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# ALLOCATION OF DEDUCTIONS AMONG RELATED TAXPAYERS UNDER SECTION 482 OF THE INTERNAL REVENUE CODE

*Robert S. Rich*

## A. *The Problem*

This paper deals with the authority of the Commissioner, under Section 482 of the Internal Revenue Code (hereinafter referred to as "IRC § 482") to allocate deductions among related taxpayers so as to reflect more clearly their respective incomes. Particular references will be made to allocations among a domestic parent corporation and its foreign subsidiary corporations.

High income tax rates have prompted many domestic corporations to migrate to other taxing jurisdictions, where the rates are lower or nonexistent. In attempting to maximize their tax advantage, however, many corporate organizations have improperly avoided United States taxes by shifting income from domestic corporations to foreign affiliates.

Some of the operational arrangements in world-wide organizations which may lead to an improper shifting of income include: (1) the domestic corporation incurring expenses for materials or services which are used by or rendered to the foreign affiliate, and the domestic affiliate taking the deduction on its own tax return; (2) the domestic corporation selling materials or providing services to a foreign affiliate at a price less than the fair market price for such materials or services; or (3) the foreign affiliate selling its product to a third party at a price which reflects the intangible value of patents or trademarks belonging, not to the foreign affiliate, but to the domestic parent.[1]

This paper focuses on the problems raised when the Internal Revenue Service questions the domestic corporation's right to deduct expenses incurred in running a world-wide organization which furnishes some of its facilities and services to separate, affiliated corporations at either a nominal charge or no charge.[2] In order to establish a tax deduction, it must show that the item was an ordinary and necessary expense incurred in its trade or business (IRC § 162). Furthermore, where there are transactions among separate entities under common control, the taxpayer can be required to show that there has been no arbitrary shifting of income or expense among them for the purpose of evading income tax and that the procedures used clearly reflect the taxpayer's income (IRC § 482). This paper will concentrate on IRC § 482, which, by comparison to IRC § 162, has not had adequate coverage.[3]

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1 T.I.R. No. 441, Jan. 11, 1963.

2 These services usually include engineering, advertising, research and development, accounting, and legal services.

3 It is to be pointed out that there is a great deal of interplay between IRC § 162 and IRC § 482. See, *e.g.*, Word Specialty Mfg. Corp., 34 B.T.A. 974, 982 (1936), for an example of this interplay. It may be noted that a showing that an expense is "ordinary and necessary in the business of the taxpayer" would necessarily imply that its deduction by the taxpayer would "clearly reflect its income," so that IRC § 482 would be inapplicable. Nevertheless, it must be recognized that there is some overlap between the sections, in that an allocation of part of an expense to a related taxpayer may be tantamount to a disallowance of that amount to the taxpayer who paid the expense, notably where the related taxpayer has no taxable income.

IRC § 482 gives the Commissioner power to correct an improper shifting of income by providing:

> In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the U.S., 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.

When IRC § 482 is applied to the operational arrangements described above, (1) the expenses incurred by the domestic corporation for materials or services used by or rendered to the foreign affiliate may either be disallowed as not being ordinary and necessary business expenses of the domestic corporation (IRC § 162), or, alternately, may be allocated from the domestic corporation to the foreign affiliate (IRC § 482); or (2) the price at which the domestic corporation supplies materials or renders services may be redetermined, *i.e.*, increased, and gross income is allocated from the foreign affiliate to the domestic corporation; or (3) a part of the gross income received by the foreign affiliate from third parties may be reallocated to the domestic corporation, to which the income-producing intangibles belong, as a rental or royalty.[4]

B. *Origin of the Section*

The original purpose of the income tax law was to raise revenue and it still is the basic purpose. However, at an early stage it became apparent that the numerous opportunities for the arbitrary shifting of income and deductions among businesses controlled by the same interests resulted in distortion of income and avoidance of taxes. In its first attempt to solve this problem, Congress enacted in 1921 a consolidated accounts provision applicable to two or more trades or businesses, whether incorporated or unincorporated, which authorized the Commissioner to consolidate accounts of related trades or businesses where he deemed it necessary in order to reflect their income accurately (Section 240(d) of the Revenue Act of 1921).[5] The Senate Report stated that "this is necessary to prevent the arbitrary shifting of profits among related businesses, particularly in the case of subsidiary corporations organized as foreign trade corporations."[6] In 1928 the reference to the power to consolidate was replaced by a provision empowering the Commissioner, at his discretion, "to distribute, apportion or allocate gross income or deductions" among related entities where necessary to prevent evasion of taxes (Section 45 of the Revenue Act of 1928). The House Report stated that Section 45 was to prevent the evasion of taxes "by the shifting of profits, the making of fictitious sales, and other methods frequently adopted for the purpose of 'milking.'"[7]

4 T.I.R. No. 441, Jan. 11, 1963.
5 Yet the roots of IRC § 482 extend farther back to the Treasury Regulations promulgated under the Excess Profits Tax Act of 1917 in respect to the filing of a consolidated return. Sherman, *A Case History of Section 45*, 29 TAXES 13 (1951).
6 S. REP. No. 275, 67th Cong., 1st Sess. 20 (1921).
7 H.R. No. 2, 70th Cong., 1st Sess. 16-17 (1928).

With a few minor statutory changes, Section 45 became IRC § 482.[8] Despite its long history as an integral part of the revenue statutes, the Section has been sparingly applied.[9] Nevertheless, it has had a significant impact upon business transactions, being dubbed the "silent policeman" because of its very existence, and the threat of its potential use. Moreover, by the passage of IRC § 6038 (Information with Respect to Certain Foreign Corporations) in 1960, and by its amendment in 1962, the Commissioner has been encouraged to make greater use of IRC § 482 as applied to foreign operations of American corporations.[10] In addition, the Revenue Act of 1962 introduced IRC §§ 951-64 which provide further means for the Commissioner to prevent tax evasion through the medium of related domestic and foreign corporations.[11]

C. *Authority of Commissioner*

IRC § 482 vests broad discretionary powers in the Commissioner to distribute, apportion, or allocate gross income and deductions among related taxpayers if he determines that such action is necessary to produce the "true taxable income" of each taxpayer. The term "true taxable income," according to the Regulations,[12] means the taxable income which would have resulted to the related taxpayers had they in the conduct of their affairs dealt with each other at "arm's length," as uncontrolled taxpayers are assumed to do.[13] Since IRC § 482 was formulated in general terms, not specifying the situations to which

8 For the legislative history of IRC § 482, see Simon J. Murphy Co. v. Commissioner, 231 F.2d 639, 643 (6th Cir. 1956), and cases cited therein; and Anderson, *Income and Expense Reallocation,* 10 U. So. Cal. 1958 Tax Inst., 344-48 (1958). The principle found in IRC § 482 is embodied in all income tax conventions concluded by the United States with foreign countries. Rado, *Foreign Corporation: Its Role in the Taxation of Income from International Trade,* 10 Tax L. Rev. 307, 328 (1955).

9 There were only forty-three cases decided under Section 45 as of January, 1951. Most of the cases involved the subdivision of businesses. Only eight involved the allocation of expenses between related taxpayers, and in these the taxpayers have won the majority of the decisions. Sherman, *supra* note 5.

