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Consolidating Foreign Affiliates

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CONSOLIDATING FOREIGN AFFILIATES

by

*Jasper L. Cummings, Jr.**

I. PROPOSAL FOR CHANGE	145
A. <i>Consolidate Foreign Affiliates</i>	145
B. <i>Reasons for Change</i>	145
C. <i>Benefits of Consolidation</i>	148
D. <i>Objections</i>	151
II. BENEFITS OF CONSOLIDATION	153
A. <i>Summary</i>	153
B. <i>Consolidation Best Reflects Income</i>	154
1. <i>Financial Accounting</i>	154
2. <i>Regulatory Accounting</i>	156
3. <i>Tax Accounting</i>	157
C. <i>Other Benefits of Full Consolidation</i>	129
D. <i>Compare and Contrast State Consolidation</i>	160
E. <i>1992 Proposal</i>	162
III. HISTORY OF THE CONSOLIDATED RETURN AND FOREIGN AFFILIATES	163
A. <i>War Excess Profits Tax of 1917</i>	163
B. <i>The First Consolidated Return Regulations</i>	165
1. <i>Prior Regulations Rejected Form for Substance</i>	165
2. <i>The First Consolidated Return Regulations</i>	167
C. <i>Revenue Act of 1918</i>	173
D. <i>Revenue Acts of 1921 Through 1926</i>	176
1. <i>Consolidated Returns in the 1920s</i>	176
2. <i>Foreign Tax Credit</i>	178
3. <i>Consolidation of Accounts</i>	179
4. <i>The Lessons of 1917-1928</i>	184

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E.	<i>Revenue Act of 1928</i>	186
1.	<i>The Accidental Creation of Section 482</i>	186
2.	<i>New Section 45</i>	190
3.	<i>What Was Section 45 Aimed At?</i>	191
4.	<i>New Consolidated Return Regulations</i>	194
F.	<i>Revenue Act of 1934 and Later</i>	195
IV.	IS CHANGE POSSIBLE?	195
A.	<i>The Political Decision Was Never Made</i>	195
B.	<i>Selling Points</i>	197
C.	<i>No Constitutional Impediment</i>	198
1.	<i>Overview</i>	198
2.	<i>History</i>	199
3.	<i>1961 Concerns</i>	202
4.	<i>International Norms</i>	205
D.	<i>Challenges of Full Consolidation</i>	206
1.	<i>Disaffiliation</i>	206
2.	<i>Other Objections</i>	207
E.	<i>Territorial Taxation or Not</i>	208
1.	<i>Global Formulary Apportionment</i>	209
2.	<i>Sourcing Rules</i>	210
3.	<i>More Substantive Sourcing Rules</i>	214
4.	<i>Effectively Connected Income</i>	214
F.	<i>Other Design and Transition Issues; Foreign Corporations</i> <i>in the Consolidated Group</i>	214
1.	<i>Domestic or Includable Foreign Corporation?</i>	214
2.	<i>Inclusion Alternatives upon Domestication</i>	215
3.	<i>Compare Other Consolidated Foreign</i> <i>Corporations</i>	216
V.	CONCLUSION	218

I. PROPOSAL FOR CHANGE

A. *Consolidate Foreign Affiliates*

Congress and the Treasury should seriously consider repealing section 1504(b)(3), thereby including as part of the consolidated filing group affiliated foreign corporations that are owned by the common parent and other members of the group. This act would expand the consolidated return to its logically proper scope and would end deferral (of U.S. taxation of active business income earned by foreign affiliates) based on the happenstance of corporate shells having been placed between them and their owners in the consolidated group. However, if the current debate over deferral, after consideration of the consolidation extension, ends in a decision to retain some sort of deferral, then consolidation of foreign affiliates still will produce a superior measurement of the entire business income without regard to legal structures. In conjunction with including foreign affiliates in the consolidated group, Congress can make a principled choice about how much of the foreign income of the group should be excluded from current (or any) taxation, based on income sourcing or some other administrable measurement.

B. *Reasons for Change*

Since 1917, consolidated returns have reflected a grand compromise between taxpayers that want to offset losses of some incorporated affiliates against income of other incorporated affiliates, and the government that wants the more accurate reflection of the income of a business (the consolidated group) that can be obtained from consolidated reporting, unimpeded by artificial legal structures. But when consolidated filing went from mandatory to voluntary in 1921, the benefit of the bargain shifted substantially in favor of the taxpayers due to the potential for electivity against the government. No one then noticed how the exclusion of foreign affiliates undercut achieving the clear reflection of income that consolidation should provide, because it was not that big a set of cases, and the income tax did not generally tax foreign corporations. But the subsequent combination of (1) a drastic expansion of foreign affiliates of consolidated groups, and (2) substantial concerns about deferral and taxation of their income, makes it past time to revisit this greatest obstacle to achieving the true reflection of income at which consolidated reporting aims.

Three quotations frame the issue. First, an eminent expert on international taxation recently answered the author's question, "Why don't we include foreign subsidiaries in consolidated returns?" by saying,

“Because of deferral; because we don’t tax them.”¹ That spontaneous utterance was correct for reasons deeper than the speaker likely intended: the only sound reason to exclude foreign affiliates from section 1504(b) includable corporations is the political choice, which eventually was made explicit by Congress, not to tax active foreign source income that is separated from the U.S. shareholders by the legal shell of a foreign corporation.

Second, some forty years earlier the author of the first article on this paper’s subject discussed the same question with Stanley Surrey, who responded (in paraphrase) that you could get rid of most of the confusion of trying to determine arm’s-length prices and of trying to administer Subpart F deferral by consolidating foreign affiliates.²

Third, Robert F. Kennedy said, “Some people see things as they are and say why; I dream things that never were and say why not?”³ In this case people do not even ask why foreign affiliates are excluded from the consolidated return.⁴

This article does not try to evaluate the economic and political validity of the gradual decision not to currently tax active income of foreign

1. For an explanation of the benefits of deferral to the U.S. shareholders, see Robert J. Peroni, J. Clifton Fleming, Jr. & Stephen E. Shay, *Getting Serious About Curtailing Deferral of U.S. Tax on Foreign Source Income*, 52 *SMU L. Rev.* 455, 464-468 (1999) [hereinafter Peroni, Fleming & Shay, *Getting Serious*].

2. Related by William C. Gifford to the author. Gifford wrote the first article proposing consolidation of foreign affiliates. William C. Gifford, Jr., *United States Tax Effects of Foreign Losses: A Symmetry Analysis*, 83 *Yale L.J.* 312, 352 (1973).

3. Robert F. Kennedy, quoting George Bernard Shaw’s play “*Back to Methuselah*.”

4. As illustrations of the failure to even consider the relevance of consolidated filing by the U.S. shareholders, see Report of the Task Force on International Tax Reform, 59 *Tax Law.* 649 (2006) [hereinafter Report] (an extensive and even handed analysis of the issues of international taxation that does not mention consolidated returns); Staff of the Joint Comm. on Tax’n, 109 Cong., *The Impact of International Tax Reform*, (Joint Comm. Print, June 21, 2006) (similarly surveying options without discussing including foreign affiliates in the consolidated group); Office of Tax Policy, Treasury Dep’t., *The Deferral of Income Earned Through U.S. Controlled Foreign Corporations, A Policy Study*, 2001 Tax Notes Today 1-1 (Dec. 29, 2000) (not discussing consolidated returns); Paul R. McDaniel, *Territorial vs. Worldwide International Tax Systems: Which Is Better for the U.S.?* 8 *Fla. Tax Rev.* 283, 292 (2007) (discussing a pure worldwide income/foreign tax credit system, but without regard to consolidated returns); Samuel C. Thompson, Jr., *Assessing the Following Systems for Taxing Foreign-Source Active Business Income: Deferral, Exemption, and Imputation*, 53 *How. L.J.* 337, 357 (2010) (discussion of imputation; does not mention consolidation).

corporations owned by U.S. shareholders.⁵ Rather it proves two facts about the choice: (1) there was no choice originally, it just happened; and (2) the de facto choice has never been reevaluated in light of the benefits of the consolidated return, although consolidating foreign affiliates was first suggested in 1973.⁶ Based on these facts this article argues that as part of the current reevaluation of deferral, the advantages of consolidating foreign affiliates should be considered.

Under normal circumstances suggesting that a long standing congressional decision is theoretically incomplete would be a fool's errand, given the ubiquity of that phenomenon. However, this article can be of more than academic interest due to the need for different approaches to influence the seeming deadlock on international tax reform.⁷ Even though consolidating foreign affiliates would not end deferral of all foreign source income of all controlled foreign corporations (and lesser owned corporations), it would end deferral as to the bulk of such foreign income,

5. One major disadvantage of deferral of taxation of active income earned by controlled foreign corporations is that it encourages holding that income offshore, to the presumed detriment of the U.S. economy and shareholders. For a recent congressional acknowledgment of this problem, see § 965, as explained in Jasper L. Cummings & Robert P. Hanson, *American Jobs Creation Act of 2004: A Selective Analysis*, ¶ 2.03[3] (2005). See, e.g., as to debates on deferral, Clifton J. Fleming, Jr., Robert J. Peroni & Stephen E. Shay, *Worse Than Exemption*, 59 *Emory L.J.* 79 (2009) [hereinafter Fleming, Peroni & Shay, *Worse Than Exemption*]; Jane G. Gravelle, Cong. Research Serv., RL 34115, *Reform of U.S. International Taxation: Alternatives*, (2010), reprinted in 2010 *Tax Notes Today* 244-20 (Dec. 17, 2010).

6. The discussion, *infra*, of the history of consolidated returns will show the lack of consideration by Congress. However, a handful of commentators have raised the possibility. These include Staff of the Joint Comm. on Tax'n, *Economic Efficiency and Structural Analyses of Alternative U.S. Tax Policies For Foreign Direct Investment*, 52-53 (Joint Comm. Print 2008); Gifford, *supra* note 2, at 352 (making the first and most extensive analysis of reasons for inclusion); Robert A. Green, *The Future of Source-Based Taxation of the Income of Multinational Enterprises*, 79 *Cornell L. Rev.* 18, 74, 78 (1993) (advocating ending deferral generally and identifying expansion of consolidated group as one mechanical means of doing so in a sufficient set of cases); Peroni, Fleming & Shay, *Getting Serious*, *supra* note 1, at 499-500 (discussing consolidation but rejecting it principally because it would be an incomplete attack on deferral); Asim Bhansali, *Globalizing Consolidated Taxation of United States Multinationals*, 74 *Tex. L. Rev.* 1401 (1996) (recommending that domestic parents be required to consolidate with fifty percent controlled foreign subsidiaries under an entirely new regime, not as an extension of present consolidated returns); (basically just recognizing the prior suggestions).

7. See, e.g., Report of the National Commission on Fiscal Responsibility and Reform (2010), reprinted in 2010 *Tax Notes Today* 231-35 (Dec. 1, 2010) (recommending a territorial system); Amy S. Elliott, *Shay Questions Significance of Lockout Effect of Deferral*, 2010 *Tax Notes Today* 221-2 (Nov. 17, 2010) (expressing doubts about territorial system).

and certainly the part about which most of the policy disputants are most concerned. Presumably the dollar amounts of deferred taxes at stake are heavily weighted into the affiliated subsidiaries of consolidated groups.⁸

The most important justification for ending deferral through consolidation of foreign affiliates is that it applies the best tool (consolidation) to combat the worst abuse of the deferral system (deferring taxation of more than the amount of income properly assignable to the foreign corporation) in the most problematic cases (assuming that the likelihood of improper income shifting rises as the percentage of ownership of the foreign corporation rises).

C. *Benefits of Consolidation*

The principal reasons for including foreign affiliates' income in consolidated returns are:

- Since 1929, Congress has labeled filing consolidated returns a privilege because it allows affiliated corporations to elect (with no power in the IRS to compel) to disregard the corporate shells that normally separate their taxation, which election is most commonly made for the beneficial purpose of reducing aggregate group taxation over time through offsetting the income and losses of affiliates.⁹
- The most important benefit to the government from this seemingly one-sided election is the clearer reflection of income of a multi-unit business by eliminating transfer pricing and other intercompany transaction concerns (i.e., section 482 has little role inside consolidated groups¹⁰), eliminating artificial barriers

8. As to the number of controlled foreign corporations that would be affiliated for consolidated return purposes, see Lee Mahoney & Randy Miller, *Controlled Foreign Corporations*, 2004, *Stat. Income Bull.*, 2008, at 60, 62, showing 10,939 U.S. corporations owning more than fifty percent of 74,676 foreign corporations, which had after tax income of \$365B and paid tax of \$68B. By comparison \$211B in corporate income tax was collected by the United States for 2002. *SOI Tax Stats, IRS Data Book, Tbl. 7, Internal Revenue Gross Collections by Type of Tax*. The amount of deferred income owned by U.S. corporations as contrasted with U.S. individuals appears to be relatively huge. See James R. Hines, Jr., *Reconsidering the Taxation of Foreign Income*, 62 *Tax L. Rev.* 269, 269 n.1 (2008). However, cf. Peroni, Fleming & Shay, *Getting Serious*, *supra* note 1, at 500 (“[T]his cure would have only a modest impact on the disease.”).

9. See *infra* Part III.E.

10. Section 482 is applicable inside consolidated groups. See Reg. § 1.482-1(f)(1)(iv); Reg. § 1.1502-80(a); see also J. Hardy Patten, *The Consolidated Return—1929 Model*, 8 *Tax Mag.* 13, 17 (1930) (asserting that § 45 could be

(i.e., the corporate shells) to the accurate measurement of a business enterprise's income, and identifying income in a way similar to that chosen long ago by the accounting profession and other branches of the federal government (i.e., the SEC) as the most accurate way to reflect corporate income.¹¹

- Excluding foreign affiliates from the consolidated return is the greatest single impediment to that clear reflection of the income of the business of the group, both because it excludes a major piece of the controlled group's business income and because it forces reliance on the hard to enforce standards of section 482, which can never be more than a second-best solution to consolidation for the intercompany transactions addressed.¹²
- The exclusion can be justified only if both (a) the political decision for deferral of taxation of active foreign source income of foreign affiliates is made with full appreciation for the countervailing advantages of a full consolidation (which it has never been), and (b) the application of section 482 to transactions between consolidated groups and foreign affiliates works well enough to fairly support the conclusion that what is being deferred is the tax on the foreign source income earned by the foreign affiliate and not the tax on misallocated income of the domestic consolidated group (about which many have expressed serious doubts).¹³
- Not only is there no reason to think that section 482 works as well as or better than consolidation of the foreign affiliates would work,¹⁴ but also there is reason to think that section 482

applied inside consolidated groups but not stating any examples); Andrew J. Dubroff et al., *Federal Income Taxation of Corporations Filing Consolidated Returns* ¶ 31.02[3] n.58 (1997) (“[A]lthough IRC § 482 applies to intercompany transactions, its effect is limited because transactions that are not at fair market value typically do not affect overall consolidated taxable income.”).

11. See *infra* Part II.B.

12. See *infra* Part II.

13. See, e.g., Michael C. Durst, *The Two Worlds of Transfer Pricing Policymaking*, 2011 *Tax Notes Today* 16-22 (Jan. 24, 2011), and articles cited therein.

14. Report, *supra* note 4, at 703, 714 (observing that however proficient the transfer pricing rules may be, there is an inescapable pressure for domestic corporations to push income offshore, whether by intent or accident; observing that the arm's length standard is actually a range and within it there is ample room to plan to push income offshore). The suspicion of the transfer pricing regime is not new. See Alan G. Choate, Steven Hurok & Samuel E. Klein, *Federal Tax Policy for Foreign Income and Foreign Taxpayers—History, Analysis and Prospects*, 44 *Temp.*

adds complexity to the system,¹⁵ which taxpayers tolerate only because of the perceived advantages, contributing to a “paradox of defects.”¹⁶

- The consolidation of foreign affiliates could be beneficial to domestic groups because it would allow their losses to be currently deducted, subject to the dual consolidated loss limitations.¹⁷
- There are no other reasons—constitutionality, sanctity of the corporate shell, practical enforcement problems, historical continuity—that either originally justified the exclusion of foreign affiliates from consolidation when that occurred, or now justify it (i.e., the tax law, particularly in the international area, has long since decided that the corporate membrane is not a sufficient reason to prevent current taxation of shareholders on corporate income, most importantly Subpart F income).¹⁸

There has never been a serious public debate about, or congressional consideration of (save for a 1992 proposal discussed *infra*), whether consolidated filing groups should include foreign affiliates and their incomes for reasons peculiar to affiliated groups.¹⁹ The purpose of this article is to encourage that discussion and to argue that foreign affiliates should be in the consolidated filing group because consolidated returns should reflect the economic income of the economic business that is the affiliated group.

L.Q. 441, 518 (1971) (calling it apportionment like “horse trading” rather than allocation on a factual basis).

15. Report, *supra* note 4, at 717.

16. *Id.* at 718 (quoting Joint Committee on Taxation observation).

17. See *id.* at 734 (observing that failure to allow current pass through of losses was one of the major objections to ending deferral). However, domestic groups likely are able to recognize much of their foreign losses at will by capitalizing CFCs with debt and liquidating them when insolvent. See also Gifford, *supra* note 2, at 352. Cf. I.R.S. LTR. 200226004 (discussing worthless stock deduction for stock of foreign subsidiary). For limitations on dual consolidated losses, see Regs. §§ 1.1503(d)-1 to -8; Dubroff et al., *supra* note 10, ¶ 41.03[3]; Joel D. Kuntz & Robert J. Peroni, U.S. International Taxation ¶ B1.05 (1991); see also *infra* Part IV.F.3.c.

18. See Report, *supra* note 4, at 699 et seq.

19. See *supra* note 4 and *infra* Part III. It is difficult to prove a negative, but when Michael Graetz does not mention the subject in a study of the historical origins of the international tax rules, you can safely assume the subject has been overlooked. See Michael J. Graetz & Michael M. O’Hear, The “Original Intent” of U.S. International Taxation, 46 Duke L.J. 1021 (1997).

D. Objections

The primary objection to the proposal will be that it ends deferral for this group of foreign corporations, and that deferral should not be ended for all sorts of policy, political, and economic reasons. Admittedly, simple consolidation would do that. The primary answer to the objection is that the change vastly improves and simplifies the determination of income and justifies the benefit embodied in the privilege of consolidation. Beyond that the choice is almost entirely political.

But as discussed in Part IV.E. below, consolidating foreign affiliates and the benefits thereof need not be linked to ending deferral. Rather it can be linked to a more rational identification of the amount of foreign income Congress does not want to tax currently or ever because of its foreign connection. That identification might be by either (a) continuing to apply separate accounting/section 482 but now inside the consolidated group and excluding the foreign affiliate's active income (which should be rejected because it defeats the purpose of consolidation); or (b) eliminating separate accounting in consolidated returns, treating the group as an economic unit, and thus eliminating the effect of intercompany transfers in terms of computing income, foreign and domestic source (which should be rejected because it is contrary to the consolidated return regulations' dogged retention of separate accounting); or (c) applying existing or more substantive income sourcing rules to identify foreign source income that will be excluded; or (d) apply some sort of effectively connected income standard or income apportionment to determine the excludable foreign income.

Other objections will relate to taxpayers trying to avoid the change. No one should recommend a major tax change without addressing the new tax avoidance efforts it would elicit. If foreign affiliates must be included in the consolidated group, and particularly if that choice ended deferral of tax on their foreign source active income, that requirement would tend to (a) drive consolidated groups out of the consolidated election, (b) drive consolidated groups to disaffiliate foreign subsidiaries,²⁰ or (c) drive consolidated groups to expatriate. Careful analysis of reactive revocation of consolidated elections would have to be made, and is beyond the scope of this article. Perhaps revocations could be generally denied under regulations section 1.1502-75(c) of the Regulations.

