the facts of *First Security Bank* represented a retreat from the earlier position taken by the Seventh Circuit Court of Appeals under almost identical facts in *Local Finance Corp. v. Commissioner*.⁸⁶ Stating that *Local Finance Corp.* was "erroneously decided,"⁸⁷ the Court instead sided with the Tax Court in *L.E. Shunk Latex Products, Inc. v. Commissioner*.⁸⁸ In *Shunk*, the Tax Court rejected the Commissioner's allocation of income to the taxpayer for underselling products to a controlled partnership on the grounds that prices charged by the taxpayer were

⁸¹ *Id.*

⁸² *Id.* at 421-22.

⁸³ *Id.* at 422.

⁸⁴ *Id.* at 420. Justice Blackmun stated that "the earnings themselves stayed within the corporate structure dominated by Holding Company, and did not pass elsewhere with consequent tax impact elsewhere." *Id.* at 422.

⁸⁵ *Id.* at 426. Justice Blackmun's reference to section 482 as a "two edged tool" denotes the Commissioner's discretion to use section 482 to prevent the evasion of taxes or to achieve the proper reflection of income. Comment, *First Security Bank of Utah-Its Effect Upon The Expanded Scope of Section 482*, 61 Ky. L.J. 845, 845 (1973).

⁸⁶ 407 F.2d 629 (7th Cir. 1969), *rev'd*, 405 U.S. 394 (1971). In *Local Finance Corp.*, Local Finance organized two corporations to serve as insurance brokers to provide fire and casualty insurance on property given as security to Local Finance by its borrowers. 407 F.2d at 630. Although state law prohibited Local Finance and its wholly owned finance companies from receiving any insurance premiums, the Seventh Circuit Court of Appeals upheld the Tax Court's determination that fifty percent of the insurance premiums were allocable to its subsidiaries under section 482 despite non-receipt. *Id.* at 633. According to the court, the issue of taxation without receipt was subordinate to the question of whether the subsidiaries would have entered into the same agreement had they bargained at arm's length. *Id.* at 632. The fact that the finance companies did not actually receive insurance proceeds did not prevent taxation. *Id.* at 633. Instead, the Commissioner's allocation properly compensated the finance companies for generating the insurance premiums. *Id.* at 632.

⁸⁷ *Commissioner v. Local Fin. Corp.*, 405 U.S. 394, 406 n. 22 (1971).

⁸⁸ 18 T.C. 940 (1952).

fixed by regulations of the Office of Price Administration and legally could not have been raised.⁸⁹

In 1980, the Sixth Circuit Court of Appeals applied *First Security Bank* to a case heavily relied upon by the Tax Court in *Procter & Gamble*. In *Salyersville National Bank v. United States*⁹⁰ the court held that a section 482 allocation of income from sales commissions to the Salyersville National Bank was unwarranted where the bank's president, a licensed life insurance agent, received sales commissions on purchases of credit life insurance by the bank's borrowers.⁹¹ The Commissioner contended that, during the tax years 1969, 1970, and 1971, insurance commissions paid to the bank's president should have been reported as income to the bank and as dividend distributions to the president.⁹² The bank argued, however, that because state law precluded receipt, the bank never could have legally received any insurance sales commissions.⁹³

Although the court did not determine whether the bank was prohibited under state law from becoming licensed insurance agents and thereby legally able to receive insurance sales commissions,⁹⁴ the court concluded that the banks never took the necessary steps to become a licensed insurance agent and therefore were never legally entitled to receive the income in question.⁹⁵ The court interpreted the Commissioner's power to reallocate income as being dependant

⁸⁹ *Id.* at 961. In *Shunk*, the court stated "[w]e would therefore regard this diversion of income as an appropriate occasion [for a section 482 allocation] were it not for certain wartime regulations issued by the Office of Price Administration." *Id.* at 959. Therefore, "the Commissioner had no authority to attribute to petitioners income which they could not have received." *Id.* at 961.

In *Local Finance Corp.*, the court distinguished *Shunk* on the grounds that in *Shunk*, the taxpayer could not have raised its prices whether dealing with a controlled or independent distributor. 407 F.2d at 634. Therefore, in *Shunk*, no allocations were necessary to place a controlled corporation on a tax parity with an uncontrolled taxpayer. *Id.*

⁹⁰ 613 F.2d 650 (6th Cir. 1980).