10 IRC § 6038(a)(1) provides:

> Every United States person shall furnish, with respect to any foreign corporation which such person controls . . . such information as the Secretary . . . may prescribe by regulations relating to . . . (D) transactions between such foreign corporation and – (i) such person, (ii) any other corporation which such person controls, and (iii) any United States person owning, at the time the transaction takes place, 10 percent or more of the value of any class of stock outstanding of such foreign corporation. . . .

See also IRC § 6046, as amended by Section 20 of the Revenue Act of 1962, relative to returns required as to organization or reorganization of foreign corporations.

11 "Prior to the Revenue Act of 1962, shareholders of foreign corporations like shareholders of domestic corporations, incurred no tax liability with respect to the earnings of their foreign corporations until and unless the earnings were distributed as dividends." Wilcox, *Operations Abroad through Foreign Subsidiaries,* N.Y.U. 21st Inst. on Fed. Tax 905 (1963). The Revenue Act of 1962 has changed this tax treatment by requiring that the American shareholders include in their gross income their pro rata share of certain income of controlled foreign corporations whether such income is distributed or not. See generally, Sloan, *Taxation of American Controlled Foreign Earnings under the Internal Revenue Act Amendments of 1962,* 9 Wayne L. Rev. 308 (1963); and O'Connor, *United States Taxation of Earnings of American-Controlled Foreign Operations,* 42 Taxes 588 (1964).

12 Treas. Reg. § 1.482-1(a)(6) (1962).

13 According to the Regulations, if the corporations which are attacked by the Commissioner are not "owned or controlled" by the same interests, or if they deal with each other at "arm's length," then IRC § 482 is inapplicable. An analysis of these two items, as well as other judicially developed limitations to the application of IRC § 482, will be undertaken in part E of this paper.

it may apply, the next section of this paper will be devoted to determining those situations, with special reference to the problems of overhead expenses.

D. *Situations to Which Applied*

In trying to determine the scope of IRC § 482, one discovers from the legislative hearings on the 1921 and 1928 Revenue Acts and the early judicial decisions[14] that there were two particular situations to which the Section was originally designed to apply: namely, (1) the situation involving inter-company manipulation of financial accounts whereby profits and losses were arbitrarily shifted from one related business entity to another in order to minimize taxes;[15] and (2) the situation wherein by an actual transaction one taxpayer transferred to a related taxpayer a specific gain[16] or loss [17] that properly belonged to the transferor. This early view of the scope of IRC § 482 is evidenced by the opinion in the *Asiatic Petroleum Co.* case.[18] The domestic corporation had had an actual profit, in the sense of increased value over cost, before the sale to the related foreign corporation, though the profit was as yet unrealized for income taxation. The court said IRC § 482 was designed to frustrate the "avoidance of the realization for taxation of such a profit through its transfer to another branch of the same business enterprise in a way which only changes its place in the business set-up."[19]

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14 See, *e.g.*, Asiatic Petroleum Co. v. Commissioner, 79 F.2d 234 (2d Cir. 1935).

15 Welworth Realty Co., 40 B.T.A. 97, 100 (1939). A small group of shareholders controlled a company and its subsidiary, the petitioner, and they were the beneficiaries of the combined profits realized by those two companies. The subsidiary owned a building which it rented to the parent for a rental which was arbitrarily adjusted at the close of each year, for the purpose of showing favorable financial statements for G Company and without regard to the actual fair rental value. *Held:* the Commissioner could allocate income from G Company to its subsidiary, the petitioner, in order to clearly reflect the latter's income, under the authority of Section 45 of the Revenue Act of 1934 (IRC § 482). *Accord,* Birmingham Ice & Cold Storage Co. v. Davis, 112 F.2d 453 (5th Cir. 1940). Two companies having the same officers and directors and owned by the same interests devised a plan of operation which provided for the shutting down of the plant of one company except in peak seasons. The chairman of the board of each company had authority to allocate at the end of the year to the other company some of the taxpayer's earnings. The Commissioner's allocation of income to the taxpayer who actually earned it was upheld as reasonable and valid under authority of IRC § 482. *Accord,* Advance Mach. Exch. v. Commissioner, 196 F.2d 1006 (2d Cir. 1952). Four related tax entities all controlled by the same interests, carrying on the same business from one office, with the same employees, using the same equipment, divided the income among all four. There was evidence that large numbers of purchase invoices had been altered to attribute them to one or another of these taxpayers and that these changes were made without any set policy to indicate that there was any motive in doing so other than to divert income from the petitioner (one of the four entities). The Commissioner determined that although there were four entities, only the petitioner, in fact, earned the income which was divided among all four. He was upheld in allocating the amount of income reported by the other tax entities to the petitioner.

16 Asiatic Petroleum Co. v. Commissioner, 79 F.2d 234 (2d Cir. 1935). A domestic corporation sold certain appreciated property at cost to a foreign corporation owned by the same interests. The foreign corporation immediately resold the property at a profit. The Commissioner was upheld in allocating the profit to the domestic corporation. *Accord,* Hall v. Commissioner 294 F.2d 82 (5th Cir. 1961).

17 G. U. R. Co. v. Commissioner, 117 F.2d 187 (7th Cir. 1941). One corporation sold for its cost property that had depreciated in value to a related corporation. The purchaser then sold the property at a large loss, which it deducted. The Commissioner disallowed the purchaser's loss by reallocating it to the selling corporation.

18 79 F.2d 234 (2d Cir. 1935). The facts are summarized in footnote 16, *supra.*

19 *Id.* at 236. It may be pointed out here (although discussed in part F *infra*) that the Commissioner could probably attack this type of transaction through application of the tax doctrines enunciated in Lucas v. Earl, 281 U.S. 111 (1930), and Helvering v. Horst, 311 U.S. 112 (1940). Although in many situations the Commissioner can attack an IRC § 482 situa-

As the scope of IRC § 482 is traced from the core situations to which it clearly applies (*e.g.*, arbitrary manipulation of financial accounts) to the penumbra where, for example, a parent corporation incurs legal fees to obtain an opinion from counsel as to whether IRC § 482 applies to expenses in running a world-wide organization, its application becomes less inevitable. When IRC § 482 is applied to a core situation, the Commissioner's reallocation of income or loss is based upon an arm's length standard, so that the tax effects of the transaction between the related taxpayers will be the same as though the transaction took place between unrelated taxpayers. But in the attempt to reallocate income and deductions in the situation where a parent corporation incurs expenses in running a world-wide organization, there is usually no applicable arm's length standard since this kind of expenditure does not exist in the case of uncontrolled taxpayers.[20] The question is, therefore, whether IRC § 482 should be applied to reallocate the expenses incurred by a parent corporation in running a world-wide business organization where there can be no comparable arm's length transactions between unrelated taxpayers.