Disaffiliation could be combated, but only if the Treasury were willing to adopt a very different approach to defining affiliation. Historically,

20. See Peter E. Gumpel, *The Taxation of American Business Abroad—Is Further Reform Needed?* 15 *J. Int'l L. & Econ.* 389, 425-26 (1981) (suggesting that decontrolling CFCs to be in a minority position would be costly and unlikely, but due to small perceived relative advantage of deferral in 1981, may not be a currently valid evaluation).

the Treasury and IRS have tolerated disaffiliation through economically meaningless arrangements, including not only foreign corporations but also partnerships of group members, etc.²¹ Such tolerance is ostensibly based on the absence of attribution rules in the definition of affiliation, leading to an interpretation of the statute to require direct ownership.²² Such tolerance reflects the same low regard for the importance and value of taxing the economic unit of affiliated corporations as does the exclusion of foreign affiliates itself. Therefore, a decision to include foreign affiliates should be compatible with a decision to prevent economically meaningless disaffiliation.²³

Whether expatriation can be controlled and limited is a huge and long-standing issue that would become more difficult if the stakes were raised in the way suggested here.²⁴ A long-debated alternative to the current methods of combating expatriation (§ 7874, et al.) is to change the definition of a domestic corporation to be based on where the corporation is managed and controlled.²⁵ Perhaps consolidating foreign affiliates would help bring this issue to a decision.

And inevitably, existing consolidated groups that were made to include foreign affiliates would claim unfairness, discrimination, and that the rules were changed after the game started, etc. The basic answer to such claims is that consolidated filing has long been a privilege, and electing groups are on notice that the regulations can be changed in substantial ways right up to the day the return is due. But also inevitably, Congress will have

21. See Dubroff et al., *supra* note 10, ¶ 11.03[1] (transfer of stock to partnership comprised of affiliates can disaffiliate). Cf. I.L.M. 201044003 (disaffiliation accomplished by inserting a partnership of members between a co-op and the members; but nevertheless treated co-op as a member of the group because the partnership did not really own the co-op as a member that did business with it; an IRS employee insisted that the I.L.M. did not “sham the partnership” or mean to generally reject the ability to disaffiliate using a partnership that satisfies the § 701 regulations, at an ABA Tax Section Meeting in Boca Raton on Jan. 21, 2011). Inserting a foreign corporation between the consolidated group and a domestic corporation that will not be in the group is called a “foreign sandwich.”

22. Dubroff et al., *supra* note 10.

23. The Rostenkowski-Gradison Bill introduced in 1992 would have applied § 1563(e) constructive ownership rules. H.R. 5270, 102d Cong., § 202(a) (2d Sess. 1992), reprinted at 92 Tax Notes Today 111-1 (May 27, 1992).

24. See Graetz & O’Hear, *supra* note 19, at 1060 (explaining how expatriation was a problem in the early 1920s). Of course if a U.S. consolidated group is owned by a foreign corporation that is not treated as a domestic corporation under § 7874, there is no need to expatriate. This article does not recommend affiliating foreign parent corporations, although they present some of the same issues as foreign subsidiaries.

25. See Report, *supra* note 4, 668, 736 et seq.

to add a sweetener to forced consolidation, and some possibilities are discussed below.²⁶

The rest of this article undertakes to support the conclusions stated above. It does so primarily by tracing the history of the consolidated return from a perspective never before taken: its interrelationship with foreign affiliates' income.

II. BENEFITS OF CONSOLIDATION

A. Summary

Consolidation of affiliated corporations' income indisputably is the best way to determine the income of the group. Failure to consolidate can be excused only if it has been determined that the income of the entire group (using a standard definition of affiliation based solely on degree of ownership of value or control) need not be ascertained. Congress has decided that consolidated reporting is generally desirable and also that the current active income of foreign corporations owned by U.S. shareholders need not be taxed currently, but has not directly addressed the relationship of the two choices, which are at odds.

One may excuse this failure if the system imposes protections that make separate accounting for the domestic and foreign segments of the affiliated group work properly. Section 482 presumably provides that protection. However, regardless of how well section 482 works, it can be no better than a second-best choice to full consolidation, whether or not the United States chooses to tax foreign source income (however source might be determined). It is second best because (1) it operates episodically as it operates only upon audit, except to the extent the taxpayer enters into an advance pricing agreement with the IRS, and to the extent that agreement serves its intended purpose; and (2) consolidation totally avoids the factual difficulties, uncertainties, and expense of transfer pricing.²⁷

Therefore, the benefits of consolidation should be extended to foreign affiliates, and any congressional choice not to tax certain foreign income should be applied on the basis of the source rules, or some other

26. See *infra* Part IV.B.

27. See Dubroff et al., *supra* note 10, ¶ 31.02[3] n.58 (“ [A]lthough IRC § 482 applies to intercompany transactions, its effect is limited because transactions that are not at fair market value typically do not affect overall consolidated taxable income.”). If, for no other reason, the transfer pricing rules are a second best solution due to the substantially varying range of prices permitted. See Peroni, Fleming & Shay, *Getting Serious*, *supra* note 1, at 475; Fleming, Peroni & Shay, *Worse Than Exemption*, *supra* note 5, at 121 (“significant income shifting” despite application of transfer pricing rules).

method, rather than on the basis of separate accounting for foreign affiliates and section 482 audits and transfer pricing.

B. Consolidation Best Reflects Income

Testimony supporting the value of consolidated financial statements, specifically including foreign corporations, comes from the private sector, the public sector, and the tax law itself.

1. Financial Accounting

The income of a foreign corporation controlled by a U.S. shareholder usually is consolidated with the income of the U.S. shareholder for purposes of financial reporting.²⁸ Financial accounting embraced consolidated reporting in the early twentieth century in order best to reflect income. But consolidation seems to have been used mostly by holding companies up to the time of the 1917 Treasury regulations requiring consolidated corporate income tax returns.²⁹ One of the founders of Coopers & Lybrand pointed out that the necessity for filing consolidated corporate income tax returns in 1917 and 1918 had served the useful purpose of bringing to the attention of many corporations the general desirability of group consolidation for financial accounting purposes.³⁰

The concept of consolidated reporting did not appear in an 1898 British accounting compendium.³¹ *Fundamentals of Accounting*, published by a Harvard accounting professor in 1921, did not mention consolidated accounting for corporations.³² But another accounting text in 1918 explained how consolidation of the accounts of holding companies and their more than fifty percent owned subsidiaries produced useful information for both investors and managers.³³ It explained that intercompany sales could be eliminated but that it would be extremely difficult and was unnecessary

28. Staff of Joint Comm. on Tax'n, Explanation of H.R. 5270 (Foreign Income Tax Rationalization and Simplification Act of 1992)(Joint Comm. Print 1992), reprinted in 92 Tax Notes Today 113-2 (May 29, 1992).

29. See H. A. Finney, Consolidated Statements for Holding Company and Subsidiaries, at v-vi (1922) (noting the paucity of literature but the importance of the subject, particularly in light of tax consolidation).

30. Robert H. Montgomery, Excess Profits Tax Procedure 1921, at 284 (1920).

31. Sidney Stanley Dawson, The Accountant's Compendium (1898).

32. William Morse Cole & Ann Elizabeth Geddes, The Fundamentals of Accounting (1921) (see chapter XVI, "Some Peculiarities of Corporation Accounts").

33. William A. Paton & Russel A. Stevenson, Principles of Accounting 567 et seq. (1918).

because "the correction is automatically made in the operating division. . . ."³⁴ Indeed, the key to the paucity of general discussion of consolidated accounting seems to be that it was isolated to the category of "holding companies," which was relatively esoteric in comparison to the burgeoning field of accounting generally.³⁵

Up to 1987, the Financial Accounting Standards Board (FASB) allowed exclusion of foreign subsidiaries from consolidated returns, due to currency translation issues, but in 1987, it reversed its stance and required consolidation of foreign subsidiaries.³⁶ At the same time, it eliminated a "nonhomogeneity" exception and based consolidation solely on a controlling financial interest.³⁷ The FASB stated, *inter alia*:

29. In an economy in which numerous and varied kinds of activities are commonly combined in a single enterprise, whether organized as a single corporation with branches and divisions or as a parent company and subsidiaries, the argument that part of an enterprise has operations so different from those of other parts that it should be accounted for in a fundamentally different way has become increasingly tenuous. The Board concluded that the increasingly diverse nature of business activity, and of business enterprises themselves, makes the fact that the business activity of a subsidiary is different from that of its parent and other subsidiaries an insufficient reason to exclude it from consolidation.

30. The managerial, operational, and financial ties that bind an enterprise into a single economic unit are stronger than the differences between its lines of business. Consolidated financial statements became common once it was recognized

34. *Id.* at 570, see also Finney, *supra* note 29, at 110-11 (items should have been "taken up" on the accounts of both companies, and eliminations will be needed on to the extent not taken up).

35. See Finney, *supra* note 29, at v-vi (noting the paucity of literature but the importance of the subject, particularly in light of tax consolidation).

36. Consolidation of All Majority-Owned Subsidiaries, Statement of Financial Accounting Standards No. 94 (Financial Accounting Standards Board, 1987), reprinted in 1-88 J. Acct. 142 (1988). This amended the general consolidation rules of ARB No. 51 and ARB No. 43, Ch. 12, Foreign Operations and Foreign Exchange. ARB No. 51 states: "There is a presumption that consolidated statements are more meaningful than separate statements and that they are usually necessary for a fair presentation when one of the companies in the group directly or indirectly has a controlling financial interest in the other companies." *Id.*

37. *Id.*

that boundaries between separate corporate entities must be ignored to report the business carried on by a group of affiliated corporations as the economic and financial whole that it actually is. Similarly, differences between the varied operations of a group of affiliated corporations that constitutes an economic and financial whole do not preclude including them all in consolidated financial statements.

40. The usefulness of information about amounts of various assets, liabilities, revenues, and expenses is also indicated by the fact that most summary indicators other than net income, earnings per share, and stockholders' equity are affected by whether a subsidiary is consolidated or accounted for by the equity method. Basic analytical tools such as the current ratio, receivables turnover, inventory turnover, times interest earned, and return on total assets are a few examples. The paramount example is the debt-equity ratio, which, for reasons already described, is much lower if finance or other highly leveraged subsidiaries are accounted for by the equity method rather than consolidated. That effect is one aspect of off-balance-sheet financing that has been criticized because transactions between affiliates and intercompany receivables and payables often make it unlikely that "do-it-yourself" consolidation can adequately approximate debt-equity ratios in consolidated financial statements provided by the enterprises themselves.³⁸

Although the objectives of financial accounting and tax accounting are divergent in some respects,³⁹ and the standards for financial consolidation and tax consolidation differ (more than fifty percent versus eighty percent), the fact that foreign affiliates are included in financial consolidated statements is a powerful testament to the value of that step in properly evaluating the income of the domestic group.

2. *Regulatory Accounting*

The earliest holding companies were railroads and other types of public service companies. They were excluded from the early Treasury regulations requiring consolidated returns because of the analogous policing

38. *Id.*

39. See discussion in *Thor Power Tool Co. v. Comm'r*, 439 U.S. 522 (1979) (contrasting goals of financial and tax accounting).

of their consolidated accounts by their governmental regulators.⁴⁰ Later, the Securities and Exchange Commission (SEC) embraced consolidated accounting. Consolidation is generally required for companies governed by SEC reporting standards, including majority owned subsidiaries, regardless of whether foreign or domestic.⁴¹ Intercompany transactions must be eliminated.⁴²

3. Tax Accounting

The history of the consolidated return regulations recounted in Part III below shows that the government initially adopted the rules to properly reflect the income of related corporations and to avoid having to detect and undo tax avoidance transactions involving off-market intercompany charges and sales. The fact that the Treasury resorted to such a remedy within months after the enactment of the War Excess Profits Tax of 1917, and without legislative authorization, reflects the stature that consolidated reporting of income already had attained in financial accounting for holding companies. When the corporate income tax returned to lower rates in 1921, consolidated filing became elective. Because taxpayer choice mostly worked against the government (by allowing groups with loss members to elect), Congress adopted another sort of consolidation—consolidation of accounts—to combat non-arm's length transactions outside of elective consolidated returns.⁴³

The benefits of ascertaining income through consolidated reporting for federal income tax purposes have been extolled many times. The Board of Tax Appeals in 1926 wrote a penetrating history of consolidated returns that embraced the concept's preeminence as a method for preventing tax evasion by intercompany transactions:

So far as its immediate effect is concerned consolidation increases the tax in some cases and reduces it in other cases, but its general and permanent effect is to prevent evasion

40. T.D. 3389, 1922-2 C.B. 266.

41. 17 C.F.R. §§ 210.3-03, 210.3A-02(d) ("Foreign subsidiaries: Due consideration shall be given to the propriety of consolidating with domestic corporations foreign subsidiaries which are operated under political, economic or currency restrictions. If consolidated, disclosure should be made as to the effect, insofar as this can reasonably be determined, of foreign exchange restrictions upon the consolidated financial position and operating results of the registrant and its subsidiaries.").

42. 17 C.F.R. §§ 210.3A-04. It may be no coincidence that the accounting standard for consolidation, majority ownership, which is also the SEC standard, is basically the same as the definition of a controlled foreign corporation in § 957(a).

43. See *infra* Part III.D.3.

which cannot be successfully blocked in any other way. Among affiliated corporations it frequently happens that the accepted intercompany accounting assigns too much income or invested capital to company A and not enough to company B. This may make the total tax for the corporation too much or too little. If the former, the company hastens to change its accounting method; if the latter, there is every inducement to retain the old accounting procedure, which benefits the affiliated interests, even though such procedure was not originally adopted for the purpose of evading taxation. As a general rule, therefore, improper arrangements which increase the tax will be discontinued, while those which reduce the tax will be retained.⁴⁴

In 1962, Congress effectively consolidated controlled foreign corporations with their U.S. owners for purposes of currently taxing tainted Subpart F income.⁴⁵ As Gifford pointed out in 1973, taxpayers sometimes achieved consolidation by using foreign branches while foreign losses were generated, but then switched to the corporate form when the foreign enterprise became profitable.⁴⁶ Although the current consolidation rules operate independently of financial accounting consolidation, many experts have examined the possibility of converting the corporate income tax into a tax on financial accounting, or "book income, which could, but does not necessarily, result in consolidation of the income of foreign subsidiaries"⁴⁷

The Supreme Court views the function of consolidated returns as finding the income of a unitary group.⁴⁸ It also said of consolidation:

44. *Gould Coupler Co. v. Comm'r*, 5 B.T.A. 499,515 (1926).

45. Cf. S. Rep. No. 1881, Cong., 2d Sess., at 83, 87 (1962) ("Your committee saw no reason for taxing the U.S. shareholders on dividends received by a CFC from a related party where the U.S. shareholder would not have been taxed if he owned the stock of the related party directly.").

46. Gifford, *supra* note 2, at 351-52. But since that article was written, Congress has imposed limits on the ability of a U.S. person to operate a start-up foreign business as a branch during its loss phase and then incorporate it to defer income taxation. See Cummings & Hanson, *supra* note 5, ¶ 2.04[2][c][i].

47. See, e.g., John McClelland & Lillian Mills, *Weighing Benefits and Risks of Taxing Book Income*, 2007 Tax Notes Today 35-61 (Feb. 21, 2007); Alvin D. Knott & Jacob D. Rosenfeld, *Book and Tax: A Selective Exploration of Two Parallel Universes*, 2003 Tax Notes Today 97-29 (May 20, 2003); George K. Yin, *Getting Serious About Corporate Tax Shelters: Taking a Lesson from History*, 54 SMUL Rev. 209, 229 (2001) (recommending taxing on book income and observing that foreign income could be included or excluded).

48. *Burnet v. Aluminum Goods Mfg. Co.*, 287 U.S. 544, 548 (1933).

The purpose of the section was to provide a method of computing the tax upon the true net income of what is in practical effect a single business enterprise, with substantially common ownership, as though it were that of a single taxpayer, despite the fact that it is carried on by separate corporations whose tax would otherwise be independently computed.⁴⁹

Not only is consolidation the best way to determine group income, but exclusion of foreign affiliates from considerations involving related corporations is not the norm in the code. Defining a group "without regard to section 1504(b)" (and thus with regard to foreign affiliates) occurs twelve times in the code, most recently added in section 355(b)(2)(D). In addition, a worldwide affiliated group accounting regime for interest allocation may one day be effective under section 864(f).

Therefore, the income tax itself recognizes the benefits of expanding consolidation to foreign affiliates.

C. Other Benefits of Full Consolidation

This article does not undertake to flesh out a full consolidation regime,⁵⁰ but the simplifying benefits to other parts of the income tax are obvious. In addition to substantially reducing the need for the application of section 482 in cross-border transactions, the importance of earnings and profits of foreign affiliates would be substantially reduced, the role of the deemed paid foreign tax credit would be substantially eliminated, base company abuse rules in subpart F in general would be less relevant, and application of section 367(a) to outbound transfers within the consolidated group would be diminished.⁵¹

Gifford explored some of these issues in 1973:

These problems have led to suggestions that any elimination of deferral should take the form of direct taxation of the taxable income of controlled foreign subsidiaries, not their earnings and profits, presumably as a means of eliminating undue complexity in the Code. This may be accomplished by extension of the consolidated return rules, on a

49. *Old Mission Portland Cement Co. v. Helvering*, 293 U.S. 289, 291 (1934).

50. See *infra* Part IV.D. for selected practical considerations.

51. See McDaniel, *supra* note 4, at 292-93 (as to § 367(a) and transfer pricing, the article observes that a per country limitation on the foreign tax credit could reintroduce some pricing considerations).

mandatory basis, to all controlled foreign subsidiaries of United States shareholders. This system would seem to solve the technical problems of foreign startup losses, permit the abolition of subpart F with its numerous complexities within and without the loss area, render moot the semi-explored niceties of the indirect foreign tax credit, and reduce the importance of the exceptions to the general rule that terminal losses on foreign direct investments are capital in character. Indirect effects of the adoption of a consolidation approach would be a dramatic reduction of the need for application of § 482 in the foreign area with attendant gains in national and international tax administration, a possible narrowing of the scope of §§ 367 and 1491-92, and the elimination of some definitional problems of § 1504(d). Moreover, adoption of the consolidated return rules in the foreign area would provide the framework for extension of complete domestic tax neutrality to the United States taxation of foreign income, including accelerated depreciation, the ADR rules, the investment credit, and percentage depletion.⁵²

D. Compare and Contrast State Consolidation

Many states allow or require consolidated corporate income tax filing.⁵³ In a sense the states have been in the consolidation business for tax purposes longer than the federal government because they had to deal with the problem of multistate operation of a unitary business (such as a railroad), which could involve multiple entities. The principal divergence between consolidated reporting at the state and federal levels is that many of the states that use consolidated reporting do not automatically include in the group all corporations that are owned at a certain percentage. Rather consolidation usually is based on the unitary group, which justifies taxing corporations that do not have nexus with the state on the basis of their business integration with corporations that do have nexus, as opposed to a mere ownership relationship.⁵⁴

This difference might cause one to ask whether the consolidated group including all foreign affiliates is really the appropriate unit to reflect

52. Gifford, *supra* note 2, at 354-56.

53. The RIA Multistate Tax Guide lists twenty-two such states. The Multistate Tax Commission adopted a Model Statute for Combined Reporting dated August 17, 2006. It provides for a "water's edge election" in the absence of which foreign affiliates are included.