⁹¹ *Id.* at 656. Although the taxpayer bank did not require credit life insurance on every loan, where the borrowers did purchase insurance, the bank would refer the borrowers to the bank's president, a licensed insurance agent, or to other agents. *Id.* at 650-51. If insurance was purchased, the bank would add the premiums to the loan amount and then credit the insurance agent's account. *Id.* at 651. At other times, borrowers would write checks directly to the bank's president. *Id.*

⁹² *Id.* at 650-51.

⁹³ *Id.* at 651. After paying a deficiency assessment, the taxpayer filed a claim for a refund with the Internal Revenue Service and then filed suit in the Federal District Court for the Eastern District of Kentucky. *Id.* The district court granted summary judgment on behalf of the Internal Revenue Service on the ground that state law did not bar the bank from becoming an insurance agent. *Id.* Therefore, a section 482 allocation of income properly reflected the bank's income. *Id.*

⁹⁴ *Id.* at 654. The parties disagreed as to whether the corporate bank could become a licensed insurance agent under Kentucky law during the tax year 1969. *Id.* at 653. However, when the Kentucky insurance code was amended in 1970, corporations apparently became eligible for licensure. *Id.* at 654.

⁹⁵ *Id.* at 655. Although the bank arguably could have been licensed during the tax years 1970 and 1971, the bank never met the prerequisites for becoming a licensed insurance agent such as the amendment of its articles of incorporation. *Id.* at 654-55. There-

upon whether the taxpayer structured its transactions with no legitimate business purpose.⁹⁶ In the instant case, the taxpayer satisfied the legitimate purpose test: all sales commissions were received and taxed to the president because the bank itself could not lawfully act as an insurance agent and receive sales commissions.⁹⁷ In the court's view, the Commissioner's primary contention was that the bank had a duty to qualify as an insurance agent so that it could lawfully receive the sales commissions.⁹⁸ The court, however, held that under *First Security Bank*,⁹⁹ even though the bank may have been able to qualify as an insurance agent, it was not required to exercise that power so that it could be taxed on the insurance commissions.¹⁰⁰ Because the bank's receipt of insurance premiums would have violated state law, a section 482 reallocation was inappropriate.¹⁰¹

V. A Critical Analysis of *Procter & Gamble* and the Applicability of the Legal Disability Doctrine to Section 482

The Tax Court's decision in *Procter & Gamble* is significant because of its expansion of the *First Security Bank* holding into the taxation of international business transactions. Under *Procter & Gamble*, the scope of section 482 is further limited by the taxpayer's inability to receive income under foreign as well as domestic law. After *First Security Bank* was decided, the Internal Revenue Service sought to limit the *First Security Bank* analysis to situations where domestic law, rather than foreign law, blocked receipt of income. In several subsequent Service rulings, the Internal Revenue Service maintained that income was allocable under section 482 notwithstanding contrary foreign law: under *First Security Bank* only laws of the United States could block a section 482 allocation of income.

For example, in Technical Advice Memorandum 7923003, a foreign subsidiary and its domestic parent entered into technical assistance agreements providing for the payment of fees equal to five

fore, the court recognized that the bank could not have legally received the sales commissions. *Id.* at 655.

⁹⁶ *Id.* at 653.

⁹⁷ *Id.* at 653. The court found several legitimate purposes served by the structure of the transactions. Referring borrowers to the president: (1) allowed the borrowers to obtain credit life insurance conveniently; (2) allowed the bank to provide a service to customers indirectly that it could not legally offer directly; and (3) relieved the bank of the burden of having to qualify as an insurance agent under Kentucky law. *Id.* at 652.

⁹⁸ *Id.* at 655.

⁹⁹ 405 U.S. 394 (1972).