Although cast in general form, the Code seems to suggest that an allocation should be made whenever it is necessary to prevent related taxpayers from avoiding taxes through inter-company transactions which have no economic reality, without limiting its application to the kinds of transactions which take place at arm's length between unrelated taxpayers. The Regulations seem to be of the same general intent, although the arm's length standard is mentioned only in the last sentence.[21] Moreover, a recent Circuit Court opinion specifically takes this position,[22] stating that

> we do not agree with the Commissioner's contention that "arm's length bargaining" is the sole criterion for applying the statutory language of [IRC § 482] in determining what the "true net income" is of each "controlled taxpayer." Many decisions have been reached under [IRC § 482] without reference to the phrase "arm's length bargaining" and without reference to Treasury Department Regula-

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tion by using other weapons, there are transactions between related taxpayers in which only IRC § 482 can be used if the Commissioner is to obtain the same tax effects that would have resulted had the transaction been between unrelated taxpayers. For example, in the situation in which several taxpayers share the same facilities but only one of them takes the deduction for rent or other overhead expenses, IRC § 482 provides the only weapon for reallocating the deductions among the related taxpayers.

20 If, however, an expense item benefits a subsidiary such that an arm's-length taxable income is possible, then the parent corporation should make an allocation so as to achieve an arm's-length taxable income, or else the Commissioner will do it for him.

21 Treas. Reg. § 1.482-1(c) (1962) Application.

> Transactions between one controlled taxpayer and another will be subjected to special scrutiny to ascertain whether the common control is being used to reduce, avoid, or escape taxes. 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 a 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 in 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.* (Emphasis added.)

22 Frank v. International Canadian Corp., 308 F.2d 520 (9th Cir. 1962). This case is noted in Friedmand & Silbert, *The Interrelationship of Puerto Rican and United States Income Tax,* N.Y.U. 21ST INST. ON FED. TAX, 807, 823 (1963).

> tions and Rulings which state that the talismanic combination of words — "arm's length" — is the "standard to be applied in every case."[23]

In addition, according to the statutory language, IRC § 482 can be applied by the Commissioner: (1) to prevent the evasion of taxes, or (2) to reflect clearly the income of related taxpayers. Although tax evasion may not be found when the parent corporation takes the entire deduction for overhead expenses, if an allocation is not made, the financial accounts of the parent and the subsidiary may not clearly reflect income, since the accounts may understate the parent's income and overstate the subsidiaries' incomes.

It is concluded, therefore, that an allocation should be made in the situation where the parent corporation takes the entire deduction for overhead expenses. The difficulty encountered is that overhead expenses consist of many different items, varying from corporation to corporation, and a simple "arm's length" formula is not appropriate. In addition, not all of the expense items will have to be allocated, and different allocation formulas may be necessary for those various items that will have to be allocated. Since each case will have to be separately considered, an examination of hypothesized situations does not advance the inquiry sufficiently to warrant extended discussion here. Nevertheless, the following analysis may be helpful whenever the question is raised.

The overhead expense items of the parent may be divided into two categories, one containing the expenses which may be deducted exclusively by the parent, and the other the expenses which must be reallocated to one or more of the subsidiaries, the reallocation sometimes including the parent. The expenses which belong in the first category are: (1) those incurred in the parent's trade or business;[24] (2) those incurred for the production or collection of income of the parent, or for the management, conservation or maintenance of property held for the production of income of the parent;[25] and (3) those which the Code specifically allows as a deduction to the parent.[26]

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23 Frank v. International Canadian Corp., *supra* note 22, at 528-29.

24 IRC § 162. Determining whether the expenses were incurred solely for the benefit of the parent will often be a very difficult question. For example, when this question is raised as to the deductibility of legal fees, it must be determined whether the legal services were for the business of the parent or for the business of the subsidiary. South Am. Gold & Platinum Co., 8 T.C. 1297, 1301 (1947), *aff'd*, 168 F.2d 71 (2d Cir. 1948). *Accord*, Allegheny Corp., 28 T.C. 298, 303 (1957). The parent and the subsidiary are distinct legal entities. It was pointed out by the Supreme Court that even if the economic advantages will ultimately redound to the parent's benefit, the parent may not take a deduction when it pays the subsidiary's expenses. Interstate Transit Lines v. Commissioner, 319 U.S. 590 (1943), cited in South Am. Gold & Platinum Co., *supra* at 1301. Advertising and general executive expenses, among others, will also give trouble. See Glenmore Distilleries Co., 47 B.T.A. 213, 224-28 (1942).

25 IRC § 212. While IRC § 212 applies only to individuals, the expenses therein should certainly be equally allowable to corporations. In fact the original split into § 23(a)(1) and (2) of the 1939 Code was necessary because the individual was not in trade or business, while a corporation was almost always assumed to be in business. Therefore, the first inquiry is whether the expense is directly related to its business.

26 See, *e.g.*, IRC § 163, which allows a deduction for all interest on indebtedness without the limitation that the indebtedness must be incurred in the taxpayer's trade or business. It might be argued therefrom that a deduction for interest can be taken in full by the taxpayer incurring the liability for the interest, even if the taxpayer subsequently loans the money interest free to a related taxpayer. This contention is based on the wording of IRC § 163, which says that "there shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness." So long as the indebtedness is bona fide, the taxpayer is permitted to take the deduction, with no further limitations, such as that the interest must be an ordinary

If it is determined that a particular expense item does not belong exclusively to the parent, then all or part of the expense item must be allocated to the subsidiaries. If an expense is incurred specifically for a particular subsidiary then an allocation is made directly to it. The problem arises when an expense item is not incurred for a particular taxpayer, but for several members of the world-wide organization. This problem is solved by application of an allocation formula which neither the Code nor the Regulations provide.[27] The cases, however, provide several,[28] and, in addition, a very useful procedural lesson. Once the Commissioner makes a reallocation, an initial presumption arises that it is correct.[29] If the taxpayer challenges the correctness of the Commissioner's allocation, this initial presumption places the burden of proof on the taxpayer.[30] Despite this, the Tax Court has consistently held that if the taxpayer's books and records clearly reflect his income, the Commissioner's reallocation will be disapproved, and this, even though the Commissioner's allocation has some merit.[31] If the parent corporation determines that a particular expense item is one that should be allocated among the related taxpayers in the world-wide

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and necessary expense incurred in the taxpayer's trade or business. Thus the taxpayer may borrow and do whatever he pleases with the borrowed funds (*e.g.*, lend the funds to a related taxpayer) and still get a deduction for the interest. Hearst Corporation, 14 T.C. 575 (1950), and Smith-Bridgman Co., 16 T.C. 287 (1951). However, the interest-free loan to the related taxpayer is a separate transaction, and if the related taxpayer derives income from the use of such funds, part of this income could be reallocated to the taxpayer under IRC § 482.

27 The Regulations dealing with the allocation of income and deductions among partners give several examples for the guidance of taxpayers. Treas. Reg. § 1.704-1 (1956).

28 Rent has been allocated according to: (a) Floor space occupied, Southern College of Optometry, Inc., 16 P-H Tax Ct. Mem. 298 (1947); (b) Gross income, Leedy-Glover Realty & Ins. Co. v. Commissioner, 13 T.C. 95 (1949), *aff'd*, 184 F.2d 833 (5th Cir. 1950); (c) Fair rental value of space occupied, Welworth Realty Co., 40 B.T.A. 97 (1939); (d) Proportion of services rendered to parent, Harris Inc., 17 P-H Tax Ct. Mem. 298 (1946).