54. See Jerome R. Hellerstein & Walter Hellerstein, *State Taxation* ¶ 8.11 (2d ed. 1992).

the business income with which the federal corporate tax should be concerned, given the fact that the states do not focus solely on degree of ownership and ask whether the foreign affiliate is integrated with the other corporations in various ways. But the reasons that impel the state limitations do not apply at the federal level. They are constitutional and historical and do not cast doubt on the ability of the federal consolidated group to include affiliates based purely on ownership and control (indeed it does so now as to domestic affiliates).

The Supreme Court first addressed valuation of property and apportionment of the corporate tax base for state tax purposes in cases involving railroads and other transportation and communication corporations.⁵⁵ It began by observing that railroads should be regarded as a unit.⁵⁶ In 1897 it stated: "We repeat that, while the unity which exists may not be a physical unity, it is something more than a mere unity of ownership."⁵⁷ In 1942 the Court articulated a "three unities" theory: unity of ownership (frequently interpreted as greater than fifty percent), unity of operation (centralized purchasing, advertising, accounting, and other staff functions), and unity of use (centralized executive force, systems of operation, and other line functions).⁵⁸ Eventually the Court restated the rules as follows:

For a State to tax income generated in interstate commerce, the Due Process Clause of the Fourteenth Amendment imposes two requirements: a "minimal connection" between the interstate activities and the taxing State, and a rational relationship between the income attributed to the State and the intrastate values of the enterprise.⁵⁹

The Supreme Court has approved state consolidation of foreign parents and foreign subsidiaries.⁶⁰ States today differ in allowing or requiring consolidation of foreign unitary affiliates.⁶¹

55. *Id.*, ¶ 8.05.

56. *State Railroad Tax Cases*, 92 U.S. 575, 608 (1875).

57. *Adams Express Co. v. Ohio*, 165 U.S. 194, 222 (1897).

58. *Butler Bros. v. McCollgan*, 315 U.S. 501 (1942).

59. *Mobil Oil Corp. v. Comm'r*, 445 U.S. 425 (1980).

60. *Barclays Bank, PLC v. Franchise Tax Board of California*, 5120.S.298 (1994); *Colgate-Palmolive Co. v. Franchise Tax Board of Cal.*, 233 Cal. App. 3d 855 (Cal. App. 3 Dist. 1991), opinion modified and superceded by *Colgate-Palmolive Co. v. Franchise Tax Board of Cal.*, 10 Cal. App. 4th 1768 (Cal. App. 3 Dist. 1992), *aff'd*, *Barclays Bank PLC v. Franchise Tax Board of Cal.*, 5120.S.298 (1994).

61. See William F. Fox & LeAnn Luna, *Combined Reporting with the Corporate Income Tax*, 2011 STN 11-1 (Jan. 18, 2011) ("Three states (Massachusetts, Utah, and West Virginia) allow firms to elect world-wide combined

But the federal income tax is not constrained by such history or constitutional requirements under the Commerce Clause. The requirement in the early consolidated return regulation that operational interconnectedness must accompany ownership interconnectedness quickly was eliminated, because they related to the type of consolidation involving brother sister corporations that might be owned by individuals.⁶² The fundamental theory of consolidated filing is that the group owns the income of all members due to ownership alone; therefore, whether they are in the same line of business or not is irrelevant.

E. 1992 Proposal

The Rostenkowski-Gradison Foreign Tax Simplification Act proposed in 1992, would have ended deferral generally for controlled foreign corporations and given them an election to be treated as domestic.⁶³ The consequences of the election included (1) treating the election as an inbound reorganization of the foreign corporation, (2) taxing their accumulated earnings and profits ratably over four years, and (3) enabling the electing foreign corporation to join the consolidated return group if a more than fifty percent ownership requirement were met based on either vote or value.⁶⁴ Section 1563(e) attribution rules would have applied to determine affiliation of the foreign corporations.

Because the consolidation of the foreign affiliates under an expanded definition was only an election offered in the context of ending deferral generally, that proposal was not grounded in a desire to enable the consolidated return regime to carry out its function fully, as is the proposal of this article. Nevertheless, that proposal contains the only thought-out plan for effecting consolidations of the sort proposed here. It could serve as a starting point for drafting a mandatory consolidation plan.

The Clinton Administration subsequently made a proposal similar to the Rostenkowski-Gradison bill, but without allowing consolidated filing.⁶⁵ Neither proposal was enacted.

reporting (WWCR), and four states (California, Idaho, Montana, and North Dakota) have mandatory WWCR unless the firm has elected water's-edge treatment. The remaining combined reporting states require firms to file on a water's edge basis, except for Alaska that requires WWCR for oil, gas, and pipeline companies.").

62. See Article 77, T.D. 3389, 1922-2 C.B. 266.

63. H.R. 5270, 102d Cong. (2d Sess. 1992), reprinted in 92 Tax Notes Today 111-1 (May 27, 1992).

64. See *id.* § 202; see also Staff of Joint Comm. on Tax'n, Explanation of H.R. 5270, (Foreign Income Tax Rationalization and Simplification Act of 1992) (Joint Comm. Print 1992), reprinted in 92 Tax Notes Today 113-2 (May 29, 1992).

65. See Deferral, Runaway Plants and Capital Allocation, 93 TNT 112-12 (May 24, 1993).

III. HISTORY OF THE CONSOLIDATED RETURN AND FOREIGN AFFILIATES

This history aims to show (a) that consolidated returns or consolidated accounting were created and pursued by the government during the first eleven years of the consolidated return (1917-1927) for the primary purpose of producing a clear reflection of the income of corporate groups for the benefit of the government, and (b) Congress never made a conscious choice to waive those benefits as to foreign affiliates in order to allow deferral of tax on their foreign source income. Therefore, that choice is yet to be made.

A. *War Excess Profits Tax of 1917*

The story of consolidated returns begins immediately after the enactment of the War Excess Profits Tax of 1917.⁶⁶ The Treasury created consolidated returns by regulation, probably exceeding its authority, at the request of taxpayers who wanted to offset income against losses and to stack up invested capital as a way of reducing a tax base that decreased as invested capital increased. The Treasury was at least equally, if not more greatly, motivated by a desire to protect the fisc from massive efforts to avoid the new high tax by shifting income among affiliated corporations.

The corporate income tax rate under the 1916 Revenue Act was two percent.⁶⁷ The corporate tax changed dramatically with the enactment on October 3, 1917 of the War Excess Profits Tax of 1917 as another tax to be reported and paid in addition to the regular income tax.⁶⁸ The excess profits tax was not solely a corporate tax but was a business profits tax that was applicable to income from partnerships and income of individuals as well as to corporations, specifically including foreign corporations.⁶⁹ At the margin, the tax could be as high as sixty percent of excess profits,⁷⁰ and so taxpayers were very interested in finding ways to reduce the tax base. Excess profits were defined with respect to invested capital: the higher the invested capital, the less excess profits, and the less the graduated tax rate on excess profits.⁷¹ The excess profits tax did not address consolidated taxation of affiliated corporations or other businesses and neither did any other part of the 1917 Act. However it did contain this statement:

66. An excellent summary of the history of consolidated returns appears at § 102, of Dubroff et al., *supra* note 10.

67. Revenue Act of 1916, ch. 63, § 10, 39 Stat. 756, 765.

68. War Excess Profits Tax of 1917, ch. 63, 40 Stat. 300, 302. The United States declared war on Germany on April 6, 1917.

69. War Excess Profits Tax of 1917, ch. 63 § § 201-202, 40 Stat. 302, 303.

70. *Id.*

71. War Excess Profits Tax of 1917, ch. 63, 40 Stat. 300, 306.

For the purposes of this title every corporation or partnership not exempt under the provisions of this section shall be deemed to be engaged in business, and all the trades or businesses in which it is engaged shall be treated as a single trade or business, and all its income from whatever source derived shall be deemed to be received from such trade or business.⁷²

The excess profits tax base was built on the normal income tax base. The Revenue Act of 1916 required foreign corporations with U.S. source income to file returns of that income;⁷³ but partnerships were not denominated foreign or domestic, and partnership income was reportable by the partners as their own, although the partnership could be made to file information returns.⁷⁴ The 1917 excess profits tax did denominate partnerships as foreign or domestic, and it defined the taxable net income of foreign corporations and foreign partnerships as their U.S. source income.⁷⁵ Returns were to be filed as required by the 1916 Act for normal income tax, but because partnerships had not previously been required to file returns a special requirement for an information return was added.⁷⁶ The law authorized the Treasury to write regulations requiring taxpayers to provide the information needed to compute the tax liability.

Thus the excess profits tax required foreign partnerships with U.S. source income to file returns for the first time and required foreign corporations to file returns only if they had U.S. source income; but the law also focused on trades or businesses rather than legal entities and contained at least an implication that the income of a trade or business could be taxed without regard to the organizational divisions of the business.

72. War Excess Profits Tax of 1917, ch. 63, §201, 40 Stat. 308.

73. The normal income tax was levied only on the U.S. source income of foreign corporations and nonresident individuals. Revenue Act of 1916, ch. 63 §10, 39 Stat. 765.

74. Revenue Act of 1916, ch. 63, § 8(e), 39 Stat. 762-763 (individuals to report partnership income and partnerships could be required to report); § 10, 39 Stat. 765-766 (foreign corporations taxed on income from sources within the U.S.); § 13(b), 39 Stat. 771 (1916) (foreign corporations to file returns where U.S. business conducted).

75. War Excess Profits Tax of 1917, ch. 65, § 201, 40 Stat. 303.

76. War Excess Profits Tax of 1917, ch. 63, § 206, 40 Stat. 305 (returns as under 1916 Act); ch. 63, § 211, 40 Stat. 307 (foreign partnership returns).

B. *The First Consolidated Return Regulations*

1. *Prior Regulations Rejected Form for Substance*

The adoption of the first consolidated return regulations with respect to the excess profits tax for 1917 appears to have had the counterintuitive effect of increasing the tax law's respect for the corporate form, in contrast to the initial tendency under the income tax. Evidently the Treasury assumed that the regulations provided for such an expansive disregard of intercorporate transactions, particularly when combined with the consolidation of accounts provision adopted in 1921 (as discussed below), that the field was occupied and there was little need, for example, to turn a parent's ownership of a subsidiary into ownership of its income, if not required by those regulations.

The pre-consolidation trend is embodied in *Southern Pacific v. Lowe*.⁷⁷ Its facts and the Supreme Court's view of them read like a modern-day state corporate income tax case in which the court rejects "shell corporation" transactions.⁷⁸ The Court ruled that Southern Pacific could not be taxed on dividends declared by its wholly owned subsidiary after March 1, 1913 from earnings prior to that date, because Southern Pacific had in substance held the earnings as its own all along for the following reasons: (1) the parent and the subsidiary were in fact one due to parent's complete ownership and control (which is true of all affiliated groups), (2) the parent had the funds all along in the form of a bookkeeping "loan" from the subsidiary (which is a common feature of banking all of the cash of a corporate group in one member, be it the parent or some other), (3) the fact that the parent scrupulously kept the subsidiary's income separate from its own on the books of the companies, which reflected the loan, did not change

77. *Southern Pac. Co. v. Lowe*, 247 U.S. 330 (1918) (taxing subsidiary's income to parent on the finding that the parent had actually carried on the business and only ascribed its income to the subsidiary). However, the Supreme Court later limited *Southern Pacific* to its peculiar facts related to the 1913 effective date of the income tax, in *Nat'l Carbide Corp. v. Comm'r*, 336 U.S. 422, 433, n.12 (1949). Even though *National Carbide* did not extend this explanation to *Gulf Oil Co. v. Lewellyn*, 248 U.S. 71 (1918) (not treating as a taxable dividend the bookkeeping transfer from creditor subsidiary to parent of receivables from other subsidiaries), another later decision stated that *Gulf Oil* did not state any rule of tax law. *Moline Props., Inc. v. Comm'r*, 319 U.S. 436 (1943). The view reflected in *Southern Pacific* and *Gulf Oil* that ignored the corporate form in tax cases went back to *Collector v. Hubbard*, 79 U.S. 1 (1870), applying the Civil War Income Tax that made undivided profits taxable (although *Southern Pacific* distinguished the terms of the Civil War Tax from the Acts of 1909 and 1913). See Jasper L. Cummings, Jr., *The Supreme Court's Federal Tax Jurisprudence* 432-43 (2010).

78. See, e.g., *Syms Corp. v. Comm'r*, 765 N.E. 2d 758 (Mass. 2002).

the realities (but today most taxpayers assume such bookkeeping establishes the realities), (4) the parent was always entitled to dispose of the subsidiary's earnings as it saw fit, and (5) there is no evidence that creditors of the subsidiary or the public had any interest in the matter (which shows that if the subsidiary had its own creditors or minority investors, then the conclusion might be different).

Although the Court stated repeatedly that its ruling was based on the peculiar facts of the case and limited to the constitutional issue at hand, it is hard to believe that the corporate income tax could give as much credence as it does today to corporate formalities if something had not changed after the *Southern Pacific* era. Indeed, the Treasury Regulations 33 promulgated January 2, 1918 under the 1916 Revenue Act reflected what was presumably the government's litigating position in *Southern Pacific* by separately addressing "branch corporations" and "subsidiaries operated as integral parts."⁷⁹ The latter were directed not to report their income, which should be reported by their parent, if the subsidiary did not conduct its own business in its own name.

That regulation was not concerned with the fact that the parent might actually receive or hold the subsidiary's net income but mostly seemed to focus on whether the parent completely disregarded the subsidiary's existence except for tax purposes. The keeping of separate accounts for the subsidiary was a factor indicating its reality, but it was not clear whether the parent doing business in the subsidiary's name counted as the subsidiary actually transacting business in its own name (and what that might mean). *Southern Pacific* went beyond the regulation in disregarding the subsidiary corporation because the facts showed the parent kept books for the subsidiary that accounted the income as the subsidiary's, but those facts did not prove that the income was the subsidiary's for purposes of the income tax.

Shortly before the *Southern Pacific* opinion was issued, and after Regulations 33 was issued, the Treasury adopted Regulations 41 specifically for purposes of the excess profits tax and it contained the first consolidated return rules discussed below.⁸⁰ When the Treasury reissued the general income tax regulations under the Revenue Act of 1918 on April 16, 1919 as Regulations 45, the "integral part" rule of Article 208 of Regulations 33 was changed into Article 621, which simply required all corporations to file returns, and Articles 631-638 contained the consolidated return provisions.⁸¹ In other words, the movement of the regulations toward a sanctioned method for finding that the nominal income of a subsidiary was really the income of

79. Reg. 33, Arts. 207, 208, T.D. 2690, 20 Treas. Dec. Int. Rev. 227-228 (1918).

80. Reg. 41, T.D. 2694, 20 Treas. Dec. Int. Rev. 294 (1918).

81. Reg. 46, T.D. 2831, 20 Treas. Dec. Int. Rev. 170, 302-303, 305-309 (1919).

a parent was eliminated, never to return to the regulations, despite the substantial support the Supreme Court had provided for the integral part approach. The best explanation for why the government surrendered its victory in *Southern Pacific* is that it discovered (and made mandatory) the consolidated return.

2. *The First Consolidated Return Regulations*

Excluding foreign affiliates from the consolidated filing group did not initially involve any policy decision at all about taxing the group's foreign income earned by foreign affiliates. Regulations 41, adopted for the excess profits tax for the 1917 tax year, provided for consolidated filing but did not mention foreign affiliates. Presumably, a consolidated filing for 1917 could have included a foreign affiliate to the extent of its U.S. source income. However, foreign affiliates with only foreign source income likely were excluded in practice because they could not be made to file returns, they were not subject to tax under the Revenue Act of 1916, and the consolidated return from 1917-1928 did not create a unitary group tax liability, but rather was only a methodology for computing the aggregate tax, which would then be allocated among group members for assessment and payment. Allocating tax to foreign affiliates would have been useless and probably would have reduced the tax collected.

The Treasury acted quickly under its authority to require information reporting for the excess profits tax.⁸² The impetus for action was both taxpayer concern and revenue concerns. The heavy excess profits tax impelled corporate groups to want to file on a consolidated basis, both to offset the losses of one affiliate against the income of another affiliate and also to increase their combined invested capital.⁸³ Indeed, accountants urged consolidation both because of the heavy excess profits tax and also because it was the accepted norm for reporting corporate income.⁸⁴ The absence of foreign affiliates from the consolidated group was the signal difference between the two.⁸⁵

82. War Excess Profits Tax of 1917, § 213, 40 Stat. 307-308. See New Income Tax Ruling: Affiliated Corporations Must Make Consolidated Returns, N.Y. Times (Mar. 8, 1918) (the Collector for the Wall Street District made public a ruling he had received from Washington that corporations must file consolidated excess profits tax returns if either (a) one corporation owned ninety-five percent of the stock of a subsidiary, or (b) there was arbitrary shifting of income among corporations ninety-five percent owned by another corporation, partnership or individual).

83. See, e.g., George R. Webster, Consolidated Accounts, 28 J. Acct. 258 (1919) (recounting that the AICPA had urged adoption of consolidated returns regulation before Treasury adopted them for 1917).

84. *Id.*

85. R.H. Montgomery, *supra* note 30, at 284.

Clearly the primary Treasury concern was to worry about intercorporate transactions that were effected or reported in a way intended to avoid the heavy excess profits tax. In effect, some corporations were trying to get the results of consolidation by pushing income into loss affiliates and other techniques. The Treasury wanted a way to require consolidated filing to thwart such tax avoidance efforts, as explained in the *Union Pacific Railroad* opinion.⁸⁶ The Treasury relied for authority for the regulation on general language in the excess profits tax law about all of a taxpayer's trades and businesses being treated as one, and on the "business truth" that a single business can be carried out in multiple corporate forms.⁸⁷

As explained in *Union Pacific*, sometime before the 1917 returns were due on April 1, 1918, between November 30, 1917 (or more likely January 2, 1918 when Regulations 33 was published) and March 6, 1918, Treasury adopted Regulations 41 Articles 77 and 78.⁸⁸ Article 77 required

86. *Union Pac. R.R. Co. v. Comm'r*, 17 B.T.A. 793 (1929), acq. 1931-1 C.B. 66.

87. Arthur A. Ballantine, *The Corporate Personality in Income Taxation*, 34 Harv. L. Rev. 573, 579 (1921).

88. 17 B.T.A. 793. The Articles appear as paragraphs 183-185 of Regulations 41 on the excess profits tax, issued as T.D. 2694, which was undated but filed in the Treasury Decisions between decisions dated April 11 and April 8, 1918. 20 Treas. Dec. Int. Rev. 294 (1918). However, their existence was referred to in the previously filed T.D. 2662; Regulations 41 was a compilation of previously issued Articles. The articles are printed here in their entirety:

Art. 77. When affiliated corporations must furnish information as to intercorporate relations.—For the purpose of the excess profits tax every corporation will describe in its return all its intercorporate relationships with other corporations with which it is affiliated, and will furnish such information in relation thereto as will enable the Commissioner of Internal Revenue to compute the amount of the tax properly due from each corporation on the basis of an equitable and lawful accounting.