¹⁰⁰ *Saylorsville Nat'l Bank*, 613 F.2d at 655. The "Commissioner appears to take the position that the taxpayer bank had a duty to qualify as an insurance agent so that it could have legally received the income the Commissioner attempts to allocate to it. It points to no authority for that proposition. Rather courts have stated that a taxpayer need not structure the business to maximize taxes." *Id.* (citing *W. Braun Co. v. CIR*, 396 F.2d 264, 267 (2d Cir. 1968)).

¹⁰¹ *Id.* at 656.

percent of the subsidiary's annual sales in exchange for scientific and technical information concerning the manufacturing and processing of the parent's products.¹⁰² The foreign government, whose authority to limit payments was equally applicable to agreements between unrelated entities, only approved fee payments of two and four percent.¹⁰³ Although the parent included in its income the fees actually paid by the subsidiary as limited by foreign law, the Service ruled that section 482 allocations could exceed those fees actually paid.¹⁰⁴ The Service asserted that the Commissioner's authority to allocate income under section 482 was limited by *First Security Bank* only "where the taxpayer is prevented from receiving income under United States law."¹⁰⁵

Under almost identical facts in Revenue Ruling 82-45, the Service held that *First Security Bank* does not prevent a section 482 allocation of income under a technical assistance contract where the fees allowed by the foreign country are less than those provided for in the contract between the foreign subsidiary and the domestic parent.¹⁰⁶ Similarly, in Technical Advice Memorandum 8001017, the Service ruled that royalties could be allocated under section 482 to a domestic parent from a foreign subsidiary even though the foreign country prohibited the foreign subsidiary from making royalty payments to the parent.¹⁰⁷

The Tax Court in *Procter & Gamble* correctly refused to recognize the distinction drawn by the Service in its earlier rulings that *First Security Bank* is limited to those situations where domestic law rather than foreign law blocked receipt of income. The position taken by the Service was based on an erroneous interpretation of *First Security Bank*.¹⁰⁸ In *First Security Bank* the court made no suggestion that its decision was limited to instances where domestic law blocked receipt of income.¹⁰⁹ Since the parent in *Procter & Gamble* was under a legal disability, *First Security Bank* applied to foreclose a section 482 allocation regardless of whether the source of the disability was foreign or domestic law.

In recognizing that foreign law as well as domestic law may preclude a section 482 allocation, the *Procter & Gamble* decision is consistent with the underlying purposes of tax treaties between the United

¹⁰² Tech. Adv. Mem. 7923003 (Feb. 22, 1979).

¹⁰³ *Id.*

¹⁰⁴ *Id.*

¹⁰⁵ *Id.* To determine the proper amount of the allocations to be made, the Service stated that the arm's length standard must be applied. *Id.*

¹⁰⁶ Rev. Rul. 82-45, 1982-1 C.B. 89.

¹⁰⁷ Tech. Adv. Mem. 8001017 (Sept. 20, 1979).

¹⁰⁸ Aland, *Can IRS Use Section 482 to Allocate Income Which Cannot Be Earned Under Applicable Law?*, 52 J. TAX'N 220, 221 (1980).

¹⁰⁹ *Id.*

States and other countries.¹¹⁰ One purpose of income tax treaties between the United States and foreign countries is the prevention of double taxation of income recognized by companies subject both to United States and foreign income tax.¹¹¹ If foreign subsidiaries and domestic parents are subject to taxation on the same income through a section 482 allocation to the parent, the treaties' purposes of prevention of double taxation will be thwarted.¹¹²

Another significant aspect of the *Procter & Gamble* decision concerns the court's discussion of whether under section 482 taxpayers have a duty to ameliorate the shifting consequences caused by application of foreign or domestic law when the taxpayer could structure its business transactions so that tax consequences would follow economic realities. As noted by the court, taxpayers are not required to structure business transactions so as to maximize their tax liability as long as legitimate business purposes are served.¹¹³ Like the taxpayer in *First Security Bank*, P&G was able to accomplish several legitimate business purposes by organizing P&G Espana as a wholly owned subsidiary of AG Swiss. Through complete ownership of P&G Espana, P&G ensured that P&G Espana would have ready access to additional capital financing.¹¹⁴ In addition, full ownership of P&G Espana through AG Swiss served to protect the confidentiality