Salaries have been allocated according to: (a) Actual recipient of the services, Southern College of Optometry, Inc., *supra;* and (b) Proportion of services rendered to each corporation, Harris Inc., *supra.* I would also suggest that salaries could be allocated on a time basis or according to the relative value of the services rendered.

General office expenses have been allocated according to: (a) Proportion of expenses rendered to each corporation, Harris Inc., *supra;* (b) Gross income, Leedy-Glover Realty & Ins. Co., *supra;* (c) Proportion of assets owned, Peacock v. Commissioner, 256 F.2d 160 (5th Cir. 1958); Anaheim Water Co., 35 T.C. No. 1072 (1961); (d) Proportion of sales made by each corporation, Glenmore Distilleries Co., 47 B.T.A. 213 (1942); Essex Broadcasters, Inc., 2 T.C. 523 (1943); Campbell County State Bank, Inc., 37 T.C. 430 (1961); and Bank of Kimball v. United States, 200 F. Supp. 638 (D. S. D. 1962).

29 Commissioner v. Smith, 285 F.2d 91, 95 (5th Cir. 1960).

30 Commissioner v. Chelsea Prods., 197 F.2d 620, 624 (3d Cir. 1952): "Since Section 45 [IRC § 482] grants the Commissioner discretionary powers the burden falls upon the taxpayer to prove that the Commissioner's determination is arbitrary."

31 Abbot Mortgage Co., 27 P-H Tax Ct. Mem. 463 (1958). The Commissioner's allocation was disapproved, on the theory that there was no necessity for it, in Briggs-Killian Co., 40 B.T.A. 895 (1939), where the court found that there was no attempt to evade taxes and the taxpayer's books and accounts clearly reflected its income. The court said that the purpose of the Section was to permit the Commissioner to act where the necessity existed and where, without some affirmative action on his part, taxes might be evaded or income would not be clearly reflected. The court went on to say that to permit the Commissioner to exercise his authority in other situations "would project Section 45 [IRC § 482] into a tax field that was not contemplated by Congress when that section was enacted." [*Id.* at 900.] This attitude of the Tax Court was reflected in Motor Sec., Inc., 21 P-H Tax Ct. Mem. 316 (1952) where the opinion commences by castigating the Commissioner for attacking a taxpayer's accounting system: "This is another in the constantly expanding group of cases in which a taxpayer's long-established and consistent accounting system is being attacked by the respondent [the Commissioner]. As in many of these cases justification for the criticism seems doubtful, [citing cases] . . . and in fact, some, what originated as an effort to protect the revenue completed its course with a loss for the Treasury instead of a gain, [citing cases]."

business organization, then an allocation according to some reasonable formula should be made in the first instance.[32] If the Commissioner subsequently challenges this allocation, the taxpayer will prevail upon a showing that his accounting is fair and reasonable and clearly reflects his income. It is also better for the taxpayer initially to make an allocation, since he is not at liberty subsequently to invoke IRC § 482.[33] Thus an allocation can serve a double purpose: (1) it may create a deduction for the subsidiary, which may be paying a tax in its country equal to or greater than that of the domestic grant; and (2) a fair allocation by the taxpayer in the first instance makes it more difficult for the Commissioner to support a different allocation. On the other hand, where no allocation is made, there may also be a double effect: (1) the Commissioner may simply disallow a portion of the taxpayer's expense without furnishing a basis for a deduction for the related company, or (2) the Commissioner may make his own allocation, which will more likely be sustained where the taxpayer has made none of his own.

E. *Limitation of Applicability*

Despite the broad scope of IRC § 482, certain limitations to its applicability are apparent on its face.

> 1. IRC § 482 applies 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.

IRC § 482 has no application unless the two or more business entities are "owned or controlled directly or indirectly by the same interests." However, even if the section did not contain this specific prerequisite to its application, a showing that two or more organizations are not owned or controlled by the same interests would be a perfect defense to an IRC § 482 attack, since, if it can be established, it normally follows that they dealt with each other at arm's length in the same manner as one "uncontrolled" taxpayer would have dealt with another. And IRC § 482 does not interdict bargain arrangements between uncontrolled taxpayers.

The term "owned," as used in IRC § 482, is not defined in the Code or the Regulations. An early General Counsel's memorandum stated that the term "owned," as used in the phrase "owned or controlled," has a well-defined meaning and no difficulty will be found with it.[34] This well-defined meaning

32 It is interesting to note that in two recent IRC § 482 cases it has been held that if no reasonable method can be found, then an allocation under the *Cohan* rule will be made. The *Cohan* rule, derived from Cohan v. Commissioner, 39 F.2d 540, 543 (2d Cir. 1930), and as applied in IRC § 482 cases, says that whenever an accurate allocation of expenses is impossible an approximation should be made. These two cases are Bank of Kimball v. United States, 200 F. Supp. 638, 642 (D. S. D. 1962); and Nicholas Loan Corp., 31 P-H Tax Ct. Mem. 149(1962). It is problematical whether the extension of the *Cohan* rule is still valid now that the rule is abolished as to travel and entertainment, the very expenses in the *Cohan* case. See § 4 of the Revenue Act of 1962, and legislative hearings thereto. U.S. CODE CONG. & AD. NEWS 1145, 3337 (1962).

33 IRC § 482 grants no right to a controlled taxpayer to apply its provisions at will, nor does it grant any right to compel the district director to apply such provisions. Treas. Reg. § 1.482-1(b)(3).

34 G.C.M. 2856, VII-1 CB 128, 130 (1928).

is probably "legal ownership," although this term itself may not be so well-defined. Nevertheless, most of the trouble has been generated by the term "controlled."

The Code does not define the term "controlled," but the statutory language seems to indicate that *de facto* control is meant as well as *de jure* control. First of all, the term "controlled" is separated from the term "owned" in the phrase "owned or controlled" by the disjunctive "or," which indicates that the "control" means something other than strict legal control. Secondly, in IRC § 482 Congress uses the phrase "owned or controlled" without any quantitative limitations. In other sections of the Code, however, Congress has specifically defined control in terms of percentage limitations.[35] Congress could have provided a strict definition of the term "control" in IRC § 482.[36] But Congress provided an elastic term indicating an intent to have the phrase construed flexibly in the light of the circumstances of each particular case.[37] In addition, the Treasury Regulations define the term "controlled" to include

> . . . any kind of control, direct or indirect, whether (or not it is) legally enforceable, and however exercisable or exercised. It is the reality of the control which is decisive, not its form or mode of its exercise. A presumption of control arises if income or deductions have been arbitrarily shifted.[38]

The courts have also taken the position that the term "controlled" means more than mere legal control. The Board of Tax Appeals stated, in an early case, that the term "controlled was not to be necessarily limited to strict legal control" but to a "genuine control actually exercised."[39] The Internal Revenue Service said that "obviously the control intended is not confined to stock ownership, as in the case of consolidated returns but control of the trades or businesses themselves, which means the 'power to dictate the corporate action of the corporation.' "[40] In *Grenada Industries, Inc.*, it was said that record ownership of the stock is immaterial in determining whether four organizations were

35 *E.g.*, IRC § 267 (more than 50 per cent in value of the outstanding stock); IRC § 269 (at least 50 per cent of the total value of shares of all classes of stock of the corporation); IRC § 351 (control as defined in § 368[c]); IRC § 355 (same as § 351); IRC § 368(c) (at least 80 per cent of the total combined voting power of all classes of stock entitled to vote and at least 80 per cent of the total number of shares of all other classes of stock of the corporation); IRC § 1551 (at least 80 per cent of the total combined voting power of all classes of stock entitled to vote or at least 80 per cent of the total value of shares of all classes of stock of the corporation); and IRC § 6038(d) (more than 50 per cent of the total combined voting power of all classes of stock entitled to vote).