For the purpose of this regulation two or more corporations will be deemed to be affiliated (1) when one such corporation owns directly or controls through closely affiliated interests or by a nominee or nominees, all or substantially all of the stock of the other or others, or when substantially all of the stock of two or more corporations is owned by the same individual or partnership, and both or all of such corporations are engaged in the same or a closely related business; or (2) when one such corporation (a) buys from or sells to another products or services at prices above or below the current market, thus effecting an artificial distribution of profits, or (b) in any way so arranges its financial relationships with another corporation as to assign to it a disproportionate share of net income or invested capital.

affiliated corporations to report intercorporate transactions. It defined affiliation as (1) parent-subsidiary by ownership or control, engaging in the same or closely related business, (2) brother-sister by ownership or control, engaging in the same or closely related business, or (3) two corporations, apparently without regard to relation of ownership, that deal with each other on a non-arm's length basis or otherwise cause a disproportionate assignment of income.⁸⁹ Article 78 authorized the Commissioner to require affiliated corporations to file consolidated returns. Presumably the Treasury intended that taxpayers would self identify the problematic relationships, and on the basis of that information the IRS would decide whether to require consolidated returns, which would almost necessarily occur upon audit. The IRS did audit and require consolidated returns for 1917 in some cases.⁹⁰

Art. 78. *When affiliated corporations may be required to make consolidated return.*—Whenever necessary to more equitably determine the invested capital or taxable income, the Commissioner of Internal Revenue may require corporations classed as affiliated under article 77 to furnish a consolidated return of net income and invested capital. Where such consolidated return is required it may be made by any one or more of such corporations or by all of them acting jointly; but if such affiliated corporations, when requested to file such consolidated return, neglect or refuse to do so, the Commissioner of Internal Revenue may cause an examination of the books of all such corporations to be made and a consolidated statement to be made from such examination. In cases where consolidated returns are accepted, the total tax will be computed in the first instance as a unit upon the basis of the consolidated return and will be assessed upon the respective affiliated corporations in such proportions as may be agreed among them. If no such agreement is made the tax will be assessed upon each such corporation in accordance with the net income and invested capital properly assignable to it.

89. For general commentary on the early standards of affiliation, see Irvin H. Fathchild, *Corporate "Affiliation" Under the Revenue Acts*, 2 Nat'l Income Tax Mag. 360 (1924) (focusing on the control issue); James S.Y. Ivins, *Affiliated Corporations: In the Light of the Decisions of the Board of Tax Appeals*, 4 Nat'l Income Tax Mag. 131 (1926), continued at 5 Nat'l Income Tax Mag. 165 (1926) (Part II); see also, Walter A. Staub, *Consolidated Returns*, in *The Federal Income Tax* 188, 189, 191-192 (Robert Murray Haig ed., 1921) (confirming that originally the possibility of manipulation alone was enough to justify consolidation).

90. See, e.g., *American Textile Woolen Co. v. Comm'r*, 23 B.T.A. 670 (1931), aff'd, 69 F.2d 820 (6th Cir. 1934), cert. den., 293 U.S. 558 (1934). In one 1917 case, the Commissioner required consolidated filing by three commonly controlled corporations, and the court rejected the taxpayers' claim that 20 year non-interest intercompany notes issued for business assets were equity and found them to be debt. *A. H. Stange Co.*, 1 B.T.A. 58 (1924). The debt was put in place in 1914, not in contemplation of the excess profits tax. Evidently under the rudimentary

The tax would be computed on the consolidated group's income, but each affiliate would be separately liable for its portion of that tax as agreed among the affiliates, and if no agreement then "in accordance with the net income and invested capital properly assignable to it." This feature of the early consolidated return regime was a substantial design flaw, presumably thought to have been necessary because (1) the regulations could not change the law that imposed tax on each separate corporation, and (2) the consolidated return and liability determination frequently would be made by the IRS on audit and necessarily asserted in the context of separate assessments against the various group members.

Cases reveal that the apportionment regime (which continued up through 1928) was "in the proportion shown on the consolidated return of their respective net incomes to the total net income thereon, ignoring, for that purpose, minus quantities."⁹¹ Evidently this meant that intercompany transactions were eliminated and the separate income of each member determined on that basis.⁹² However, a part of the income of a group that was profitable in the aggregate could not be allocated to a loss member.

The original Articles 77 and 78 did not define partnerships as affiliates, nor did they make any reference to an entity's status as foreign or domestic. Therefore, while they did not apply to partnerships, except as a partnership might be the common owner of two affiliated corporations, they could have applied to foreign corporations,⁹³ but only to their U.S. source income.⁹⁴

method of consolidation then employed, the taxpayers would have added up the capital of each affiliate, which effectively doubled much of the capital. Instead of eliminating the duplicated capital directly, the court found it to be debt (as it nominally was) and thus eliminated it from the invested capital of the debtor affiliate. Subsequent refinements were supposed to eliminate duplication, but duplicated intercompany capital remained a tax avoidance method. See Frank Hornum, *The Importance of Showing Contingent Tax Liability*, 1 *Nat. Inc. Tax Mag.* 16, 17 (April 1923) (listing including borrowed capital and failing to eliminate inter-corporate stockholding).

91. *Mather Paper Co.*, 3 B.T.A. 1 (1925), acq. 1927-1 C.B. 4; see also *Amer. Textile Woolen Co. Com.*, 23 B.T.A. 670 (extended discussion of difficulty of ascertaining agreement). The IRS seems to have tried to avoid the issue of allocation by urging one affiliate to make the payment to the IRS and figure out the apportionment among themselves. *Montgomery* supra note 30, at 323 (citing a 1919 Mimeograph).

92. See *Montgomery*, supra note 30, at 284-85 (Problem 231).

93. T.B.R. 60, 1919-1 C.B. 20, 22, concluded that references to corporations without limitation to domestic or foreign or resident or nonresident meant all corporations.

94. Section 200, 40 Stat. 300, 302 (1917). Revenue Act of 1918 applied the excess profits tax to foreign corporations (§ 312) but incorporated the income

The fact that the tax could not apply to the foreign source income of foreign affiliates would seem to be a reason to include them in the affiliated group rather than exclude them: the proper part of the income could be apportioned to them and the foreign source portion would not be taxed. However, if the part of the taxable domestic income apportioned to them was greater than that actually reported by them, then U.S. tax collections would diminish. Conversely, if consolidation resulted in shifting some nominally foreign income to the domestic affiliates, then questions might arise whether foreign source income of foreign corporations had been taxed in violation of the Revenue Act.⁹⁵

While such considerations might have affected the Treasury's thinking, it is more likely that foreign affiliates would not have been included as a practical matter, simply because they did not have to file returns if they had no U.S. source income, and there was no way to collect tax from them, absent group liability for the consolidated tax, which did not arrive on the scene until 1929. Therefore, the exclusion of foreign affiliates from the 1917 consolidated return began as a necessary consequence of the method of apportioning and collecting the consolidated tax liability and of the nontaxability of their foreign income under the normal tax, which did not reflect a decision explicitly made for policy reasons, as shown below.

Even though foreign affiliates might at least have been included in consolidated returns to report their U.S. source income, it was generally understood that foreign affiliates could not be included in the consolidated return whether they did business in the U.S. or not.⁹⁶ If the Treasury had thought about it, foreign affiliates could have been included in one of three ways, the first conservative and the second and third somewhat more liberal: (1) include foreign affiliates with U.S. source income that were required to file returns anyway, and include only that U.S. source income;⁹⁷ (2) include all of the income of foreign corporations required to file; or (3) include all of the income of all foreign affiliates, whether or not they were otherwise required to file.

None of these alternatives depends on actually taxing the foreign source income of the foreign corporation. Rather, the second and third

definition of the regular income tax, which was limited to U.S. source income (§ 312).

95. See Ludlow S. Smyth, *Consolidation of Accounts and Consolidated Tax Returns*, 5 Nat'l Income Tax Mag. 449, 452 (1927); see also *infra* Part IV.C., discussion of constitutionality.

96. Staub, *Consolidated Returns*, in *The Federal Income Tax*, *supra* note 89, at 193 (“[F]oreign corporation cannot, under any circumstances, be merged. . .”).

97. Even today the IRS will not allow a foreign corporation with a U.S. permanent establishment to join the consolidated group. See Richard E. Andersen, *Analysis of United States Income Tax Treaties* ¶ 20.02[2][b][ii] (discussing nondiscrimination rule).

alternatives would have determined the proper amount of foreign source income that would not be taxed. Indeed one IRS ruling suggested that alternative (3) might have been possible. It involved a dividend received in 1917 from a foreign affiliate that never derived U.S. source income, and that evidently had no 1917 income at all (though this is not clear) but in any event was assumed to have paid the dividend from pre-1917 foreign source income.⁹⁸ The ruling determined that the dividend was not taxable because it would not have been subject to the excess profits tax in the earlier years when the foreign corporation earned the income. The ruling then justified this conclusion by stating it was not unreasonable because it produced the same result as if the domestic corporate shareholder and the foreign affiliate had filed consolidated returns. It is not clear whether the ruling depended on the absence of any 1917 income or on the absence of 1917 U.S. source income, but it clearly contemplated a consolidated filing with a purely foreign affiliate in which the dividend would be disregarded and the foreign source income not taxed.

The truly radical approach would have been to include all foreign affiliate corporations in a consolidated return and to treat their foreign source income as income of the unitary trade or business owned by the U.S. shareholder corporation, which would be taxable under normal rules because it was the income of a resident corporation.

Obviously the Treasury did no such thing, but it still was willing to reach in asserting its power to consolidate. The Treasury must have realized that the information reporting and subsequent audit approach of Articles 77 and 78 was impractical as 1917 returns began to come in. On March 16, 1918, the Treasury adopted Treasury Decision 2662, which required corporations to file consolidated returns under Article 78 if they engaged in practices that arbitrarily or artificially affected their incomes or invested capital.⁹⁹ The instructions to excess profits tax Form 1103 asked whether the return was a consolidated return, which may have indicated to taxpayers that filing a consolidated return was at their option.¹⁰⁰

Perhaps acting on the open invitation to admit to off-market transactions with affiliates, most corporations identified themselves as eligible for consolidated filing and filed the consolidated return, probably

98. T.B.R. 60, 1919-1 C.B. 20, 24.

99. 20 Treas. Dec. Int. Rev. 41 (1918). The return for 1917 was due April 1, 1918. See *Comm'r v. Nat'l Land & Constr. Co.*, 70 F.2d 349 (6th Cir. 1934). T.D. 2662 also made clear that each affiliate must file a return, excluded public service companies (railroads and other utilities that were regulated), and defined substantially all of the stock as including ninety-five percent ownership.

100. Form 1103, available at <http://www.irs.gov/pub/irs-prior/f707--1917.pdf>. It refers to Article 78 and asks for schedules explaining the consolidation.

because the resulting consolidated return reduced their tax.¹⁰¹ Dr. T.S. Adams estimated that about seventy-five percent of the corporate tax collected for 1917 was by voluntarily filed consolidated returns.¹⁰²

C. Revenue Act of 1918

The Revenue Act of 1918 affirmed consolidated filing because (1) it more clearly reflected the income of the business unit without regard to artificial legal boundaries between affiliates, (2) it was a tool to prevent evasion, (3) Congress understood consolidated returns could be a relief measure for corporations, and didn't want that relief enjoyed by unworthy corporations.¹⁰³ The Act specifically identified domestic corporations as affiliates for consolidated return purposes and created the deemed paid foreign tax credit, reflecting a tradeoff between excluding the foreign affiliates from the consolidated group and taxing their income when received as dividends for which the credit was needed.

When Congress first addressed consolidated returns in 1919 (when it adopted the 1918 Revenue Act), it extended consolidation to the regular income tax as well as the excess profits tax, made consolidated filing mandatory "with the approval of the Secretary," and defined affiliation non exclusively as covering domestic corporations (section 240).¹⁰⁴ The 1918 Act also located in subsection (c) of the consolidated returns section 240 the first deemed paid foreign tax credit, which was to be triggered by dividends received from foreign subsidiaries, without explicitly limiting the credit to shareholders that were in consolidated groups. Rather, it was limited to domestic shareholders that were corporations and owned a majority of the

101. See, e.g., *Freeport Texas Co. v. United States*, 58 F.2d 473 (Ct. Cl. 1932), cert. denied, 287 U.S. 660 (1932) (consolidated return filed voluntarily on April 1, 1918); *Newport Co. v. Comm'r*, 22 B.T.A. 833 (1931) (originally filed consolidated and later asked to expand the group), rev'd, 291 U.S. 485 (1934); *Swift & Co. v. United States*, 67 Ct. Cl. 322 (1929) (voluntarily filed consolidated); *Morris Cty. Crushed Stone Co. v. Comm'r*, 6 B.T.A. 800 (1927) (parent did so but other affiliates did not; held they failed to file returns and the statute of limitations had not run as to them); *Yunker Bros., Inc. v. Comm'r*, 8 B.T.A. 333 (1927), acq. 1928-2 C.B. 44 (voluntarily filed consolidated); *Huyler's v. Comm'r*, 8 B.T.A. 13 (1927), acq. 1928-2 C.B. 19 (fact of affiliation evidently sufficient to require 1917 consolidated return).

102. See quotation in *Union Pac. R.R. Co. v. Comm'r*, 17 B.T.A. 793, 798 (1929).

103 See comments of Rep. Kitchen agreeing to the consolidation provision only when it was denied to corporations that had profiteered on sales to the government during the war, in House Passes New Revenue Bill, Voting 310 to 11, *N.Y. Times*, Feb. 9, 1919; Conferees Advance War Revenue Bill, *N.Y. Times*, Jan. 14, 1919 (senators added consolidated return rule to prevent avoidance of the tax).

104. Section 240, Revenue Act of 1918; 40 Stat. 1057, 1081-1082 (1918).

stock of the foreign corporation. This was part of the creation of the foreign tax credit in section 238.¹⁰⁵

The location of the deemed paid tax credit in the consolidated returns section shows that Congress thought foreign affiliates would not be included in consolidated returns and so dividends from them would require tax credit protection. This view is supported by the fact that the Senate initially thought that foreign affiliates might voluntarily join in a consolidated return, with Canadian affiliates being the stated example.¹⁰⁶ The House rejected the proposal of the Senate to so specify when foreign affiliates could join, leaving to be finally adopted only the second part of the Senate proposal that allowed the deemed paid foreign tax credit.¹⁰⁷ (This is the first of several instances in which the statute related to consolidated filing was amended piecemeal with provisions that were part of one regime imported into another regime; a similar situation occurred with respect to the 1928 Act, as discussed below).

The legislative history of the 1918 Act also shows that Congress thought the one year experiment with consolidation proved the wisdom of officially allowing the Commissioner to require consolidation.¹⁰⁸ It observed the tendency of corporations to incorporate multiple entities and divide up a unitary business among them with the effect, if not the purpose, of allowing intercorporate dealings to improperly decrease the taxation of some of them. It observed that tax reduction effects could result from inaction of taxpayers as much as from intentional reduction efforts and so cast the consolidated return as a reasonable response to inevitable self-protective actions and inactions of multi-affiliate corporate groups.

Most importantly, Congress understood at the start the principle that this article argues Congress has overlooked since—that consolidated filing is the best way to ascertain the income of the business unit:

While the committee is convinced that the consolidated return tends to conserve, not to reduce, the revenue, the committee recommends its adoption not primarily because it operates to prevent evasion of taxes or because of its effect upon the revenue, but because the principle of taxing as a

105. Revenue Act of 1918, ch. 18, §§ 222, 238, 40 Stat. 1057, 1081-1082; see Graetz & O'Hear, *supra* note 19, at 1043 et seq. There immediately arose issues about foreign taxes accrued but not paid by the foreign corporation, and the Bureau ruled that the foreign corporation had to pay the tax for the tax to be creditable T.B.R. 36, 1919-1 C.B. 237.

106. J. S. Seidman, *Seidman's Legislative History of Federal Income Tax Laws 1938-1861*, at 935-36 (1938).

107. *Id.* at 936.

108. See *Gould Coupler Co. v. Comm'r*, 5 B.T.A. 499, 515 (1926) (quoting Senate Report).

business unit what in reality is a business unit is sound and equitable and convenient both to the taxpayer and to the Government.¹⁰⁹

Even though the 1918 Act limited the definition of affiliation to the amount of ownership or control,¹¹⁰ Regulations 41 and later 45 contained additional requirements. Regulations 45, Articles 631-638, provided that while affiliation based on ninety-five percent ownership was automatic, affiliation between fifty percent and ninety-five percent required reporting of information to the IRS, preferably before the return due date, so that the IRS might conclude that the corporations were affiliated; and the methodology of consolidation was referred to as combining the net incomes of the affiliates.¹¹¹

There is no evidence that the manipulations with which Congress was initially concerned involved misuse of nonrecognition rules or shifting income to foreign affiliates (which became important under section 482 decades later). Rather, it appears to have involved non-arm's length taxable transactions. Conceptually, affiliated corporations can reduce their aggregate tax liability through non-arm's length intercompany transactions in at least three ways:

- To get the same effect as consolidation by shifting income to the affiliate with otherwise unusable losses by a transaction that also produces deductions for the affiliate with income. For example X and Y are affiliated. Aside from the transactions described here, X would report \$100 income and Y would report \$100 loss. Y provides a service to X and charges \$100 too much. The resulting income enables Y to use its loss and produces a deduction that offsets X's income, which has the effect of shifting Y's loss to X. The aggregate net result, zero income, is the same, but the aggregate tax liability can be less than without the off market transaction.

109. S. Rep. No. 617, 65th Cong., 3d Sess., at 8, 9 (1918), quoted in Gould Coupler, 5 B.T.A. at 515, and quoted in Smyth, *supra* note 95, at 450; see also Senators Alter Tax Allowances, N.Y. Times, Oct. 24, 1918 (reporting that on October 23, the Senate Finance Committee had voted to make consolidated returns mandatory).

110. See Joseph D. Peeler, Apportionment of Taxes under Consolidated Returns, 6 Nat'l Income Tax Mag. 127 (1928) (the statute contained no requirement of intercompany transactions or being in the same business).

111. Regs. 45, T.D. 2831, 21 Treas. Dec. Int. Rev. 170, 305-309 (1919); T.D. 2901, 21 Treas. Dec. Int. Rev. 738 (1919); Regs. 45, Arts. 631-638, T.D. 3146, 23 Treas. Dec. Int. Rev. 511-515 (1921).

- Same as above except the corporation receiving the income is in a lower tax bracket or has other favorable tax characteristics.
- Same as above except the corporation receiving the income is not a taxpayer, which is the ultimate favorable tax characteristic, i.e., a foreign affiliate.

The foregoing methods don't really work with arm's length pricing. For example, if in the first case the \$100 payment is arm's length, then no shifting of income has occurred because it must be assumed that the payor receives value that will augment its own income in some offsetting way. Consolidated returns correct all of these ploys, except to the extent the definition of affiliation is not uniformly applied, which it has not been as to foreign affiliates.

Even though consolidation was mandatory during this period, the definition of affiliation was fluid and so taxpayers sometimes fought to get into consolidation, illustrating the whipsaw effect that would be exacerbated when consolidation became elective. For example, a corporation that imported rubber caused a Brazilian rubber plantation to be incorporated in New York in 1919 and sought consolidation.¹¹² The corporations were owned by largely, but not completely, overlapping shareholders. The court denied affiliation. Presumably one or the other of the corporations was losing money. If it were the rubber plantation, then it needed to be domestic, which permitted at least a try for consolidation; if the rubber company had been making money, it could have been reincorporated in Brazil.

D. Revenue Acts of 1921 Through 1926

1. Consolidated Returns in the 1920s

The decade of the 1920s revealed that the Treasury had not really figured out how to administer consolidated returns; they were ultimately retained in 1928 in part because Congress directed the Treasury to write definitive rules. During the period between 1921 and 1929: (1) consolidated filing was made entirely voluntary due to the repeal of the high war profits tax, (2) the courts and the Treasury struggled with the meaning of consolidation (legal model versus economic/accountant's model), and (3) the Treasury wielded a new but similarly unformed tool against tax abuse through intercorporate transactions, the consolidation of accounts. The consolidated return continued to be only a method to determine tax liability that was allocated among the group members.