¹¹⁰ The United States has tax treaties with many other countries. See, e.g., Canada Convention and Protocol for the Avoidance of Double Taxation, Mar. 4, 1942, United States - Canada, 56 Stat. 1399, T.S. No. 983; Convention Between the Union of Soviet Socialist Republics and the United States of America on Matters of Taxation, June 20, 1973, United States - U.S.S.R., 27 U.S.T. 1, T.I.A.S. No. 8225; Convention With Respect to Taxes on Income, Dec. 4, 1973, United States - Romania, 27 U.S.T. 165, T.I.A.S. No. 8228; Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion With Respect to Taxes on Income, Oct. 8, 1974, United States - Poland, 28 U.S.T. 891, T.I.A.S. No. 8486; Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion With Respect to Taxes on Income, Feb. 12, 1979, United States - Hungary, 30 U.S.T. 6357, T.I.A.S. No. 9560.

¹¹¹ R. HELLAWELL & R. PUGH, *TAXATION OF TRANSNATIONAL TRANSACTIONS 1987-1988* at 201 (1987). Kelly, *A Comparative Analysis of the United States - People's Republic of China Tax Treaty: United States Tax Treaty Policy Concerning Developing Countries*, 13 SYRACUSE J. INT'L L. & COM. 83, 84 (1986). But see Owens, *United States Income Tax Treaties: Their Role in Relieving Double Taxation*, 17 RUTGERS L. REV. 428, 430 (1963) (stating that U.S. income tax treaties play a "very marginal role in relieving double taxation").

¹¹² See Aland, *supra* note 108, at 222. (stating that the type of section 482 allocation as proposed in Technical Advice Memorandums 7923003 and 8001017, *supra* notes 102-07 and accompanying text, "presents the type of double taxation situation" that tax treaties are "designed to prevent").

During the years 1978 and 1979, no tax treaty existed between the United States and Spain. *Procter & Gamble*, 95 T.C. at 333 n.3.

¹¹³ *Procter & Gamble*, 95 T.C. at 338 (citing Gregory v. Helvering, 293 U.S. 465 (1935)). As Judge Learned Hand stated in *Commissioner v. Newman*:

[T]here is nothing sinister in so arranging one's affairs as to keep taxes as low as possible. Everybody does so, rich or poor, and all do right, for nobody owes any public duty to pay more than the law demands: taxes are enforced exactions, not voluntary contributions. To demand more in the name of morals is mere cant.

159 F.2d 848, 850-51 (2d Cir.), cert. denied, 331 U.S. 859 (1947).

¹¹⁴ *Procter & Gamble*, 95 T.C. at 338.

of P&G's technological rights and allowed P&G to shoulder the risks associated with producing consumer products in a competitive industry.¹¹⁵ Therefore, the *Procter & Gamble* court emphasized that P&G was not attempting to avoid taxation by capitalizing P&G Espana through one hundred percent ownership in AG Swiss. Hence, P&G was not required to organize P&G Espana through less than fifty percent ownership so that royalties could be paid to AG Swiss.¹¹⁶

A disturbing aspect of the *Procter & Gamble* decision is the court's refusal to address whether the Tax Court would have reached a different conclusion if legitimate business purposes had not been served by AG Swiss's dominant control over P&G Espana.¹¹⁷ Arguably the court could have found that legitimate business purposes were lacking if P&G had organized P&G Espana through AG Swiss to take advantage of the Spanish government's prohibition against the payment of royalties to AG Swiss.¹¹⁸ If the Tax Court had been faced with a taxpayer who structured its transactions to take advantage of a legal prohibition against the receipt of income, the Tax Court may have concluded that control, and not foreign law, was the driving force behind the shifting of income. Had the *Procter & Gamble* court recognized the potential for this form of tax evasion, the court's analysis of the legitimate business purpose requirement would be more complete.

Although the *Procter & Gamble* court was consistent with *First Security Bank* in focusing upon the fact that P&G did not exercise control over P&G Espana to shift income, examination of section 482 indicates that the Commissioner's ability to reallocate income under section 482 may not be limited to those situations where the parent has exercised its control over the subsidiary in order to shift income and thereby evade United States taxation.¹¹⁹ Section 482 states that the Commissioner may reallocate income as is necessary to "prevent evasion of taxes or clearly to reflect the income" of related busi-

¹¹⁵ *Id.* at 326.