36 See Hall v. Commissioner, 294 F.2d 82, 90 (5th Cir. 1961), where it was said in the dissenting opinion that "The cases and regulations [dealing with the problem of 'control' in IRC § 482] do not depend on percentages as such," citing Grenada Indus., Inc. v. Commissioner, 202 F.2d 873 (5th Cir. 1953), discussed *infra.*

37 See Appeal of Rishell Phonograph Co., 2 B.T.A. 229 (1925), where it was said that in the phrase "owned or controlled directly or indirectly by the same interests," Congress has again used terms which are doubtful and impossible of strict definition of the term to be applied in every case, for the same reasons that have caused the courts to avoid attempting to define due process of law. "If a strict and generally applicable definition were practicable, it probably would have been furnished by Congress. The very use of elastic terms indicates an intent to have them construed flexibly in the light of the peculiar circumstances of each particular case." [*Id.* at 232.]

38 Treas. Reg. § 1.482-1(a)(3).

39 Appeal of Isse Koch & Co., 1 B.T.A. 624 (1925).

40 G.C.M. 2856, VII-1 CB 128, 130 (1928), quoting from Yazoo & M.V.R. Co. v. Searles, 85 Miss. 520, 37 So. 939, 953, 68 L.R.A. 715 (1905), a case construing the state anti-trust statutes.

"owned or controlled directly or indirectly by the same interests," the significant thing being who dominates the organizations, who in fact exercises the actual control at all times.[41] The court said that

> Section 45 [IRC § 482] speaks in sweeping terms. It refers to "two or more organizations . . . owned or controlled directly or indirectly by the same interests. . . ." The type of control contemplated by these provisions is reflected in the regulations which deal with the concept in all-embracing language as follows:
>
> > The term "controlled" includes 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.[42]

While a "controlled" situation exists when one corporation has a majority stock interest in another and *a fortiori* in the case of a parent and its wholly owned subsidiary, a "controlled" relationship may also exist in situations where only 50 per cent or less of the stock is owned.[43] Even the creditors of a corporation may be deemed in control of the corporation for the purposes of IRC § 482, either because of the nature, quantity or terms of the debt instruments or because the debt may be treated as disguised equity.[44] Nevertheless, the Board of Tax Appeals has stated that although "we have held that control in the statute[45] is not necessarily limited to strict legal control, such as might be enforced by ordinary legal processes . . . circumstances which might indicate *control* in one case would not necessarily constitute it in another, where other circumstances involving other elements were at variance."[46] Thus, while the statute and the regulations give the broadest meaning to the term "control," the courts have attempted to clarify its meaning to some degree, and in a few cases have construed more narrowly the required elements of ownership and control.

In the case of *Lake Erie & Pittsburgh Ry. Co. v. Commissioner,*[47] a subsidiary corporation was owned evenly by two independent corporations, and the Tax Court held that the required degree of control did not exist,[48] stating:

> Together they do have [control]. But that amounts to nothing more than that the stockholders of a corporation control it. . . . We do not think that it can be said that where two or more corporations owned by different sets of stockholders control another corporation, such other corporation is controlled by the same interests.[49]

The Pennsylvania Railroad Co. and the New York Central Railroad Co. made an agreement with the taxpayer for the use of its tracks and other facilities, for

41 17 T.C. 231 (1951), *aff'd,* 202 F.2d 873 (5th Cir. 1953).
42 *Id.* at 254. The *Grenada* case has been cited for its holding on the concept of "control" in many subsequent cases; see especially Friedlander Corp., 25 T.C. 70, 74 (1955).
43 See, *e.g.,* Essex Universal Corp., v. Yates, 305 F.2d 572, 579 (2d Cir. 1962), where the court said, ". . . 28.3 per cent of the voting stock of a publicly owned corporation is usually tantamount to majority control. . . ."
44 Note the contention of the United States Government in the *Interhandel* case. Societe Internationale Pour Participations Industrielles et Commerciales, S.A. v. McGranery, 111 F. Supp. 435 (D.D.C. 1953), *aff'd,* 225 F.2d 532 (D.C. Cir. 1955), *rev'd,* 357 U.S. 197 (1958).
45 Section 240(b) of the Revenue Act of 1918.
46 Rishell Phonograph Co., 2 B.T.A. 229, 232 (1925).
47 5 T.C. 558 (1945).
48 There was a dissenting opinion but only as to the factual issue as to whether the two corporations were independent.
49 5 T.C. 558, 564-65 (1945).

which each was to pay rent based upon use plus $215,000 per year. The two railroad companies paid rent to the taxpayer from 1908 to 1937, and in each year they received a dividend from the taxpayer. In 1939 an amended agreement, effective as of 1937, provided that the renting companies would discontinue payment of the $215,000 and waive their rights to dividends. Under the authority of IRC § 482 the Commissioner allocated $215,000 of the gross income of the New York Central and Pennsylvania Railroad companies to the taxpayer in order to provide it a rental income.

The taxpayer appealed on the ground that it was not "controlled" by the same interests during the taxable years and therefore the Commissioner was not authorized by IRC § 482 to make an allocation of gross income of the two railroad companies. The question before the Tax Court was whether the taxpayer and either of the lessee corporations were owned or controlled directly or indirectly by the same interests.

The court found that the New York Central and the Pennsylvania were competing railroads, each owning 50 per cent of the stock of the taxpayer, unless the same set of stockholders owned the stock in both the New York Central and the Pennsylvania, which, held the court, was apparently not the case. Hence the Commissioner had no authority under IRC § 482 to allocate a part of the income of the New York Central and the Pennsylvania to the taxpayer for the purpose of giving it a taxable income.[50] The court said that: "Clearly two or more corporate stockholders owning all of the stock of a subsidiary have a right to fix the amount of the rental which the stockholders shall pay for the facilities of such subsidiary."[51] Since in the opinion of the court the two lessee railroad companies and the subsidiary were not owned by the same interests, there was no authority for the Commissioner to allocate part of the income of the two lessee corporations to the taxpayer under IRC § 482.