¹¹² *Comm'r v. Adolph Hirsch & Co.*, 30 F.2d 645 (2d Cir. 1929).

In 1921, consolidated filing became elective by statute, coincidental with the end of the excess profits tax.¹¹³ The corporate income tax rate dropped to a relatively low flat rate (ten percent for 1921 and twelve-and-a-half percent thereafter) and the impact of income shifting that prompted mandatory consolidated returns was thought to have diminished substantially.¹¹⁴ Among the reasons for making consolidated returns elective was the fact that the IRS thought it was losing a lot of revenue due to its inability to audit the large number of required consolidated returns that had been filed.¹¹⁵ The 1921 Act contained a separate section 1331 that validated the regulations requiring consolidated filing in 1917, retroactively. Article 636 of Regulations 45 in 1921 specifically precluded inclusion of foreign affiliates, whether voluntary or not.¹¹⁶

During the 1920s, the courts attempted to work out the meaning of consolidation for accounting purposes. There were two competing theories, known as the legal theory and the accounting theory.¹¹⁷ The choice was between the aggregate or legal method of adding up the accounts of the various affiliates, and the accountant's or economic unit method of treating the corporations as one unit.¹¹⁸ The Board of Tax Appeals followed the economic unit method.¹¹⁹ However, the Treasury continued to pursue the legal model for some purposes, resulting in confusion that contributed to the House vote to end consolidated filing in 1928.¹²⁰

113. Revenue Act of 1921, ch. 136, § 240, 42 Stat. 227. Section 301 limited the excess profits tax to the final year of 1921.

114. See Smyth, *supra* note 95, at 450.

115. Billions in Taxes Due to Government, N.Y. Times, Feb. 24, 1920 (finding that two-thirds of the unassessed taxes are in 15,000 consolidated returns that the IRS was not able to properly audit).

116. Regs. 45, Art. 636, T.D. 3146, 23 Treas. Dec. Int. Rev. 514 (1921). This was true even if the foreign corporation was between two affiliates that would be in the consolidated return. See ruling reported in Montgomery *supra* note 30, at 309.

117. See Smyth, *supra* note 95; see also *Gould Coupler Co. v. Comm'r*, 5 B.T.A. 499 (1926) (this opinion appears to be the fruit of the symposium held by the Board of Tax Appeals to school itself on consolidated returns as reported in Fathchild, *supra* note 89, Lyle T. Alverson, Consolidated Returns and Invested Capital, 2 Nat'l Income Tax Mag. 165 (1924) (objecting to the Treasury's approach of treating the affiliated corporations as a unit rather than adding up their separate items and eliminating intercompany items); J.S. Seidman, Consolidated Invested Capital of Affiliated Corporations (Part I), 5 Nat'l Income Tax Mag. 129 (1927), continued in 5 Nat'l Income Tax Mag. 172 (1927), (Part II).

118. See Smyth, *supra* note 95.

119. *Id.*; see *Gould Coupler*, 5 B.T.A. 499; see also, J.S. Seidman, *supra* note 117.

120. Patten, *supra* note 10, at 420.

The 1924 Revenue Act changed the "owns directly or controls" portion of the affiliation definition to "owns at least 95 percentum." This change was thought to have so constricted the definition that "comparatively few economic groups can meet these requirements today," and the consolidated return was "practically at an end" by April 1928 (when its abolition was being discussed in Congress).¹²¹ A third factor that seemed to reduce the importance of consolidated returns was the reduced revenue impact, after the corporate income tax rate had become flat and the excess profits tax based on invested capital had been eliminated. However, the value of consolidated returns to the proper reflection of income was recognized.

This emphasizes all the more strongly the underlying principle of consolidated returns as viewed by Congress in enacting the various revenue laws, namely, to levy the tax on the true net income of a single enterprise.¹²²

But instead of abolishing consolidated returns, effective in 1929 Congress shifted the authorization for consolidated return regulations from section 240 to section 141 in the 1928 Revenue Act and the Treasury wrote entirely new regulations, opening the modern period of consolidation that continues to this day.¹²³

2. Foreign Tax Credit

Foreign tax credits were one of "various provisions intended to stimulate the expansion of American investments and trade abroad."¹²⁴ The 1921 Revenue Act relocated the deemed paid foreign tax credit to the general credits section 238(e). Dr. T.S. Adams explained to the Senate Finance Committee the differences and similarities between a U.S. corporation operating a branch in France and a subsidiary in France. He said the incorporated subsidiary situation "[L]egally is different, but economically

121. Peeler, *supra* note 110, at 128. Before codification, Treasury regulations had stated that ninety-five percent ownership constituted affiliation without more, but many courts did not agree. See, e.g., *United States v. Cleveland P. & E. R. Co.*, 42 F.2d 413, 417 (6th Cir. 1930).

122. Smyth, *supra* note 95, at 450.

123. *Id.* (Regulation 75 applicable to 1929 and later years). The 1928 change also eliminated the possibility of consolidation of corporations commonly controlled by same non corporate interests, which also had caused considerable confusion. *Id.*

124. Mitchell B. Carroll, *Double Tax Relief for Foreign Trade in the Revenue Act*, 7 Nat'l Income Tax Mag. 179 (1929) (referring to the accumulation of provisions in the Revenue Act of 1928).

and practically is much the same.”¹²⁵ The similarities justified providing the deemed paid foreign tax credit (in 1918).

3. Consolidation of Accounts

Although the 1921 Revenue Act seems to have ended any possibility of foreign affiliates joining the consolidated return voluntarily (they could not be made to file), it expanded the possibility of the Commissioner applying a similar regime to foreign corporations through the consolidation of accounts provision, which was originally intended solely to protect the revenue in cases where taxpayers could not be forced to file consolidated returns.¹²⁶ Although the consolidation of accounts provision is the precursor of section 482, it differed fundamentally in adopting the concepts, if not the form, of the consolidated return, as contrasted with the method of reallocating discrete tax items as occurs today under section 482.

Another reason for the adoption of the consolidation of accounts provision was the concurrent proposal to defer tax on all of the foreign income of certain domestic corporations, which eventually was enacted in the form of deferral for possessions corporations.¹²⁷

The 1921 Act through the 1926 Act (effective through 1927) subsection 240(d) (later (f)) allowed the Commissioner to “consolidate the accounts” of related trades or businesses, whether or not incorporated and whether foreign or domestic for the purpose of making an “accurate distribution” of gains and other tax items.¹²⁸ The 1924 Act required the Commissioner to do so if asked by the taxpayer, and taxpayers appear to have asked frequently,¹²⁹ a development that likely limited the utility of the provision for its original purpose. The methodology after the 1924

125. 95A Internal Revenue Laws of the United States 1909-1950, Legislative Histories, Laws and Administrative Documents 389 (Bernard D. Reams, Jr., ed., 1979) [hereinafter Internal Revenue Laws].

126. See *Remco Steamship Co. v. Comm’r*, 30 B.T.A. 579, 582 (1934), aff’d, 82 F.2d 988 (9th Cir. 1936), cert. denied, 299 U.S. 555 (1936).

127. See Choate, Hurok & Klein, *supra* note 14, at 453-54; I.R.S. Gen. Couns. Mem. 33,481, n.1 (Jan. 3, 1967) (citing congressional reports discussing “foreign trade corporations,” a provision that was not enacted).

128. Revenue Act of 1921, ch. 136 § 240(d), 42 Stat. 227. Article 637 of Treasury Regulations 62, interpreting § 240(d), provided: “This provision relates not to the payment of taxes, but to the determination of the true income of related trades or businesses, and thus indirectly to the amount of taxes which may be due under Title II and Title III of the statute.”

129. See, e.g., *Remco Steamship Co.*, 30 B.T.A. 579 (taxpayer wanted consolidated accounts but Commissioner did not find affiliation and court agreed); *Flambeau Pub. Serv. Co. v. Comm’r*, 27 B.T.A. 299 (1932) (same); *Northern Waterproofing Co. v. Comm’r*, B.T.A. Memo 1933-431 (same).

amendment was not for the taxpayer to voluntarily file a consolidated return with the foreign affiliate, but rather to file a separate return and a request for consolidation of accounts with the necessary information about its dealings with the foreign affiliate.¹³⁰ The IRS viewed consolidation of accounts as differing from a consolidated return in that (1) it did not have to include all of the affiliates, and (2) it did not create a continuing obligation once undertaken, but applied only to the year.¹³¹

The explicit application of section 240(d) to unincorporated and foreign entities reflected Congress's intent that their incomes should be determined on the basis of a unit, like the income of ninety-five percent affiliated corporations in consolidation; even though they did not meet the affiliation definition, they were "nevertheless a part of a single economic unit which should be treated as such in determining taxable income and the tax thereon."¹³² Transactions with foreign affiliates were clearly a principal target of section 240(d) and could be corrected in the consolidation of accounts to properly compute the income of each member without requiring the foreign affiliate to pay a tax.¹³³ In fact, as late as 1932, the Board of Tax Appeals stated that whether section 240(d) was limited to foreign corporation and possessions corporations was an open question, although it tended to think not.¹³⁴

130. See I.T. 2121, IV-1 C.B. 53 (1925).

131. I.T. 2261, V-1 C.B. 100 (1926) (Mexican affiliate); I.T. 2429, VII-2 C.B. 158 (1928) (duty of continued consolidated filing).

132. Smyth, *supra* note 95, at 452 (quoting Montgomery's 1927 Tax Procedure).

133. *Asiatic Petroleum Co. v. Comm'r*, 31 B.T.A. 1152 (1935) (quoting legislative history concern with foreign corporations), *aff'd*, 79 F.2d 234 (2d Cir. 1935), *cert. denied*, 296 U.S. 645 (1935); I.T. 2151, IV-1 C.B. 53, 54 (1925) ("The intent of Congress in enacting the subdivision above quoted was to prevent the improper allocation of profits between domestic and foreign related trades or businesses"); *Graetz & O'Hear*, *supra* note 19, at 1061 (quoting testimony of T.S. Adams referring to income shifting to foreign subsidiaries); Smyth, *supra* note 95, at 453; see also Emerson Emmanuel Rossmoore, *Federal Income Tax Problems 1922*, at 285-86 (1922) (Problem 232) (describing as the sole example of an allocation of accounts, the case of a foreign affiliate selling goods for resale to a domestic affiliate at an unreasonably high price).

134. *Roessler & Hasslacher Chemical Co. v. Comm'r*, 25 B.T.A. 915 (1932). Senate Finance Committee Report 275, as quoted in *Broadway Strand Theater Co. v. Comm'r*, 12 B.T.A. 1052 (1928) stated:

"A new subdivision is added to this section giving the Commissioner power to consolidate the accounts of related trades or businesses owned or controlled by the same interests, for the purpose only of making a correct distribution of gains, profits, income, deductions, or capital, among the related trades or businesses. This is necessary to prevent the arbitrary shifting of

Dr. T.S. Adams explained the proposal to the Senate Finance Committee in the context of a parallel proposal to eliminate taxation of dividends received from foreign corporations.¹³⁵ He stated:

At the present time it is possible—and I am afraid the device is being used increasingly—to incorporate a subsidiary and throw the profits one way or the other. If that subsidiary is a foreign corporation you can throw the profits to it; in other words, by selling products to it at artificially high prices. [Presumably Adam's meaning was garbled in transcription] We have got to have some way of stopping that. The best way to stop it is to find out whether it is wrong for that subsidiary to consolidate its accounts with the parent corporation. This provision gives the Commissioner the power to do that, although not to tax them as a consolidated return. . . . To ascertain whether the accounts have been properly carried, it becomes very necessary, if you make this dividend change that you spoke of. You have got to know that they are not milking the subsidiary.¹³⁶

Professor Graetz has described the “consolidated accounts” provision as the precursor of the arm’s length standard of section 482, which it is in a way, but not in the way that matters most.¹³⁷ As discussed below this provision was transmuted in 1928 into the tax item reallocation rule that became section 482, but between 1921 and 1928 it approached the problem of related party dealings in the more straightforward method of consolidation, which simply eliminated the effects of the intercompany

profits among related businesses, particularly in the case of subsidiary corporations organized as foreign trade corporations.”

Note, however, that § 240(d) in 1921 had a confusing introductory sentence about possessions corporations, which was relocated to its own subsection (e) in the 1924 Act, but caused some to wonder whether the 1921 provision was limited to such corporations. See S.M. 2396, IV-1 C.B. 240 (1925).

135. Internal Revenue Laws, *supra* note 125, at 66, 80.

136. *Id.* at 80. Later he stated: “[A] provision authorizing the Commissioner of Internal Revenue to make a consolidation of corporations in order simply to determine the correct net income of each, not to tax them but to prevent milking.” *Id.* at 252. This was the source of the “milking” statement that appeared in the official legislative history: “Subsidiary corporations, particularly foreign subsidiaries, are sometimes employed to ‘milk’ the parent corporation, or otherwise improperly manipulate the financial accounts of the parent company.” H.R. Rep. No. 350, 67th Cong. 1st Sess., at 14 (1921).

137. Graetz & O’Hear, *supra* note 19, at 1060; see also *Foster v. Comm’r*, 80 T.C. 34 (1983) (tracing § 482 back to Articles 77 and 78).

pricing. When revising the section 482 regulations in 1988 the Treasury recounted the history of the consolidated return rules and section 240(d) but did not discern particular significance in the shift from dealing with cross border related party transactions through consolidation as contrasted with the section 482 model of adjusting particular tax items.¹³⁸ This is typical of the failure of the government after 1928 to recognize the value of consolidation in solving the problems at which section 482 aims.

Articles 77 and 78 of the 1922 Treasury revision of the 1918 regulations again contained the consolidation rules.¹³⁹ The regulations appeared to relate to the permissive consolidations under the 1921 Act but must have been intended also for the "consolidated accounts" mandatory consolidation because the regulations required information reporting like the 1918 regulations and extended the requirement to affiliated partnerships. The statute referred to partnerships only in connection with the "consolidated accounts." However, in 1925, the IRS made clear that the consolidated accounts were different from consolidated returns.¹⁴⁰

Unlike the 1917 and 1918 regulations, the 1922 regulations showed (which may have been intended before) that income shifting or non arm's length dealing alone would not create affiliation for purposes of required consolidation; rather the requisite parent-subsidiary or brother-sister relationship must exist plus operating in the same or closely related business, selling goods or services off market or otherwise assigning income improperly. These parts of the affiliation definition were not conditions of voluntary consolidation but were conditions of the type of affiliation that triggered the requirement to report intercompany transactions under Article 77.

The consolidation of accounts provision likely was converted into what is now section 482 due to uncertainties about consolidation generally that the Treasury never undertook to resolve.¹⁴¹ Taxpayers, who also could seek consolidation of accounts, continued to argue that it allowed true consolidations, meaning a unitary determination of tax liability, as contrasted with a means to determine the income of one corporation.¹⁴² In addition, even viewed as a means of determining the correct income of each of two corporations whose accounts were consolidated, the procedure suffered from the crucial lack of guidance as to how to apportion the income once the

138. 1988-2 C.B. at 459.

139. T.D. 3389, 24 *Treas. Dec. Int. Rev.* 1126, 1127 (1922); see Peeler, *supra* note 110, at 127.

140. S.M. 2396, IV-1 C.B. 240 (1925); see also I.R.S. Gen. Couns. Mem. 2,856, VII-1 C.B. 128 (1928).

141. See Edward H. McDermott, *Problems Before the Joint Committee on Internal Revenue Taxation*, 6 *Nat'l Income Tax Mag.* 445, 447 (1928).

142. See Smyth, *supra* note 95, at 450-51.

accounts had been consolidated.¹⁴³ This is, of course, the same issue faced by states that tax corporations on a consolidated basis but must allocate and apportion the unitary income to the state. How the consolidated tax was to be apportioned among the affiliates was never resolved under the pre-1928 consolidation regime.¹⁴⁴ In practice the IRS often treated the liability as the debt of the parent and encouraged the parents to pay the whole tax.¹⁴⁵ Taxpayer objections to collecting tax on the income of one corporation from another were rejected.¹⁴⁶

In discussing two possible views of consolidations of accounts, Smyth noted the following about foreign corporations in the context of analyzing accomplishing a true consolidation of accounts under section 240(d):

The foreign corporation's participation in this enterprise might include gains or losses not only from sources within the United States but from without the United States. Its income from sources without the United States could not be taxed under the revenue laws of this country. Moreover, any reapportionment of that income from sources without the United States would naturally affect income from sources within the United States thereby occasioning serious disputes as to the legality of such a procedure.¹⁴⁷

Smyth's concern about taxing the nominal foreign source income of the foreign affiliate to the domestic shareholder is odd. He must have assumed that the power of section 240(d) to identify the true income earner could not overcome the Revenue Act's direction that foreign corporations not be taxed on their foreign source income. Alternately, he may have had some concern about the constitutionality of a reallocation. But such concerns fly in the face of Congress's fundamental purpose to apply consolidated accounts specifically for the reason of undoing a nominal shifting of income offshore (or otherwise in a fashion to reduce aggregate tax liability).

Nevertheless, in at least one case of voluntary consolidation of accounts the IRS allowed the income of the foreign subsidiary to be reported by the domestic parent, albeit in the form of a loss.¹⁴⁸ The taxpayer bought the produce of its Mexican subsidiary's mines and wanted to claim depletion

143. *Id.*

144. See Peeler, *supra* note 110, at 128-29.

145. *Id.*

146. See, e.g., *United States v. Whyel*, 19 F.2d 260 (W.D. Pa. 1927), *aff'd*, 28 F.2d 30 (3d Cir. 1928), *cert. dismissed*, 278 U.S. 664 (1929).

147. Smyth, *supra* note 95 at 452.

148. I.T. 2261, V-1 C.B. 100 (1926).

on that capital through consolidation of accounts. The IRS agreed that the intercompany transactions should be eliminated, presumably leaving the Mexican sub with nothing but depletion that the parent would claim.

The Smyth article details another example of a taxpayer benefiting from consolidation of accounts with a foreign corporation involving a foreign holding company that was created in what we would call an expatriation.¹⁴⁹ The holding company suffered losses and Smyth explained that section 240(d) could be applied at the request of the taxpayer to consolidate accounts so that part of the losses of the Canadian parent could be apportioned to the U.S. subsidiaries and reduce their tax liabilities.

The Smyth article, published in December 1927, said that even experts were at a loss to know how section 240(f) should be applied; there had been no authoritative general ruling explaining it, particularly no explanation of the allocation of taxable income.¹⁵⁰ Finally Smyth suggested that the major source of the confusion of section 240(f) was its conversion from an anti-abuse provision in 1921 to also be a relief provision in 1924.¹⁵¹

These problems with the consolidation of accounts provision, plus the problems with the voluntary consolidated return provisions discussed in Part III.D. above, led to a major revision in 1928.

4. *The Lessons of 1917-1928*

Consolidated filing began as an anti-abuse measure aimed at policing improper income shifting through intercorporate transactions. While not the principal focus, such policing obviously included foreign affiliates, which is why Congress added the consolidation of accounts subsection in 1921. Consolidation served a parallel relief role for taxpayers, who sought relief with respect to foreign affiliates through consolidation of accounts. The whole theory of the economic unit, on which consolidation was based, necessarily included foreign affiliates. For the first year of consolidation, 1917, the IRS thought that foreign corporations might be consolidated affiliates.