¹¹⁶ *Id.* at 338 n.6.

¹¹⁷ "[S]ection 482 does not apply where the taxpayer's *legitimate business purposes* subject it to legal restraints effectively blocking receipt of income. We do not have before us, and therefore do not address, whether a section 482 allocation may be appropriate where *legitimate business purposes* are lacking." *Id.* at 341 (emphasis added). In past cases, the Commissioner has not been allowed to apply section 482 where legitimate business purposes were present. *The Expanded Scope of Section 482*, *supra* note 4, at 849; *W. Braun Co. v. Commissioner*, 396 F.2d 264 (2d Cir. 1968); *V.I. Monette & Co. v. Commissioner*, 45 T.C. 15 (1965), *aff'd*, 374 F.2d 116 (4th Cir. 1967).

¹¹⁸ "On this record, as was the case in *First Security Bank*, there is no evidence whatsoever that [P&G] utilized its control over its subsidiaries to manipulate or shift income amongst them. . . . Because the deflection of income in this case arose as a direct consequence of [P&G]'s valid business purposes and good faith compliance with Spanish law, an allocation under section 482 is inappropriate." *Procter & Gamble*, 95 T.C. at 338.

¹¹⁹ Initially, courts only applied section 482 to prevent tax evasion. *The Expanded Scope of Section 482*, *supra* note 4, at 848.

nesses.¹²⁰ The clear wording of section 482 indicates that two alternative grounds exist for a section 482 reallocation: the prevention of tax evasion and the proper reflection of true taxable income. There is no indication in the statute or regulations that the absence of one objective of section 482 precludes the Commissioner from allocating income under section 482 to achieve the other.

In *First Security Bank*, Justice Powell argued that under section 482 regulations no allocation may be made unless the deflection of income is caused by the exercise of dominant control rather than the application of foreign law.¹²¹ Treasury Regulation 1.482-1(b)(1) states that "the 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 . . . business of each of the controlled taxpayers."¹²² According to Powell, this assumption of "complete power" is not valid where foreign law rather than the exercise of dominant control causes the deflection of income.¹²³

Upon further inspection of the regulations, however, one must question the validity of Justice Powell's assertion that complete power to deflect income is a prerequisite to a section 482 allocation. In determining the true taxable income of a controlled taxpayer, subsection (c) of Regulation 1.482-1 provides:

[T]he district director is not restricted to the case of improper accounting, to the case of a fraudulent, colorable, or sham transaction, or to the case of a device designed to . . . avoid tax by shifting or distorting income The authority to determine true taxable income extends to any case in which either by inadvertence or design the taxable income . . . of a controlled taxpayer, is other than it would have been had the taxpayer . . . been an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer.¹²⁴

Arguably, by implication, the issue of "complete power" to shift income is irrelevant when foreign or domestic law acts to distort income irrespective of whether the taxpayer improperly utilized control to alter the tax consequences of transactions between the affiliated entities.¹²⁵ Under this interpretation of section 482, the source of the taxpayer's inability to receive income is irrelevant re-

¹²⁰ 26 U.S.C. § 482 (1986).

¹²¹ *First Security Bank*, 405 U.S. at 404-05.

¹²² Treas. Reg. 1.482-1(b)(1)(1988). Justice Powell relied upon this regulation in stating that a section 482 allocation must be premised upon the taxpayer's "complete power" to shift income to the subsidiary. *First Security Bank*, 405 U.S. at 404.

¹²³ *First Security Bank*, 405 U.S. at 404-05.

¹²⁴ Treas. Reg. 1.482-1(c)(1988) (emphasis added).

¹²⁵ Treas. Reg. 1.482-1(c)(1988) seems to allow the Commissioner to allocate income even where business purposes are served by the corporate organization and the taxpayer is not attempting to minimize taxes. Mansfield, *The 482 Proposed Regs: The Problems with Which Practitioners Will Have to Contend*, 28 J. TAX'N 66, 68 (1968).

ardless of whether the disability is the result of the application of foreign law or even intentional tax evasion.