It is suggested that the decision in the *Lake Erie & Pittsburgh Ry. Co.* case would not be followed today, first, because it dealt with an attempt by the Commissioner to create income, an area in which the Commissioner has been unsuccessful, and not with a taxpayer claiming a deduction to which it was not entitled. Second, if the New York Central and the Pennsylvania each had a wholly owned subsidiary like the Lake Erie & Pittsburgh Ry. Co., then the Commissioner's allocation under IRC § 482 would have been sustained. It is submitted that if they each own 50 per cent of the subsidiary and carry on the same transactions, the two railroads would not escape the impact of IRC § 482 because of the contention that there is no "controlled situation." If the New York Central owned 51 per cent of the stock and the Pennsylvania owned

50 The dissenting opinion did not find that the stockholders of the New York Central were not the same interests as the stockholders of the Pennsylvania. The dissent said: "Since Section 45 of the Internal Revenue Code [IRC § 482] authorizes the Commissioner to allocate income or deductions between corporations 'owned or controlled directly or indirectly by the same interests,' and in the absence of a finding negativing such ownership or control, by the same interests . . . we do not seem . . . justified in concluding that the Commissioner erred in making the allocation. So far as the record shows — and certainly we can not take judicial notice in this respect — the two corporations which own the petitioner may be owned or controlled by the same interests. I would sustain the Commissioner for lack of evidence." [*Id.* at 566.]

51 *Id.* at 565.

49 per cent, would the Commissioner have a basis to make an allocation between the New York Central and the subsidiary but not between the Pennsylvania and the subsidiary? It is only by virtue of their stock ownership in the subsidiary that they are able to arrange such a transaction. And control in IRC § 482 does not mean majority stock ownership but "control however exercisable or exercised."[52]

> 2. The Secretary or his delegate may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses.

The Commissioner is not compelled to act under IRC § 482, nor can a taxpayer force the Commissioner to make an allocation.[53] Even where the Commissioner exercises his discretion, his authority under IRC § 482 is limited to the "distribution, apportionment or allocation of gross income,[54] deductions, credits or allowances" among the related businesses.

The Commissioner may not create income on transactions between related taxpayers where none was actually earned. In the case of *Smith-Bridgman & Co.*[55] a subsidiary loaned money to a parent corporation without interest. The Commissioner required the subsidiary to accrue interest income at 4 per cent. The Tax Court held that the Commissioner improperly created income where none existed. In a similar case involving two corporations controlled by the same interests, *Tennessee-Arkansas Gravel Co. v. Commissioner,*[56] one corporation leased equipment to another corporation, for one year at 1,000 dollars per month, but charged that corporation no rent for the second year. The Circuit Court refused to sustain the Commissioner's action in allocating $12,000 income to the lessor corporation for the second year under IRC § 482, saying that that section did not authorize the Commissioner to set up income where none existed, and that no income was realized in this case. However, the Court implied that the result might have been different had the Commissioner allocated to the lessor a portion of the lessee's income from the use of the equipment in lieu of merely setting up rental income. That is, any income that the lessee makes on the equipment can be taxed to the lessor on the theories enunciated in *Lucas v. Earl,*[57] and *Helvering v. Horst.*[58]

Although the conclusion reached in the *Tennessee-Arkansas* case is probably correct, its reasoning leaves much to be desired in the way of explanation and clarification.[59] If an inadequate rental can be increased and taxed as additional income to the lessor corporation under IRC § 482, as held in the *Welworth*

52 Treas. Reg. § 1.482-1(a)(3).
53 Treas. Reg. § 1.482-1(b)(3): "Section 482 grants no right to a controlled taxpayer to apply its provisions at will, nor does it grant any right to compel the district director to apply such provisions." It has been said that IRC § 482 is a one-way street. Anderson, 10 U. So. Cal. 1958 Tax Inst., 343, 372 (1958).
54 The Commissioner cannot make an allocation of net income. Commissioner v. Chelsea Prods., 197 F.2d 620, 622 (3d Cir. 1952). Yet the allocation of gross income and deductions is, in effect, an allocation of net income (or loss).
55 16 T.C. 287 (1951).
56 112 F.2d 508 (6th Cir. 1940).
57 281 U.S. 111 (1930).
58 311 U.S. 112 (1940).
59 See 29 Taxes 13, 36 (1951).

*Realty Co.* case,[60] it is difficult to see why a proper rental cannot be charged for the use of equipment where no rental was charged to the related corporation. Thus, in *Southern College of Optometry, Inc.*,[61] the taxpayer corporation did not charge any rental to its two affiliated corporations for the portion of the space occupied by them, yet the Tax Court held that an allocation was proper under IRC § 482. The mere fact that the two controlled corporations in the *Tennessee-Arkansas* case agreed that no rental was to be charged for the use of the equipment is not controlling because, prima facie, it does not appear to be an arm's-length agreement. However, a sound reason was given for the nonrental arrangement in the case, namely, that it was better to keep the equipment in use, without any rental charge, than to let the equipment stand idle and deteriorate from nonuse. Where a sound business reason is the motivating force of a particular transaction, the Commissioner should not be permitted, under the alleged authority of IRC § 482, to substitute his judgment for that of the corporate directors and officers and thereby create income which, in fact, is nonexistent.

Another limitation apparent in the statute is that the Commissioner may not disallow a proper deduction.[62] "The distribution, apportionment, or allocation required by IRC § 482 necessarily implies an allowance of the claimed deduction to one of the related taxpayers."[63] Although disallowance of deductions is not permissible under IRC § 482, an expense, loss, or other deduction may, of course, be disallowed under other sections of the Code.[64]

The Commissioner may not combine or consolidate the net income of separate (though related) taxpayers if their businesses are, in fact, separately conducted without distortion of income.[65] In fact, the old Treasury Regulations state that § 45 is "not intended (except in the case of the computation of consolidated net income under a consolidated return) . . . to effect in any case such a distribution or allocation of gross income and deductions . . . as would produce a result equivalent to a computation of consolidated net income under § 141 [of the 1939 Code]."[66]

The Commissioner may not compel an arbitrary allocation of intercompany expenses if the taxpayer's method of allocation is fair and reasonable.[67] Further, he may not allocate income and deductions where two separate business entities, although owned or controlled by the same interests, deal with each

60 40 B.T.A. 97 (1939).

61 6 TCM 354 (1947).

62 See General Indus. Corp., 35 B.T.A. 615 (1937), cited with approval in Hypotheek Land Co. v. Commissioner, 200 F.2d 390 (9th Cir. 1952), where it was said that "§ 482 authorizes the distribution, apportionment, or allocation of income and deductions, but it nowhere permits disallowance thereof."

63 Hearst Corp., 14 T.C. 575 (1950); 7 MERTENS, LAW OF FEDERAL INCOME TAXATION § 38.63, n. 50 at 128.

64 See "Alternative Weapons of Commissioner," part F, *infra*.

65 Commissioner v. Chelsea Prods., Inc., 197 F.2d 620, 623 (3d Cir. 1952); Cedar Valley Distillery Inc., 16 T.C. 870, 876 (1951); Twin Oaks Co. v. Commissioner, 183 F.2d 385, 387 (9th Cir. 1950); Seminole Flavor Co., 4 T.C. 1215, 1232-35 (1945).

66 Treas. Reg. 111, § 29.45. And the new regulations issued under the 1954 Code are to the same effect. *But see* Advance Mach. Exch. v. Commissioner, 196 F.2d 1006 (2d Cir. 1952), and comment thereto in Anderson, *supra* note 53, at 356.