When consolidation became elective for domestic corporations in 1921, Congress created a new consolidation tool for the IRS to use that specifically included foreign affiliates. If that regime had been fleshed out it could have served an important role in policing transactions with foreign affiliates through consolidation. However, the Treasury never provided adequate guidance, and confusion over consolidation generally continued to abound.

149. Smyth *supra* note 95, at 452-453.

150. *Id.* at 453.

151. *Id.*

For that and other reasons, a proposal to reject general consolidation in 1928 led to the section 482 approach, which continues to this day and does not involve consolidation; but when the final 1928 Act included consolidation with a stiffer direction to the Treasury to provide regulations, the non-consolidation section 45 (now section 482) stayed in the law.

There was no good theoretical or policy reason to exclude foreign affiliates from consolidated returns; the reasons were practical: Congress had not tried to tax their non-U.S. source income generally, and the failure of the original consolidation regime to impose the tax liability on the group made it impossible to collect the tax owed by the foreign affiliates. The IRS used consolidation as a measuring rod for correct reporting. Section 240(d) effectively dictated consolidation of accounts for foreign affiliates. The logic of treating all of the income of an affiliated group as the income of one unified business dictated including the foreign affiliates in the consolidated group. But when the 1928 Act was passed, the chance to do so was lost, apparently by accident, as discussed below.

That Congress and the Treasury thought consolidation was the right way to compute income of affiliated corporations is clear.

- The original 1917 regulations were in two parts, one requiring affiliated corporations to reveal non-arm's length pricing and other income shifting transactions (such of sales of goods at inflated prices) and the other allowing the Commissioner to require consolidated filing. Such transactions obviously do not respect country boundaries.
- The 1918 regulations required that consolidated returns be filed when "contracts or trade or financial practices . . . arbitrarily or artificially influence or determine the amount of the invested capital or net income of one or more of the corporations so affiliated."¹⁵² That regulation excluded public service corporations from the affiliated category because public service commission's policed the accuracy of their accounts.¹⁵³
- The 1918 Regulation 45, Art. 631, explained that affiliated corporations were really like branches of one business, and without consolidated filing taxpayers would be afforded opportunities for income shifting.
- The legislative history of the 1918 Act requiring consolidation discussed the tendency of taxpayers to divide up a unitary business into corporate shells.
- The 1921 enactment of section 1331 showed that public service corporations (railroads and public utilities) that were operated

152. T.D. 2662, 20 Treas. Dec. 41 (1918).

153. See *Union Pac. R.R. Co.*, 17 B.T.A. 793 (1929), acq., 1931-1 C.B. 66.

independently of industrial corporations ordinarily would not be treated as affiliated. But if a utility was owned by an industrial corporation and operated as an integral part of a group organization, it was to be treated as part of that affiliated group. The 1922 revised regulation picked up this exclusion.¹⁵⁴

- The Tax Court explained the exclusion of public service companies in a 1929 case addressing the government's effort to combine several railroads.¹⁵⁵ It stated that the railroads had what we would call today unitary business features, but nevertheless they could not be combined because there was no possibility of tax reduction due to the regulation of their accounts by public commissions (perhaps an overly optimistic assessment).

All of these considerations apply to foreign affiliates.

E. Revenue Act of 1928

1. The Accidental Creation of Section 482

- The 1928 Revenue Act, section 141, worked a major revision of what had been section 240 and laid the foundations of the consolidated return regime that began in 1929 and continues to this day.¹⁵⁶
- Filing consolidated returns became a "privilege" that required taxpayers to consent to all regulations prescribed prior to the due date of the return;
- Congress directed the Treasury to write regulations that spelled out how consolidation works, so that the confusion and numerous court cases of the 1920s might be abated;
- The consolidation produced a joint tax liability and a single return, in place of the apportioned taxes filed on multiple returns under the prior approach;¹⁵⁷
- Only 95 percent controlled domestic corporations were affiliates;¹⁵⁸
- Wholly owned contiguous country subsidiaries could be affiliates if incorporation was required by local law;¹⁵⁹

154. T.D. 3389, 24 Treas. Dec. Int. Rev. 1126, 1127 (1922).

155. See *Union Pac. RR. Co.*, 17 B.T.A. 793 (1929) acq., 1931-1 C.B. 66.

156. Section 141 applied to consolidation in 1929 and subsequent years. Section 142 applied to consolidation in 1928 and basically continued the 1926 provision.

157. Revenue Act of 1928, § 141, 45 Stat. 791 (1928).

158. As if to emphasize the point, § 238 states that foreign corporations could not be affiliates for 1928 or thereafter.

- What had been the section 240(f) consolidation of accounts provision was moved out of the consolidation section, now 141, into a separate section 45 that provided only for readjustment of tax items among related businesses at the order of the Secretary and not at the request of the taxpayer, wholly unrelated to consolidated returns.

The Joint Congressional Committee on Internal-Revenue Taxation, which had been created by the 1926 Revenue Act, proposed the 1928 rewrite of the revenue act. In November of 1927 its staff proposed a reorganization of the entire act, mostly for purposes of simplification rather than substantive change; the proposal retained both consolidated returns and consolidation of accounts but separated them into different sections, 141 and 45.¹⁶⁰ Apparently this reorganization effort is the cause of the separation of what became section 482 from the consolidated return section.

But further Committee recommendations show that the conversion of the consolidation section into an apportionment of tax items section (now section 482) was made in the context of a general rejection of all types of consolidation that Congress ultimately did not adopt. If it had not been for that rejected proposal, the shift to the item reallocation regime of section 482 might never have occurred.

The Committee augmented the November proposed reorganization of the Revenue Act with substantive recommendations on December 22, 1927.¹⁶¹ It recommended that due to (1) the declining importance of income shifting after the repeal of the excess profits tax, (2) the fact that the signal feature of voluntary consolidation was offsetting income with losses of another affiliate, and (3) the complexity that attended consolidated returns, the consolidated return as such should be ended and affiliated corporations should simply be allowed to offset affiliates' net losses; it also recommended

159. See I.T. 2543, IX-2 C.B. 142 (stating that when a contiguous country foreign corporation was in the group, the use of its foreign tax credits was not limited to its dividends but rather was treated as if paid by a domestic group member).

160. See Staff of Joint Comm. on Tax'n, 70th Cong., *The Report of the Joint Congressional Committee: Vol. II—Proposed Rearrangement of Income Tax*, Title 41-42 (Joint Comm. Print 1927); see also H. Maurice Darling, *The Report of the Joint Congressional Committee*, 6 *Nat. Inc. Tax Mag.* 18 (1928). The origins of the Report are discussed in L.H. Parker, *Delinquency in Enforcement of Section 220 Reported*, 5 *Nat. Inc. Tax Mag.* 125, 141 n.11 (1927) (stating that the effect of consolidated returns has never been completely studied).

161. Staff of Joint Comm. on Tax'n, 70th Cong., *Report on Internal Revenue Taxation: Vol. I*, at 13-14 (Joint Comm. Print 1927). See also *Tax Laws Modifications Approved by the Ways and Means Committee*, 5 *Nat. Inc. Tax Mag.* 447 (1927); Darling, *supra* note 160; Peeler, *supra* note 110.

eliminating the brother-sister affiliation. The proposal to simply offset affiliates' losses was viewed as a "short cut."¹⁶²

However, the House bill for the 1928 Revenue Act proposed to eliminate consolidated returns, eliminate the "consolidated accounts" provision, and convert the latter into what was very similar to the current section 482.¹⁶³ The 1921 Act's permission to elect consolidation was seen as a drain on the revenue due to the flat corporate income tax rate and the inevitable reduction of the tax base when losses offset income of other corporations.¹⁶⁴ The House Report explained this proposal as required by the difficult problems of interpretation and application that attended the consolidated returns and had never been addressed authoritatively, and the need for broadened protection (in section 45) for the government to prevent evasion "by the shifting of profits, the making of fictitious sales, and other methods frequently adopted for the purpose of 'milking'." Such alternate remedy would be needed because milking would no longer be policed by consolidated returns or "consolidated accounts," if repealed. The report partly explained the shift from consolidation of accounts to reassignment of tax items by calling "erroneous" the view that consolidation of accounts could require consolidated returns for unaffiliated businesses.¹⁶⁵

But taxpayers objected to the elimination of the consolidated return.¹⁶⁶ One expert objected to the IRS placing all of its abuse fighting power in the area of intercorporate dealings on reallocating tax items, because "[t]he Commissioner will probably be hard put to it to apply section 45 reasonably to these new arrangements" (referring to intercorporate contracts designed to effect de facto consolidation).¹⁶⁷ The Senate rejected the elimination of consolidated returns, while leaving the change to the "consolidated accounts" subsection intact. The Senate Report explained that the motive for retaining consolidated returns was not revenue raising but simply that it was the right thing to do; it made no more sense to tax the corporations in an affiliated group separately than to tax the single corporation's manufacturing and sales departments separately.¹⁶⁸

Thus, the revised section 240(f) consolidation of accounts provision, which was changed to a reallocation of tax item section 45 by the House as

162. Edward H. McDermott, *supra* note 141, at 447 (1928).

163. Seidmans, *supra* note 106, at 522, 539 (1938) (discussing proposed § 45 at page 522 and discussing proposed elimination of consolidated returns and consolidated accounts at page 539).

164. Roswell Magill, *The Federal Revenue Act of 1928*, 6 *Nat. Inc. Tax Mag.* 87, 89 (1928).

165. Seidmans, *supra* note 106, at 522.

166. See, e.g., *Washington Tax Talk*, 6 *Nat. Inc. Tax Mag.* 61, 63 (Feb. 1928) (Chamber of Commerce of the State of New York opposition).

167. Magill, *supra* note 164, at 89.

168. Seidman, *supra* note 106, at 540, 541.

part of a general rejection of consolidation, survived unchanged even though the Senate reinstated consolidated filing. One might say section 482 was removed from the consolidation regime by accident.

As finally enacted, new section 141, effective for 1929, provided the privilege of filing consolidated returns to domestic parent-subsidiary and not brother-sister corporations, on the condition of agreeing to the regulations promulgated before the return due date, with the tax due from all of the group as a unit and the Treasury charged with writing what came to be called legislative regulations.¹⁶⁹ The 1928 Act created a specific confusion about foreign affiliates: section 141(e) directed that the consolidated return could be made by only the domestic affiliates, but the definition of affiliation in section 141(d) did not exclude foreign corporations. Therefore, one taxpayer contended that two domestic subsidiaries of a foreign corporation could affiliate, and the Board of Tax Appeals agreed, despite another provision, section 238, that said a foreign corporation could not be affiliated for purposes of section 141. The Second Circuit reversed, with Judge Learned Hand stating the theory of consolidation that would require including the foreign parent or none at all:

When a business is single, industrially and financially, it ought to be assessed as such; there is but a single income and intramural transactions cancel each other; that is the notion which supports the affiliation. But if a foreign corporation is the only nexus which unites domestic subsidiaries—if it is the “parent,”—this theory can be realized only by bringing its income into hotchpot with the rest, just what section 141(e), 26 USCA § 2141(e), itself forbids. To eliminate that income and still to treat as a unit those companies which are a unit only because the excluded foreign corporation holds their shares, is to deny the premise and affirm the conclusion.¹⁷⁰

The Supreme Court has relied on the “privilege” aspect of consolidated returns to construe the regulations strictly.¹⁷¹

169. See New Income Tax Provisions of the Revenue Act of 1928, 6 Nat. Inc. Tax Mag. 207, 211 (1928).

170. *Comm'r v. Manus Muller & Co.*, 79 F.2d 19 (2d Cir. 1935), cert. denied, 296 U.S. 657 (1936), rev. 30 B.T.A. 1015 (1934).

171. See *Old Mission Portland Cement Co. v. Helvering*, 293 U.S. 289, 292 (1934) (“The Government, having thus conferred upon groups of affiliated taxpayers the privilege of computing their tax as though they were a single taxpaying entity, it would require plain language in statute and regulations to support the conclusion that it was also intended that they should retain the advantages which, before affiliation, attached peculiarly to their status as independent tax computing entities.”).

2. *New Section 45*

In the context of eliminating consolidated returns the proposal to convert section 240(f) from a consolidation of accounts to a reallocation of tax items was touted as a "broadening" of the Secretary's authority.¹⁷² However, there was no real broadening.¹⁷³ Before and after the amendment the section applied to incorporated and unincorporated and foreign and domestic trades and businesses, which was a much broader scope than consolidation generally; before and after it required only vague ownership or control directly or indirectly by the same interests, which also was a much broader scope than for consolidation generally.

The only changes were (1) to eliminate the right of taxpayers to ask for consolidation of accounts, and (2) to substitute direct adjustment of income and deduction items for consolidation of accounts as the methodology. Despite the puny or non-existent nature of the broadening, the term was seized upon to characterize section 45 as a broadening made necessary by the elimination of the consolidated return,¹⁷⁴ which of course did not wind up being eliminated.

Section 45 did mention evasion prevention and clear reflection of income as grounds for action, in place of the prior ground of making an accurate apportionment. The courts had never created a body of law as to what was an accurate apportionment.¹⁷⁵ The IRS understood the purpose of section 240(d) or (f) to be to redistribute tax items when necessary to prevent improper manipulation or shifting of income.¹⁷⁶

The new reference to evasion did not necessarily add to the Commissioner's powers because it was cited by taxpayers as a ground not to apply section 45 to them because they were not evading taxes.¹⁷⁷ In addition the new authority to allocate income was used against the Commissioner when he attempted to allocate 100 percent of one taxpayer's income to

172. Seidman, *supra* note 106, at 522.

173. See Walter A. Cooper, Section 45, 4 Tax L. Rev. 131, 133 (1949) (viewed it as narrowing the authority).

174. See, e.g., I.R.S. Gen. Couns. Mem. 33,481, n.1 (Jan. 3, 1967).

175. See, e.g., *Nowland Realty Co. v. Comm'r*, 47 F.2d 1018 (7th Cir. 1931).

176. I.R.S. Gen. Couns. Mem. 2,856, VI-1 C.B. 128, 131 (1928), citing Solicitor's Memorandum 2396, IV-1 C.B. 240.

177. See, e.g., *Asiatic Petroleum Co. v. Comm'r*, 79 F.2d 234 (2d Cir. 1935), cert. denied, 296 U.S. 645 (1935) (rejecting taxpayer argument); *Epsen Lithographers v. O'Malley*, 67 F. Supp. 181 (D. Neb. 1946) (agreeing with taxpayer); *Miles-Conley Co. v. Comm'r*, 10 T.C. 754 (1948), aff'd, 173 F.2d 958 (4th Cir. 1949); *Central Cuba Sugar Co. v. Comm'r*, 16 T.C. 882 (1951), aff'd in part and rev'd in part, 198 F.2d 214 (2d Cir. 1952), cert. denied, 344 U.S. 874 (1952).

another.¹⁷⁸ And when the Commissioner attempted to disallow a deduction the terminology of section 45 tripped him up.¹⁷⁹ Some courts focused on the new terminology “clearly reflect income” as supporting the application of section 45 when evasion did not necessarily appear.¹⁸⁰

The IRS did use section 45 against taxpayers that were not affiliated for purposes of the consolidation definition because they were foreign. For example in *Asiatic Petroleum*, Royal Dutch and British Shell owned 60 percent and 40 percent of the stock of a domestic and a foreign corporation and the domestic corporation sold property to the foreign corporation for its basis and the foreign corporation sold the same property to another buyer for a large profit.¹⁸¹ The Commissioner relocated the profit to the domestic subsidiary, which had the effect of taxing the foreign income as if the foreign affiliate had been in the consolidated return, in part.

In 1945 the Tax Court said that section 45 had been “sparingly applied.”¹⁸² A 1947 article stated that there had been relatively few cases under the section, probably because tax advisors took account of it in planning.¹⁸³ A 1951 article counted forty-three cases under section 45 and thought that small.¹⁸⁴ These and other early articles on section 45 did not even identify its application to foreign affiliates as a major category of concern or grouping of cases.¹⁸⁵

3. *What Was Section 45 Aimed At?*

As explained above in discussion of the 1928 Revenue Act, section 45 was retained when it was thought the consolidated return provision would be eliminated, to arm the Commissioner to prevent income shifting, milking of profits, and fictitious sales. The same problems can be neutralized by

178. See, e.g., *J.E. Dilworth Co. v. Henslee*, 98 F. Supp. 957 (M.D. Tenn. 1951) (taxpayer won).

179. See, e.g., *Hypotheek Land Co. v. Comm'r*, 200 F.2d 390 (9th Cir. 1952); *General Industries Corp. v. Comm'r*, 35 B.T.A. 615 (1937), reviewed, acq., 1937-1 C.B. 10.

180. See, e.g., *Central Cuba Sugar Co. v. Comm'r*, 198 F.2d 214 (2d Cir. 1952), cert. denied, 344 U.S. 874 (1952).

181. *Asiatic Petroleum Co.*, 79 F.2d at 235.

182. *Seminole Flavor Co. v. Comm'r*, 4 T.C. 1215, 1228 (1945).

183. Robert S. Holzman, *Arm's Length Transactions and Section 45*, 25 *Taxes* 389 (May 1947).

184. Samuel Joyce Sherman, *A Case History of Section 45*, 29 *Taxes* 13 (1951).

185. In addition to the Holzman and Sherman articles, see Walter A. Cooper, *Section 45*, 4 *Tax L. Rev.* 131 (1949); Karl H. Spaeth, *Section 482: Past and Future*, 47 *Taxes* 45 (1969) (discussing the application of the 1968 regulations to cross border transfers).

having consolidated returns include the corporate parties to such transactions. Section 45 was aimed at non arm's length transactions between related parties, as reflected by the government's insistence over many decades on the arm's length standard in applying it.¹⁸⁶

Section 45 appeared to apply to non-arm's length transfers but its words could be read to apply to nonrecognition transactions that resulted in shifting income to a nontaxpayer or a taxpayer at a lower rate. The latter problem was not addressed specifically until the predecessor of section 367(a) was enacted in 1932 as section 112(k), applying to foreign to domestic corporate transfers.¹⁸⁷ But the nonrecognition rules were pulled into section 45 by the decision in *National Securities*, which ruled that a loss that had accrued before the exchange but was recognized after the exchange could be reallocated to the shareholder.¹⁸⁸

National Securities applied section 45 to a section 351 exchange with a wholly owned subsidiary without even questioning the absence of an arm's length pricing issue. It explained that the court was not ignoring the nonrecognition rule: it still applied, but the court reallocated the subsidiary's loss to the parent. It planted in the tax law a conundrum of how to apply an arm's length test in a situation to which arm's length pricing was irrelevant. Eventually section 482 as applied to section 351 exchanges came to be limited, in effect, to transfers to wholly owned subsidiaries in which either (1) the parent assigned economically realized losses (as in *National*

186. See, e.g., I.R.S. Gen. Couns. Mem. 33,481 (Jan. 3, 1967) ("First, we want to make it abundantly clear that a Section 482 adjustment must be determined, exclusively, by the arm's length standard."). See also Note, Collateral Effects of Price Agreements Between Affiliated Corporations, 28 Colum. L. Rev. 627 (1928) (explaining how states and the IRS could control transfer pricing problems by seeking "true income" through consolidation).

187. Section 367(a) began as § 112(k) of the Revenue Act of 1932. The object of this section was a type of income shifting different from the income shifting at which the predecessor of § 482 was aimed: the sometimes transitory shifting of appreciated property to a foreign corporation for sale by the foreign corporation but without recognition of gain or loss in the United States due to application of § 351 or the reorganization provisions. Seidman, *supra* note 106, at 452-453. See also Stanley S. Surrey, *The United States Taxation of Foreign Income*, 1 J.L. & Econ. 72, 75-76 (1958). The provision was not given much attention at the time. See, e.g., *New Provisions of the Revenue Act of 1932*, 10 Tax Mag. 201 (1932) (the only contemporaneous article mentioning it in passing).