The view that section 482 authorizes income allocation irrespective of taxpayer control finds further support in that the stated purpose of section 482 which is "to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer."¹²⁶ Such tax parity is achieved where domestic or foreign law blocks the receipt of income from either controlled or unrelated enterprises. In *First Security Bank* this was precisely the situation faced by the court: federal law prohibited the Banks from receiving referral commissions regardless of whether the source of the payments was an unrelated entity or a member of a controlled group.¹²⁷ In this regard, a distinction can be drawn between the application of the legal restrictions on the taxpayers in *First Security Bank* and *Procter & Gamble*.

Unlike the legal restriction imposed upon the taxpayers in *First Security Bank*, the Spanish government's prohibition against royalty payments was based solely upon capital ownership. P&G Espana was completely free to make royalty payments to any other unrelated foreign entity. The *Procter & Gamble* court, however, failed to recognize this crucial distinction. In a statement on the scope and purpose of section 482, Treasury Regulation 1.482-1(b) provides that in determining the true taxable income of the taxpayer, "[t]he standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer."¹²⁸ If AG Swiss had transacted at arm's length with an unrelated Spanish company, it would have required royalty payments for the use of P&G's technology. Had the *Procter & Gamble* court recognized that in *First Security Bank* the legal restriction imposed upon the banks applied even where referral commissions were received from unrelated parties, the *Procter & Gamble* court conceivably could have distinguished *First Security Bank* and given effect to the arm's length standard prescribed by the regulations.

Applying the arm's length standard of Treasury Regulation 1.482-1(b) to the facts of *First Security Bank*, the Supreme Court would have come to the same conclusion that section 482 did not mandate adjustment based on the fact that the banks would not have been able to receive income from referrals even where the banks dealt at arm's length with an unrelated insurance company. In the body of the Court's opinion, Justice Powell in fact recognized that the banks would not have been able to receive referral income from an unrelated enterprise.¹²⁹ In this regard the Supreme Court could

¹²⁶ Treas. Reg. 1.482-1(b)(1)(1988).

¹²⁷ *First Security Bank*, 405 U.S. at 405-07. See *supra* notes 75-76 and accompanying text.

¹²⁸ Treas. Reg. 1.482-1(b)(1988).

¹²⁹ *First Security Bank*, 405 U.S. at 407.

have ignored the issue of whether complete power to shift income is indeed a prerequisite to a section 482 allocation.

It is not clear whether the court in *First Security Bank* intended to limit the scope of its holding to those situations where legal restrictions operate to block receipt of income from both affiliated and unrelated enterprises. In any event, the *Procter & Gamble* court seized upon the Court's final determination in *First Security Bank* that section 482 should not apply unless the controlling member has used its "complete power to shift income" to cause the deflection of income. Since the Tax Court was bound to follow the Supreme Court's interpretation of the scope of section 482, the *Procter & Gamble* analysis is consistent with *First Security Bank*.

VI. Conclusion

In his dissent in *First Security Bank*, Justice Blackmun took solace in his belief that the majority's interpretation of section 482 would "only affect a few taxpayers."¹³⁰ Instead, the *First Security Bank* decision served as a springboard for the *Procter & Gamble* court's application of taxpayer disability and volition principles into the area of international taxation.¹³¹ As a result, *Procter & Gamble* represents a severe impediment to the Treasury's ability to reach income where foreign law operates to block the flow of taxable income back into the United States. For domestic business enterprises with foreign affiliates, the Tax Court's decision represents a significant opportunity to circumvent section 482 where the taxpayer alleges non-tax related reasons for capital investment in those countries that impose legal restrictions upon outbound expenditures. Whether the legitimate business purposes requirement will be sufficient to prevent some of these international corporations from avoiding U.S. taxation is unclear. It is clear, however, that future Tax Court decisions will be rendered under the guidance of a weakened section 482.

KEITH WOOD

¹³⁰ *Id.* at 426 (Blackmun, J., dissenting).

¹³¹ See Teschner, *supra* note 76, at 267 (characterizing the *First Security Bank* decision as a "taxpayer bill of rights with respect to overriding principles of taxpayer disability and taxpayer volition").