67 Welworth Realty Co., 40 B.T.A. 97 (1939), *acq.*, 1939-2 CUM. BULL. 39; Harris, Inc., 5 TCM 480, CCH Dec. 15, 223(M) (1946).

other at arm's length as they would deal with strangers in their respective business activities. This follows from the purpose of IRC § 482, which is not to punish the mere existence of common ownership or control but to assist in preventing distortion of income and evasion of taxes through the exercise of that control or ownership.[68]

Basically, the arm's-length standard is concerned with the fairness and adequacy of the consideration paid for the property transferred or for the services rendered by one controlled taxpayer to another. This standard may be vague and uncertain, but in that respect it is no more indefinite than other standards that are found in the law (*e.g.*, "reasonableness" in the areas of compensation, depreciation, etc.). In any event, the decided cases do not evidence any undue difficulty on the part of the courts in applying the arm's-length standard to a particular factual situation.

Proof that transactions between entities owned or controlled by the same interests were at arm's length was found in the fact that the prices were (1) the same as those charged to unrelated entities,[69] (2) at market price,[70] or (3) fair and reasonable.[71] Proposed IRC § 482(b) (4) defines "arm's length price" for the purpose of IRC § 482(b)(2) as

> (A) the price at which tangible property similar or comparable to the property referred to [in paragraph (1)] generally is or can be sold in transactions in the same [general marketing] areas involving unrelated persons and made under similar conditions of sale; and
> (B) if subparagraph (A) does not apply, the price at which tangible property similar or comparable to the property referred to in paragraph (1) is sold in the same or other [market] areas under similar circumstances and in transactions involving unrelated persons, with adjustment for material differences in quantity, market conditions . . . and other relevant factors.[72]

Because many controlled taxpayers have shown that their transactions were genuine and made at arm's length, the Commissioner has actually lost more IRC § 482 cases in the courts than he has won.[73] For example, in the *Seminole Flavor Co.* case,[74] the taxpayer showed to the satisfaction of the Tax Court that the contracts between the related entities for advertising and selling operations were at arm's length. The court found that the taxpayer paid the related entity 50 per cent of the invoice price. The taxpayer produced evidence that prior to the arrangement it had paid 48 per cent for such services. The Tax Court, on this evidence, said that the compensation was fair and there-

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68 This position was taken in a proposed amendment to IRC § 482 in H.R. 10650, 87th Cong., 2d Sess., § 6, p. 37. It was not passed. Proposed IRC § 482(b)(1) provided that "this section shall not apply with respect to any sale of tangible property for which the taxpayer can establish an arm's-length price."
69 Commissioner v. Chelsea Prods., Inc., 197 F.2d 620, 621 (3d Cir. 1952).
70 General Indus. Corp., 35 B.T.A. 615 (1937), *acq.*, 1937-1 CUM. BULL. 10; Grenada Indus., Inc., 17 T.C. 231, 255 (1951), *aff'd*, 202 F.2d 873 (5th Cir. 1953).
71 Polak's Frutal Works, Inc., 21 T.C. 953 (1954), *acq.*, 1955-1 CUM. BULL. 6; Friedlander Co., 25 T.C. 70 (1955).
72 See also, *TIR-441*, Jan. 11, 1963.
73 See Virginia Metal Prods., Inc., 33 T.C. 788, 800 (1960), *rev'd on other grounds and remanded*, 290 F.2d 675 (3d Cir. 1961), *cert. denied*, 368 U.S. 889 (1961); Friedlander Corp., 25 T.C. 70, 77 (1955).
74 4 T.C. 1215 (1945).

fore must be recognized for tax purposes (*i.e.*, classified as an arm's-length transaction).[75]

> 3. 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.

The statute limits the exercise of the Commissioner's authority to cases in which, as a condition precedent, he "determines that an allocation is necessary in order to prevent evasion of taxes or clearly to reflect income." The statute does not permit disregard of valid entities[76] (*i.e.*, those serving a good business purpose), nor does it permit the division of a business activity into severable taxable entities.[77]

The Commissioner may not make an allocation except among members of the controlled group (*i.e.*, the related businesses). He may not use the section unless his proposed allocation or reallocation prevents the evasion of taxes or clearly reflects income.[78] In addition, the allocation cannot be made beyond the extent necessary to prevent evasion of taxes or clearly to reflect income.[79]

F. *Alternative Weapons of Commissioner*

Although IRC § 482 can be applied to most cases of improper shifting of income and deductions among related taxpayers, there are, as we have seen, certain limitations to its application. Nevertheless, the Commissioner may attack the transaction with other weapons. For instance, the Commissioner may rely on other statutory provisions, such as IRC §§ 61, 162, 269 or 1551, or he may rely on the "common law" tax theories, such as the sham, step transaction, lack of business purpose, net economic effect, or assignment of income doctrines.[80] He may also treat the transaction as a constructive dividend or as a contribution to capital depending upon the circumstances.

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75 See Frank v. International Canadian Corp., 308 F.2d 520, 528 (9th Cir. 1962), discussed in part D *supra*, where it is suggested that if the transactions between the related taxpayers are "fair and reasonable" they will withstand an attempted reallocation by the Commissioner, even if the transactions would have been different had they been at arm's-length between unrelated taxpayers.

76 Commissioner v. Chelsea Prods., 197 F.2d 620 (3d Cir. 1952). "Sec. [482] grants to the Commissioner power to allocate gross income, deductions. . . . There is no mention of authority to disregard completely the corporation entity. . . ." See also, Interior Sec. Corp., 38 T.C. 330 (1962); Campbell County State Bank, Inc., 37 T.C. 430 (1961).

77 Twin Oaks Co. v. Commissioner, 183 F.2d 385 (9th Cir. 1950). Nevertheless, the Commissioner could reallocate income from an entity treated as a sham for tax purposes to the true taxable entity under IRC § 61(a), which defines income. The Commissioner can also utilize IRC § 61(a) to reallocate income between taxpayers where both are recognized as valid entities for tax purposes. See "Alternative Weapons of Commissioner," Part F, *infra*. In addition, see Hewitt N.Y.U. 20TH INST. ON FED. TAX. 463, 465 (1962).

78 16 J. TAXATION 261, 262 (May, 1962). There is a recent case in which the Commissioner's reallocation was disapproved because it "arrived at a result which would not exist under any factual situation, if the corporation were dealing at arm's length." Motor & Indus. Fin. Corp. v. Scofield, 48 AFTR 1774 (W.D. Tex. 1955).

79 Grenada Indus., Inc., 17 T.C. 231 (1951), *acq.*, 1952-2 CUM. BULL. 2, *aff'd*, 202 F.2d 873 (5th Cir. 1953), *cert. denied*, 346 U.S. 819 (1953). However, the rule that allocation is authorized only to the extent necessary to achieve a taxable income equivalent to that which would have resulted if the transaction were at arm's-length between uncontrolled taxpayers may not be correct in all situations. See Tennessee Life Ins. Co. v. Phinney, 280 F.2d 38 (5th Cir. 1960), *cert. denied*, 364 U.S. 914 (1960), and comment thereto in N.Y.U. 20TH INST. ON FED. TAX. 463, 489 (1962).

80 See Hewitt, *Section 482—Allocation of Income and Deductions Among Related Taxpayers*, N.Y.U. 20TH INST. ON FED. TAX. 463, 465-68 (1962).