188. *Nat'l Secs. Corp. v. Comm'r*, 137 F.2d 600 (3d Cir. 1943). A surprising connection between § 482 and the consolidation rules is that *National Securities* incorrectly states that consolidated returns were repealed in 1928 and justifies applying § 482 to overrule § 351 by stating that the predecessor of § 482 co-existed in the consolidated § 240. Unfortunately, Treasury regulations cite this opinion; when regulations cite a court opinion the court opinion tends to be unduly exalted. Reg. § 1.482-1(f)(1)(iii).

Securities), or (2) income was separated from the expenses that produced the income. The second set of cases is reflected best in *G.D. Searle & Co.*, which produced a sort-of judicial discovery (as to earlier years) of the principles of section 367(e) before it was enacted in 1984 and the 1986 amendment to section 482 related to intangibles.¹⁸⁹

It was not until the early 1960s that section 482 achieved its current status as aimed principally at abuses involving foreign corporations.¹⁹⁰ The hearings on the creation of the Subpart F regime in 1961 and 1962 likely spurred interest in the subject.¹⁹¹ Rev. Rul. 65-142 stated that section 482 of the Code is “particularly important to the proper administration of the tax laws in the foreign or international area.”¹⁹² In the same year, a General Counsel Memorandum showed that the IRS was highly interested in using section 482 to prevent income from being shifted beyond United States tax jurisdiction but cautioned that it was too soon to publicly indicate that domestic application was not important.¹⁹³ The new section 482 regulations, promulgated in 1968, emphasized transfer pricing involving U.S. and related foreign corporations.¹⁹⁴

Thus section 45 was aimed at correcting non-arm’s length transactions between related businesses, not exclusively involving foreign businesses but certainly including them. Its application to nonrecognition transfers occurred through the flawed *National Securities* opinion, which was given undue emphasis by the Treasury in regulations for a purpose that was never fully figured out, and had been dealt with in the predecessor to section 367(a). Section 45 attempted to deal with the non arm’s length cases through the second best method of item reallocation because it was written on the assumption that consolidation was to be removed from the code. This is hardly a ringing endorsement for the income tax system’s reliance on section 482 to resolve problems of cross border transactions with affiliates.

189. *G.D. Searle & Co. v. Comm’r*, 88 T.C. 252 (1987) (involving 1974 and 1975 tax years).

190. See Choate, Hurok & Klein, *supra* note 14, at 473-474.

191. See Peroni, Fleming & Shay, *Getting Serious*, *supra* note 1, at 474 (explaining linkage of § 482 and Subpart F); Bittker & Lokken, *Federal Taxation of Income, Estates & Gifts*, ¶ 69.1 (2010) (subpart F generally).

192. Rev. Rul. 65-142, 1965-1 C.B. 223.

193. I.R.S. Gen. Couns. Mem. 32,988 (Mar. 11, 1965).

194. Reg. § 1.482-1 (1962). See Spaeth, *supra* note 185. This article, written by counsel for Scott Paper, viewed the pre-1968 period of § 482 as devoted almost exclusively to non-arm’s length pricing transactions, but looked askance at the drastic change in the 1968 regulations, which he considered in the context of cross-border joint ventures.

4. *New Consolidated Return Regulations*

The 1928 Act directed the Treasury to do what it had failed to do during the first eleven years of consolidated filing: write regulations explaining how the consolidated return would work and so reduce the litigation and confusion that had attended earlier consolidations. Section 141(b) specifically authorized for the first time regulations to compute the consolidated income so as to properly reflect income and prevent tax avoidance.¹⁹⁵ Regulation 75, adopted in 1929 under the 1928 Act, was viewed as the first legislative regulation on consolidation.¹⁹⁶ *Inter alia*, it made all group members severally liable for the entire group tax liability.¹⁹⁷ The 1929 regulations remained in effect, with modifications, until 1966.¹⁹⁸

The 1929 regulations employed, as do the current regulations, a hybrid mixture of economic unit and separate entity concepts. An early commentator, who was an accountant, recommended following the obvious principle of treating the consolidated group as a "single economic unit, and ignoring the multiplicity of legal creations."¹⁹⁹ However, Andrew Mellon himself explained in an article overviewsing the regulations that the Treasury had demurred from the economic unity model because the law generally was written in terms of legal entities.²⁰⁰

Thus the 1929 version of consolidated returns reflected the economic unit approach more than the 1917 version in that it collected the tax from the group through a common parent, but consciously chose not to go so far as to wholly amalgamate the legal entities, as financial accounting largely did. This seminal rewrite of the consolidated return rules gave no specific consideration to foreign affiliates.

195. See Ellsworth C. Alvord, *Possibilities of Future Tax Law Simplification*, 6 *Nat. Inc. Tax Mag.* 365, 367 (1928) (citing the consolidated regulations authorized in 1928 as the most significant example in the tax law of Congress stating a general rule and authorizing Treasury to define it).

196. *Id.* See *Consolidated Returns of Affiliated Corporations*, 26 C.F.R. pt. 4 (1938).

197. See J. Hardy Patten, *The Consolidated Return—1929 Model: Part III*, 8 *Tax Mag.* 13, 15 (1930).

198. See Irving Salem, *The Consolidated Return Regulation Revision: Its Genesis and Objectives*, 17 *Tax Exec.* 163, 164 (1965). T.D. 6894, 1966 I.R.B. 42, at 8 (the new regulations).

199. Frank E. Seidman, *Suggestions for Consolidated Returns Regulations under the Act of 1928*, 6 *Nat. Inc. Tax Mag.* 410, 424 (1928).

200. Andrew W. Mellon, *Consolidated Returns Regulations—Summary of Provisions*, 7 *Nat. Inc. Tax Mag.* 105 (1929). See also J. Hardy Patten, *The Consolidated Return—1929 Model*, 7 *Nat. Inc. Tax Mag.* 419, 420 (1929); J. Hardy Patten, *The Consolidated Return—1929 Model: Part II*, 7 *Nat. Inc. Tax Mag.* 459 (1929).

F. Revenue Act of 1934 and Later

In 1934 Congress limited consolidated filing to railroads and Pan American Trade Corporations due to the view that large corporations unfairly benefited from the ability to offset gains and losses.²⁰¹ This limitation continued to 1941; from 1942 to 1964, a 2 percent additional tax on consolidated taxable income was imposed. The 1954 code reduced the ownership percentage from 95 percent to 80 percent. In 1966, the Treasury adopted a completely revamped set of regulations designed to move toward the legal view of the members of the group and away from the economic unit view, for reasons thought to be needed to prevent tax avoidance through manipulation of the tax attributes of particular members.²⁰² Also the 1934 regulations installed the “uncontrolled taxpayer dealing at arm’s length with another uncontrolled taxpayer” method in the section 45 (later section 482) regulations.²⁰³

IV. IS CHANGE POSSIBLE?*A. The Political Decision Was Never Made*

Stanley Surrey explained in 1958 that what he called the “foreign subsidiary rule,” now called “deferral,” was not planned, it just happened.²⁰⁴ It may have been “automatic when first made,” but has become an increasingly important policy decision.²⁰⁵ Nevertheless, in hindsight he called it a “jurisdictional rule” and said:

These jurisdictional rules, in the United States and probably elsewhere, developed almost intuitively without any intensive consideration of the situation. In fact, the combination of initially low tax rates and the small volume of international activities meant there was no situation to consider. But the rules were there, and as rates and international activities increased, the rules formed the

201. See *G.U.R. Co. v. Comm’r*, 41 B.T.A. 223, 227 (1940), *aff’d*, 117 F.2d 187 (7th Cir. 1941) (explaining how Congress severely limited consolidated filing in 1934 because it wanted to stop the offsetting of losses and income); Robert N. Miller, *The Taxation of Intercompany Income*, 7 *Law & Contemp. Probs.* 301 (1940) (outlining history of consolidated returns and explaining 1934 changes).

202. Dubroff et al., *supra* note 10, ¶ 1.02.

203. Reg. 86, art. 45-1 (1934).

204. Stanley Surrey, *The United States Taxation of Foreign Income*, 1 *J.L. & Econ.* 72, 76 n.8 (1958).

205. Stanley Surrey, *Current Issues in the Taxation of Foreign Corporate Investment*, 56 *Colum. L. Rev.* 815, 817, 827 (1956).

foundation of the tax structure in this area and shaped the consequent tax treatment.²⁰⁶

In response to arguments that the norm should be viewed as not taxing foreign subsidiaries' income rather than viewing that a benefit, Surrey stated:

This assertion sounds plausible only because the remission-of-profits rule which governs the taxation of foreign subsidiaries has existed for such a long time that there is a tendency to regard it as legally immutable. But other countries have not adopted this rule.²⁰⁷

Surrey observed that it was not until 1957 that Great Britain developed tax rules that approached the benefits of the U.S. foreign subsidiary rule. But Surrey's hindsight justification was not compelling. First he pointed to the fact that the income usually had already borne tax in the foreign country; but of course the same was generally true of foreign branch income, which is subject to immediate taxation in the United States. Surrey came closer to the mark when he stated that the federal taxing jurisdiction was not limited by legal lines but national policy and attitudes.²⁰⁸

Taxation of foreign income of U.S. taxpayers was largely quiescent up to 1960 due to the general ability of the Treasury to raise revenue from domestic sources and to the support for expanding outbound investment after World War II.²⁰⁹ However, these trends began to end in the early 1960s. Between 1962 and 1980 the net current income after taxes of controlled foreign corporations that were majority owned by U.S. corporations increased from \$2.5 billion to \$31 billion.²¹⁰ The result was the adoption of Subpart F, adoption of the effectively connected income regime, and the new section 482 regulations.²¹¹

Respecting the membrane of a legal shell drawn between a U.S. parent and its foreign subsidiaries that carried out its business abroad turned out, in retrospect, to be a "close enough for government work" compromise

206. Surrey, 1 J.L. & Econ. 72, *supra* note 204, n.7. To illustrate the point, an early book devoted solely to holding company consolidated accounting did not mention foreign subsidiaries. Harry Anson Finney, *Consolidated Statements for Holding Companies and Subsidiaries* (1922).

207. Surrey, 56 Colum. L. Rev. 815, *supra* note 205, at 817, 826.

208. *Id.* at 817.

209. See Choate, Hurok & Klein, *supra* note 14, at 483-486.

210. Melissa Redmiles & Jason Wenrich, *A History of Controlled Foreign Corporations and the Foreign Tax Credit*, IRS Statistics of Income Bulletin, Summer 2007, at 129, 132.

211. *Id.*

between the forces that would exclude all foreign source income and the opposing forces. This conflict is ancient in the federal tax law, but in earlier times the opponents were more forthcoming about their appraisals. For example, Senator Furnifold Simmons, no flaming liberal on social issues but an economic progressive on the people's issues, joined Senator "Fightin Bob" LaFollette in opposing a proposal in 1921 to exclude foreign source income by stating that it "came from sources 'profoundly interested in advancing the interests of consolidated, coordinated, combined and predatory wealth. . . .'"²¹²

One legitimate problem facing the taxation of foreign income, whether earned in a branch or subsidiary, was the problem of foreign currencies. The foreign profits usually were accounted for in the foreign currency and they might be remitted in dollars or the foreign currency. And of course the value of foreign currencies fluctuated. The translation problem was a serious one for branches and subsidiaries in early times.²¹³ While such difficulties may have played some role in the original exclusion, presumably they receded as trade increased. As noted in Part II.B.1. above, the financial accounting world finally rejected that excuse for not consolidating foreign affiliates in 1987.

So exclusion of foreign affiliates from the consolidated return cannot be justified on the basis of some reasoned choice that was thought out in earlier days; it never was.

B. Selling Points

There would be substantial resistance to ending deferral of the active business income of foreign affiliates by forcing them to join the consolidated returns of their U.S. parents. However, there are some selling points that could be used to entice taxpayers:

- There could be a large one-time deferral for income from intercompany sales to what had been controlled foreign corporations (CFCs).²¹⁴
- Consolidation would mitigate the burden of reconciling book-tax differences.²¹⁵

212. Roy G. Blakey, *The Revenue Act of 1921*, 12 *Am. Econ. Rev.* 75, 96 (1922) (quoting 61 *Cong. Rec.* 8994 (1921)), also quoted in Graetz and O'Hear, *supra* note 19, at 1062 n.167.

213. See L.R. Dicksee & J.E.G. De Montmorency, *Advanced Accounting* 27 (1903).

214. See Paul W. Oosterhuis & Roseann M. Cutrone, *The Cost of Deferral's Repeal: If Done Properly It Loses Billions*, 58 *Tax Notes* 765, 766-67 (Feb. 8, 1993).

- Inclusion of foreign losses, subject to the dual consolidated loss limitation could be beneficial.²¹⁶
- The foreign affiliates would no longer be subject to Subpart F, PFIC, and other regimes based on their foreign status.
- Most importantly, there would be a potential for complete or partial forgiveness of tax on repatriation of previously earned and untaxed foreign earnings and profits, discussed below in Part IV.F.2.

An additional selling point is that the European Commission Taxation and Customs Union is considering a common consolidated corporate tax base.²¹⁷ One of its selling points would be elimination of expensive transfer pricing studies.²¹⁸ The CCCTB, as it is known, may not arrive any time soon, but the substantial commentary it has generated could inform the proposal of this article.

C. No Constitutional Impediment

1. Overview

There is no constitutional impediment to including in the consolidated group return in the year of recognition the active income that is not effectively connected with a U.S. trade or business earned by foreign affiliates, whether for purposes of taxation or measurement of the portion of the group's income to be taxed.

Stanley Surrey long ago stated that he had no doubt that the United States has tax jurisdiction to pierce through the foreign subsidiary and tax its income to the U.S. parent, much as it taxes the income of a foreign personal holding company; alternately the United States could treat the subsidiary as domestic because it is managed and controlled in the U.S.²¹⁹ Unfortunately

215. See Staff of Joint Comm. on Tax'n, 110th Cong., *Economic Efficiency and Structural Analyses of Alternate U.S. Tax Policies for Foreign Direct Investment* 63 n.215 (Joint Comm. Print 2008).

216. Reg. §§ 1.1503(d)-0 to -8. See Part IV.F.3.c., *infra*.

217. See European Commission: Taxation and Customs Union, *Common Tax Base*, http://ec.europa.eu/taxation_customs/taxation/company_tax/common_tax_base/index_en.htm (last visited Feb. 21, 2011).

218. See Lee Sheppard, *Technical Problems with the Common Consolidated Corporate Tax Base*, 46 *Tax Notes Int'l* 975 (Jan. 4, 2007).

219. Surrey, *supra* note 204, at 76; Surrey, *supra* note 205, at 827. When he surveyed constitutional limitations on the taxing power, Boris Bittker did not discuss nationality and concluded generally that there were no meaningful limitations. Boris I. Bittker, *Constitutional Limits on the Taxing Power of the Federal Government*, 41 *Tax Law.* 3 (1987).

some erroneous statements have muddied the water; for example, during discussion of what became Subpart F in 1961, the Joint Committee counsel testified (incorrectly as the following discussion shows) that taxing the income of foreign corporations before payment as dividends would be unconstitutional unless necessary to prevent tax avoidance.²²⁰

2. History

Before the 1894 Tariff Act containing the corporate income tax was stricken down in *Pollock*,²²¹ only residents and citizens had been subject to income taxation (although corporations were subject to other taxes).²²² However, the Civil War tax act in effect taxed corporate income through a tax on distributed earnings.²²³ It included distributions to "non-residents whether citizens or aliens."²²⁴ If the tax be viewed as upon the recipient but only collected from the U.S. payor, then it is a prototype of taxing nonresidents on U.S. source income.²²⁵

From the inception of the income tax on corporations in the 1894 Act,²²⁶ and in the 1909 Act,²²⁷ and the 1913 Act,²²⁸ the taxable income of foreign corporations was limited by statute to U.S. source income. However, this limitation has suffered several breaches. Since 1962 the income of controlled foreign corporations has been taxed to their U.S. shareholders when the income is described in Subpart F. This income is deemed to be

220. See President's 1961 Tax Recommendations: Hearings Before the H. Comm. on Ways & Means, 87th Cong., Vol. 1, 311-313 (1961) (memorandum of Staff of the Joint Committee on Taxation).

221. *Pollock v. Farmer's Loan & Trust Co.*, 158 U.S. 601 (1895).

222. Ch. 119, § 90, 12 Stat. 422, 423, 473 (1862); Ch. 78, 13 Stat. 469, 479 (1865). See *Springer v. United States*, 102 U.S. 586 (1880) (finding Civil War income tax constitutional).

223. See *Pac. Ins. Co. v. Soule*, 74 U.S. 433 (1868) (holding tax constitutional).

224. Ch. 184, 14 Stat. 138 (1866) (deduct and withhold tax from dividends).

225. See dissent of Justice Harlan in *Pollock v. Farmer's Loan & Trust Co.*, 157 U.S. 429 (1895).

226. Sections 31 and 32 applied the corporate tax only to corporations "doing business for profit in the United States;" foreign corporations were taxed only on U.S. source income. Ch. 349, §§ 31, 32, 28 Stat. 509, 556 (1894).

227. Section 38 limited the taxable income of foreign corporation to that derived from business in the United States. Tax of 1909, Ch. 6, 36 Stat. 11 (1909). For discussion of the constitutionality of the 1909 tax, see Francis W. Bird, *Constitutional Aspects of the Federal Tax on the Income of Corporations*, 24 *Harv. L. Rev.* 31 (1910); William E. Dorman, *The Federal Corporation Tax Constitutional?*, 22 *Green Bag* 168 (1910).

228. Income Tax Title, section G(a) was the same as the 1909 Act. Ch. 16, 38 Stat. 114, 172 (1913).

current income earned by the shareholders despite the corporate membrane that separates the legal owner of the income from the shareholders.²²⁹

Before that, the foreign personal holding company rules adopted in 1937 taxed shareholders on certain types of undistributed foreign source foreign corporation income.²³⁰ Section 897(a) taxes foreign persons and corporations on the sale of stock of a U.S. real property holding corporation by deeming them to own a direct interest in an effectively connected business. Foreign sales corporations were foreign corporations that were taxed on the nonexempt portion of their foreign trade income (albeit by election).²³¹ Therefore, the federal income tax has long since gotten over any constitutional question about the power of the federal government to tax the income of foreign corporations not sourced to the United States through the simple expedient of taxing the domestic owners of the corporation, or otherwise.

But over a century ago there was some question regarding the constitutionality of taxing the income of foreign persons who were neither citizens nor residents, even when the source was from the United States.²³² An early commentator on the pre-1929 consolidated return rules expressed a concern about the legality of consolidating foreign source income.²³³ The concern may have been justified in the context of a consolidated return regime that undertook to tax each affiliate on its own income, because that regime might not have been able to rely on the claim that it was taxing the domestic owner on the foreign income, and could not practically force the foreign corporation to report or pay. The concern has no place in the current consolidated return regime that imposes the tax liability on the group, which can exist only if it has a domestic common parent (this article does not propose that foreign affiliates become common parents). The requirement of a domestic common parent for consolidated returns today means that any foreign affiliates are ultimately and substantially owned by domestic corporations and the foreign income can be treated as their income.