The Commissioner can utilize IRC § 61 (which defines income) to attribute income to the taxable entity which earns it. Thus in *Grenada Industries Inc.,*[81] involving four business entities all owned by the same interests, where income earned by two of the entities was being deflected to the other two entities, the Tax Court, citing *Lucas v. Earl,*[82] said that "in such circumstances the general provisions of section [61] are undoubtedly sufficient to charge the income to the one that actually earned it."[83] But, said the Court, "in the case of organizations under common control, the detailed provisions of section [482] . . . explicitly authorize the Commissioner to unscramble any such situation, so that income may be charged to the organization that earned it."[84]

Similarly, the Commissioner can utilize IRC § 162 instead of IRC § 482 to disallow expenses to a taxpayer on the grounds that the former "contemplates the deduction of only such ordinary and necessary business expenses as are personal to the taxpayer (*i.e.,* incurred in the taxpayer's trade or business)."[85]

G. *Summary and Conclusions*

The dominant purpose of the revenue laws is the taxation of income to those who earn or otherwise create the right to receive it and enjoy the benefits of it when paid,[86] which means inferentially that deductions attributable to particular income shall be allocated to such income. On the other hand, the taxpayer has the legal right to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means permitted by law.[87] Hence, he will necessarily attempt to make allocations most favorable to himself.

The Commissioner's function is to protect the revenue. The taxpayer makes all the initial determinations in the preparation of the tax return. Since the taxpayer decides whether or not (and to what extent) to make an allocation, the Commissioner must have a means for determining whether an allocation in a controlled situation clearly reflects the income of the individual taxpayers, and if it does not, he must have the power to correct it. This is the reason for IRC § 482 and its predecessors, which authorize the Commissioner to reallocate items of income and deductions, etc., where he finds that, in the case of entities under common control, there has been no allocation or an improper one, which produced a result different from that which would have existed absent opportunities obtained through common control.

It is clear that the area in which the Commissioner can and should exercise his power comprises those sections of the law whose application is restricted to items incurred "in the taxpayer's trade or business."[88] On the other hand, there

81 17 T.C. 231 (1951).
82 281 U.S. 111 (1930).
83 Grenada Indus., Inc., 17 T.C. 231, 253 (1951).
84. *Ibid.*
85 Word Specialty Mfg. Corp., 34 B.T.A. 974, 982 (1936). And if the Commissioner uses IRC § 162 to disallow the expenses, the taxpayer has no right to compel the Commissioner to allocate them to the affiliated taxpayer under IRC § 482. Treas. Reg. § 1.482-1(b)(3).
86 Helvering v. Horst, 311 U.S. 112 (1940).
87 Gregory v. Helvering, 293 U.S. 465 (1935).
88 *E.g.,* IRC § 162 (ordinary and necessary expense in the trade or business); and IRC § 167(a)(1) (depreciation on property used in the trade or business).

are many sections which allow deductions without regard to their relationship to any trade or business, and it is unsettled or at least very doubtful whether the Commissioner may make an allocation here.[89]

While the burden of proof is on the taxpayer to show that a proposed allocation by the Commissioner is incorrect, the power of the Commissioner is not without limitations. For example, where the taxpayer has made his own allocation and his records clearly reflect the income of the individual entities, the Commissioner will not be permitted to make a different allocation. However, where no allocation has been made by the taxpayer and because of common control the procedure seems to effect an evasion of taxes, an allocation by the Commissioner will more likely be sustained.

Of course, it is recognized that the Commissioner has power other than that enumerated in IRC § 482, where a transaction is a sham or where a principal purpose is the avoidance of taxes.[90] In addition, somewhat broader authority for the Commissioner is suggested in certain leading cases.[91] However, as noted, this paper has concerned itself chiefly with IRC § 482 and items of deductions. Nevertheless, the principles stated are equally pertinent, for example, with respect to items of income, credits and exemptions.

Obviously, in any case where there are transactions between taxpayers under common control, it is important to consider the possible application of IRC § 482 by the Commissioner in arranging the form and terms of such transactions and in recording the results. The best defense, as noted, is a showing that the taxpayer's records clearly reflect the income of the separate entities as would result in the case of uncontrolled taxpayers dealing at arm's length. It is therefore desirable to prepare and preserve data which will show the bases of the allocations made as well as to indicate the propriety of the bases used. In the case of interest and taxes, the further defense should be asserted that allocation by the Commissioner is improper, since it is tantamount to a disallowance contrary to the terms of the statute, which allows such deductions.

Nevertheless, the taxpayer should not arrange his transactions primarily to meet the threat of IRC § 482, but should conduct his affairs according to good business practice. If a businessman in his own sound business judgment thinks an expenditure necessary for proper conduct of his business, he should make the expenditure and not be deterred by possible controversy with the Commissioner. For it is suggested that where the taxpayer can show a valid business purpose for an expenditure — namely, that it is ordinary and necessary in carrying on his trade or business — the possible danger of arbitrary and unreasonable allocation by the Commissioner will be very much minimized. Moreover, the likelihood is that if the taxpayer conducts his business this way in good faith, he will be more successful in resisting any attempt at artificial allocations thereafter by the Commissioner.

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89 *E.g.*, IRC § 163 (interest); *and* IRC § 164 (taxes).

90 *E.g.*, IRC § 269 (acquisitions made to evade or avoid income tax); *and* IRC § 1551 (disallowance of surtax exemption and accumulated earnings credit).

91 See, *e.g.*, Helvering v. Horst, 311 U.S. 112 (1940); Gregory v. Helvering, 293 U.S. 465 (1935); and Lucas v. Earl, 281 U.S. 111 (1930).

Therefore, where a parent corporation has incurred business expenses, depreciation, interest charges, etc., for the purpose of facilitating the conduct of business by its income-producing subsidiaries, it should not hesitate to justify these items as proper deductions. It need only show that such services or facilities were furnished to the subsidiaries primarily to permit the parent company to exercise its right and duty to supervise effectively the operations of the subsidiaries. In fact, it should be recognized (and even stressed) that transactions between controlled taxpayers, by their very nature, will be different from those between unrelated taxpayers. It would appear to be an entirely proper expenditure in the trade or business of the parent corporation to insure smooth and efficient cooperation between itself and the various subsidiaries as well as among the subsidiaries themselves. Obviously, this kind of expenditure would not exist in the case of uncontrolled taxpayers. Provided that the transactions between parent and subsidiary are normal and proper in that context and have not been arranged with a principal purpose of tax avoidance, they should be able to resist any attack by the Commissioner under IRC § 482.

In short, one must look at the nature of the transaction. If it is one that exists and can be measured among taxpayers not under common control, then there is a basis for the Commissioner's finding that the arrangement was for tax purposes and should be subject to his power to reallocate. But where the expenditure is incurred by a parent corporation for the purpose of facilitating the co-ordination of the activities of numerous world-wide subsidiaries and for protecting the financial health and public image of the enterprises as a whole, there is no comparable standard of dealing among uncontrolled companies which would even suggest that the arrangement is a tax-saving device rather than a bona fide ordinary and necessary expense incurred in the business of the parent corporation.