There is scant law supporting any constitutional limitation to citizen/residence and source taxation on the taxing power of the United States.²³⁴ Rather, discussions of similar limitations arise mostly in cases

229. IRC § 951.

230. See Bittker & Lokken *supra* note 191, ¶ 70.2.

231. IRC §§ 921-927 (repealed).

232. See dissent of Justice Field in *United States v. Erie Ry. Co.*, 106 U.S. 327 (1882). For summary of then-current law, see Henry Crofut White, *The Federal Income Tax* 21-23 (1913).

233. Smyth, *supra* note 95, at 452. It is unclear whether the reference to illegality related to the exclusion of foreign corporations from the income tax by statute or constitutional concerns.

234. See generally, Walter Hellerstein, *Jurisdiction to Tax Income and Consumption in the New Economy*, 38 Ga. L. Rev. 1, 3-13 (2003).

involving the states and the Commerce Clause; cross fertilization of that law to limit the power of the United States is unwarranted.²³⁵ Sometimes discussions of international norms also conflate such norms with legal rules binding on the United States.²³⁶

Shaffer v. Carter and *Yale & Towne* are often cited for the principle that a state of the United States may tax the income of its residents and citizens and income from sources within the state.²³⁷ However, those cases involved state taxes and concluded only that the states were subject to no more strict requirements of due process than the federal government, and observed that the federal government taxed based on source (although the Commerce Clause imposed other limits on states). The due process limitations applied to the states' taxing power do not apply to the federal government to the same extent.²³⁸ Similarly, *Cook v. Tait* contrasted the unlimited power of the federal government to tax the worldwide income of citizens, with the more limited power of the states.²³⁹ *Lord Forbes* and *Frank*

235. Cf. William Thomas Worster, *The Constitutionality of the Taxation Consequences for Renouncing U.S. Citizenship*, 9 Fla. Tax Rev. 921, 977 (2010) (conflating state taxes on multistate corporations with limits on the federal taxing power).

236. See, e.g., Yoram Kienan, *The Case for Residency-Based Taxation of Financial Transactions in Developing Countries*, 9 Fla. Tax Rev. 1, 3 (2009) (citing 1923 League of Nations report).

237. *Shaffer v. Carter*, 252 U.S. 37 (1920); *Travis v. Yale & Towne Mfg. Co.*, 252 U.S. 60 (1920).

238. See, e.g., *United States v. Bennett*, 232 U.S. 299, 306 (1914) (tax could be imposed on a yacht that had never been located in the United States, but was owned by a citizen, in contrast to the power of a state). See also *License Tax Cases*, 5 Wall. 462, 471 (1866) ("very extensive power"). See generally, Arthur A. Ballantine, *Some Constitutional Aspects of the Excess Profits Tax*, 29 Yale L.J. 625 (1920) (one of the first and still the most complete analysis of constitutional limitations on income taxation).

239. *Cook v. Tait*, 265 U.S. 47 (1924). See Albert Levitt, *Income Tax Predicated Upon Citizenship—Cook v. Tait*, 11 Va. L. Rev. 607 (1924). See also for limitations on state taxation, *McCulloch v. Maryland*, 17 U.S. 316 (1819) (state could not tax Bank of the United States); *St. Louis v. Ferry Co.*, 78 U.S. 423 (1870) (city could not tax transient boats); *Dewey v. Des Moines*, 173 U.S. 193 (1899) (denying jurisdiction of a municipality to impose personal, as opposed to in rem, tax liability on nonresident owner of property). Cf. *The Apollon*, 22 U.S. 362 (1824) (which did involve federal jurisdiction to seize property within the jurisdiction of a foreign nation in payment of U.S. customs taxes and asserted that the "revenue jurisdiction" of the United States could not extend that far for collection purposes, but did not address subjecting foreign persons to tax); *Rose v. Himely*, 8 U.S. 241 (1808) (holding that it was beyond the law of nations to conduct an extraterritorial seizure for breach of municipal regulation). See also *Burnet v. Brooks*, 288 U.S. 378 (1933) (analyzing the jurisdictional reach of the estate tax).

W. Ross confirmed the statutory reach of the income tax to U.S. source dividends paid by a foreign corporation to a nonresident.²⁴⁰

The Supreme Court has said the federal taxing power is not limited by the due process clause except in cases of extreme arbitrariness.²⁴¹ In the 1920s the Supreme Court defended the discretion of Congress not to tax foreign corporations that bought or made goods here and sold them abroad on any or all of their incomes from the sales, against a claim of discrimination made by domestic corporations. The opinion cited a variety of reasons, mostly political, why Congress had the flexibility to make that choice; nowhere did the Court suggest that Congress could not constitutionally tax foreign corporations.²⁴²

The Tax Court rejected constitutional attacks on Subpart F on the grounds of the prior approval of the foreign personal holding company tax,²⁴³ and the authority for taxing one person on the income of another person has been upheld,²⁴⁴ as well as the doctrine of constructive receipt (being taxed on income not actually received).²⁴⁵ Courts cannot invalidate federal taxes due to suspicion about the motives of the Congress, absent extreme abuse of power.²⁴⁶

3. 1961 Concerns

At the request of the Senate Finance Committee the Joint Committee on Taxation prepared a memorandum entitled "Constitutional Power to Tax

240. *Frank W. Ross v. Comm'r*, 44 B.T.A. 1 (1941), nonacq. 1941-2 C.B. 23, vacated, 32 A.F.T.R. 1729, 43-2 U.S. Tax Cas. 9686 (4th Cir. 1943); *Lord Forres*, 25 B.T.A. 154 (1932), acq., 1932-1 C.B. 3.

241. *Billings v. United States*, 232 U.S. 261, 282 (1914); *Brushaber v. Union Pac. R.R. Co.*, 240 U.S. 1 (1916) (dictum excepting a tax so arbitrary that it is a confiscation of property).

242. *Barclay & Co., Inc. v. Edwards*, 267 U.S. 442 (1925) (distinguishing the different rules that applied to state taxation).

243. *Garlock, Inc. v. Comm'r*, 58 T.C. 423 (1972), aff'd, 489 F.2d 197 (2d Cir. 1973), cert. denied, 417 U.S. 911 (1974) (citing *Eder v. Comm'r*, 138 F.2d 27 (2d Cir. 1943) (which said the purpose was valid and the method reasonable)); *Whitlock v. Comm'r*, 59 T.C. 490, 506-10 (1972), aff'd in part and rev'd in part, 494 F.2d 1297 (10th Cir. 1974), cert. denied, 419 U.S. 839 (1974); discussed in Henry Ordower, *Revisiting Realization: Accretion Taxation, the Constitution, Macomber, and Mark to Market*, 13 Va. Tax Rev. 1, 21-24 (1993).

244. See, e.g., *Helvering v. Nat. Grocery Co.*, 304 U.S. 282 (1938); *Burnet v. Wells*, 289 U.S. 670 (1933). See also *Corliss v. Bowers*, 281 U.S. 376, 378 (1930) ("But taxation is not so much concerned with the refinements of title as it is with actual command over the property taxed—the actual benefit for which the tax is paid.").

245. See *Heiner v. Mellon*, 304 U.S. 271 (1938).

246. *McCray v. United States*, 195 U.S. 27 (1904).

Shareholders on Undistributed Income of a Corporation,” in connection with President Kennedy’s recommendations on tax revision.²⁴⁷ Signed by Colin F. Stam, Chief of Staff, the memo approached the issue from the viewpoint of historic corporation/shareholder income tax cases and the definition of income under the Sixteenth Amendment, rather than from the standpoint of the taxing power of Congress. The memo reasoned as follows:

- If a U.S. shareholder is to be taxed on the income of its corporation not received in the form of a distribution, the taxation must be based on deeming a dividend because the corporate entity is not disregarded except in cases of fraud or evasion.
- Taxing shareholders on the income of foreign personal holding companies is an example of such a case of evasion.
- Simply owning a foreign corporation (the example was 25 percent ownership) that operates a related business is not such an evasion as to fit within the exception.
- Relying on *Eisner v. Macomber* and *Pollock*, the memo stated that severance of the distribution from the corporate stock was required for taxation.
- Not only would there be no severance if the income of the foreign corporation were taxed to shareholders without distribution, but there would be no change in the corporate structure or shareholding at all, so the shareholder could not be treated as receiving a taxable stock dividend.
- Based on *Eisner v. Macomber*, a shareholder cannot be taxed due to the mere increase in value of the stock.
- The shareholders would not be in constructive receipt of income under normal principles.

These objections are no longer valid, if they ever were.²⁴⁸ They would prevent the S corporation regime, which had been enacted three years

247. President’s 1961 Tax Recommendations: Hearings Before H. Comm. on Ways & Means, 87th Cong., Vol. 1, 311-313 (1961) (memorandum of Staff of the Joint Committee on Taxation).

248. The signer was Colin F. Stam, long time Chief of Staff of the Joint Committee. Although highly esteemed, Stam was clearly the product of an earlier age and a more conservative approach to taxation. His service in the Bureau began in 1922, after which he moved on to the Committee in 1928. Although he obviously served while the Democrats controlled Congress (Chief of Staff from 1937-1964), he got his start in the Republican administrations. According to the Joint Committee website, his last professional association was with the Tax Foundation, a conservative tax think tank.

earlier.²⁴⁹ Although the S corporation might be distinguished because it is elective, the consolidated return regime similarly is elective but only in a limited sense because electing groups have agreed to be bound by any regulations adopted before the due date of the return,²⁵⁰ and the Commissioner must consent to revocation of the election.²⁵¹

The only constitutional objection in the analysis by the staff of the Joint Committee on Taxation (JCT) was based on *Eisner v. Macomber's* view of the definition of income.²⁵² That definition has been superceded by subsequent Supreme Court decisions.²⁵³ Furthermore, even if it still applied, the exigencies of potential evasion, when limited to foreign corporations controlled at the 80 percent level certainly align the current proposal more with the foreign personal holding company (which the JCT blessed), than with a 25 percent owned foreign corporation.

In response the Treasury submitted a more lengthy memorandum authored by Robert H. Knight finding that current taxation would be found valid under the taxing power and the power to regulate foreign commerce.²⁵⁴ The arguments included:

- If the inclusion were limited to the controlled foreign corporation definition, the U.S. shareholders would be part of a small group that could control the distribution of the corporation's income and thus qualify for constructive receipt treatment under traditional concepts.
- *Eisner v. Macomber* involved only stock dividends where there had been no increase in value of the corporation; it has subsequently been limited by the Supreme Court to the extent it seemed to require severance for taxation of income,²⁵⁵ and it did not involve constructive receipt.
- Even if constructive receipt alone were not enough to justify taxation, the addition of the factor of preventing avoidance of tax would be more than sufficient.²⁵⁶

249. Pub. L. No. 85-866, 72 Stat. 1606 (1958).

250. IRC § 1501.

251. Reg. § 1.1502-75(c).

252. *Eisner v. Macomber*, 252 U.S. 189 (1920).

253. See generally Cummings, *supra* note 77, at 47-54.

254. President's 1961 Tax Recommendations: Hearings Before H. Comm. on Ways & Means, 87th Cong., Vol. 1, 313-322 (1961).

255. Citing *Helvering v. Bruun*, 309 U.S. 461 (1940) (building tenant built on leasehold treated as income to landlord at end of lease).

256. Citing *Brushaber v. Union Pac. R.R. Co.*, 240 U.S. 1 (1915) for principle that due process will prevent arbitrary taxation in egregious cases, and *Hoepner v. Tax Comm'r*, 284 U.S. 206 (1931) for principle that one person may not be taxed on the income of another, but then citing *Corliss v. Bowers*, 281 U.S. 376

- Article 1, section 8, clause 3 of the Constitution authorizes Congress to regulate commerce with foreign nations. Because a major purpose of the proposed legislation is to encourage repatriation of income earned abroad, that objective is regulation of foreign commerce. The Treasury's extensive analysis of the commerce clause cites numerous Supreme Court opinions upholding the use of taxes in effecting commerce purposes.²⁵⁷

The Knight/Treasury memo is far more persuasive than the Stam/JCT memo. Because the proposal of this article would affect only foreign corporations 80 percent of whose vote and value is owned by a domestic consolidated group, there is ample support for treating the foreign corporation's income as currently constructively received by the group. In addition, removal of the barrier to repatriation of foreign earnings is a ground for reliance on the foreign commerce clause.

4. *International Norms*

Currently taxing the business income of 80 percent owned subsidiaries fits within international norms for taxation. According to the Third Restatement of the Foreign Relations Law of the United States, jurisdiction to tax normally must be based on either (a) a person's nationality (including domicile and residence), (b) a person's presence in the jurisdiction, or (c) a transaction's occurrence in the jurisdiction.²⁵⁸ However, the broader bases of jurisdiction to prescribe law include the jurisdiction to prescribe law with respect to "conduct outside its territory that has or is intended to have substantial effect within its territory."²⁵⁹ This is known as effects-based jurisdiction.²⁶⁰ Choosing to prescribe law on the basis of local economic effects is subject to considerations of reasonableness.²⁶¹

(1930) and other Supreme Court opinions for the principle that it is the control over the income that justifies income taxation.

257. See, e.g., *Sunshine Anthracite Coal Co. v. Adkins*, 310 U.S. 381 (1940); *United States v. Darby*, 312 U.S. 100 (1941); *Board of Trustees v. United States*, 289 U.S. 48 (1933). The same issues arise in the attacks on the 2010 Healthcare Affordability and Patient Protection Act. See Jennifer Staman, et al., Cong. Research Serv., R40725, *Requiring Individuals to Obtain Health Insurance: A Constitutional Analysis* (Oct. 15, 2010), reprinted at 2010 Tax Notes Today 201-23 (Oct. 15, 2010).

258. Restatement (Third) of Foreign Relations Law of the United States § 411 (ALI 1987).

259. *Id.* § 402.

260. See Michael S. Kirsch, *The Tax Code as Nationality Law*, 43 *Harv. J. on Legis.* 375, 391 (2006).

261. *Id.* § 403.

Others have written that there is no limitation other than the practical on taxing all U.S. shareholders of all foreign corporations on their shares of the corporations' incomes.²⁶² And taxation is not literally limited to source or residence because the United States taxes effectively connected income of nonresidents that is not U.S. sourced.²⁶³

D. Challenges of Full Consolidation

1. Disaffiliation

Assuming consolidation of foreign affiliates were required and not just permitted, the government will have to be concerned with evasive disaffiliations. Congress might choose to push down the percentage ownership required for affiliation in the case of foreign subsidiaries, as was proposed in the Rostenkowski-Gradison Bill in 1992, but this likely would introduce more complexity than it is worth.²⁶⁴ If the 80 percent test applies, then safeguards against mechanistic disaffiliation should be installed, and those safeguards arguably should be applied both in the domestic and foreign contexts under a renewed commitment to the purpose of the privilege of consolidation.

That purpose is to more clearly reflect income of a business enterprise conducted in multiple corporate forms. Carrying out that purpose means that the "direct ownership" test for affiliation must give way to attribution rules. Like other parts of the law addressed above, it is likely that the direct ownership test "just happened," although it may be explained on grounds of administrability, in hindsight. But it is too late in the day to hang onto any such shred of administrability in the morass of the consolidated return regulations, not to speak of section 482, Subpart F, and the tax credit regimes.

Section 1504(a) defines affiliation in terms of stock "owned directly," no constructive ownership rules appear in the code or regulations, and no constructive ownership rules apply to the determination of affiliation.²⁶⁵ However, the IRS and courts interpret the direct ownership test to mean beneficial ownership, so that nominal ownership without beneficial ownership doesn't count and lack of nominal ownership with beneficial

262. See Choate, Hurok & Klein, *supra* note 14, at 446-447 n.20; William W. Park, *Fiscal Jurisdiction and Accrual Basis Taxation: Lifting the Corporate Veil to Tax Foreign Company Profits*, 78 *Colum. L. Rev.* 1609, 1609 (1978) ("No rules of international law exist to limit the extent of any country's tax jurisdiction.") (quoting *Norr, Jurisdiction to Tax and International Income*, 17 *Tax L. Rev.* 431, 431 (1962)).

263. IRC § 864(c).

264. H.R. 5270, 102d Cong., (2d Sess. 1992).

265. Hennessey, et al., *The Consolidated Tax Return* ¶2.02[2] (2010).

ownership does count.²⁶⁶ At one time the courts applied a purposive interpretation of the control definition to aid in preventing manipulation of profits and income shifting,²⁶⁷ but that approach did not last. At the very least, section 1504 should be amended to include "indirectly" owned stock, and it might even be desirable to apply the section 318 attribution rules, if for no other reason than to prevent breaking affiliation by inserting into the chain of ownership a partnership wholly (or nearly wholly) owned by two or more corporate members of the group.

In addition to evasive disaffiliation or expatriation efforts of corporations mentioned above, other definitional difficulties would have to be addressed. The advent of hybrid entities that are treated as corporations under the laws of one country and disregarded or partnership under the laws of other countries would raise special problems.

2. *Other Objections*

While the proposal in this article would eliminate transfer pricing concerns within the newly defined affiliated group of includable corporations, traditional section 482 transfer pricing would continue to be applied to transactions between U.S. subsidiaries and their foreign parents and in other transactions involving unaffiliated corporations. Of course that distinction might be remedied by broadening this proposal to force foreign parent's to join their U.S. subsidiaries' consolidated groups. Aside from many practical objections to such a plan (often there are multiple U.S. consolidated groups), the consolidation of foreign parents does not share the same conceptual justification as the consolidation of foreign subs of U.S. parents: that the U.S. person owns the income of the foreign corporation, albeit indirectly.

Therefore U.S. parents would argue that they are prejudiced relative to the foreign owned U.S. corporations because they do not have the advantage of possibly getting a better result from transfer pricing than from the elimination of the need for transfer pricing. One answer to the argument is that it compares apples and oranges: the foreign subsidiaries of U.S. parents do not generally compete in the same markets with the U.S. subsidiaries of foreign parents. Another answer is that inability to solve all problems is no reason not to solve many problems. The apparent discrimination is just an extension of the discrimination between the way we

266. See Rev. Rul. 84-79, 1984-1 C.B. 190; *Miami National Bank v. Comm'r*, 67 T.C. 793 (1977). See also I.R.S. CCA 201044003 and I.R.S. CCA 200729035 (forcing cooperative to be in the consolidated group even though owned by partnerships).

267. See, e.g., *In re Temtor Corn & Fruit Prod. Co.*, 299 F. 326 (D. Mo. 1924), *aff'd*, *Schlafly v. United States*, 4 F.2d 195 (8th Cir. 1925).

tax U.S. and foreign persons. The long-standing choice to tax U.S. citizens and residents on their worldwide income makes the consolidation of foreign affiliates appropriate for a reason that is simply inapplicable to U.S. subs of foreign parents.

E. Territorial Taxation or Not

This article proposes ending deferral for consolidated foreign affiliates as an obvious concomitant of consolidation. However, if policy makers reject ending deferral they should still embrace the consolidation of foreign affiliates for the reasons described above and establish another method for determining the excludable foreign income that will better carry out the policies Congress intends than the current method based on one second best solution (section 482 transfer pricing) and the wholly artificial and manipulable fact of corporate chartering.

Prominent commentators have recommended broadly ending deferral of taxation of active income earned by controlled foreign corporations and imputing that income to U.S. shareholders without regard to whether corporate affiliation with a parent corporation existed.²⁶⁸ It is important to understand that the choice to consolidate foreign affiliates need not be a choice to tax foreign source income, whether earned by foreign corporations or not. Rather it allows that choice to be made in a consistent and rational matter, not dependent on the happenstance of the insertion of a corporate skin between the U.S. parent and the foreign subsidiary, and not dependent on the efficacy of section 482 transfer pricing.

Either in connection with a broader choice not to tax certain active foreign income whether earned by CFCs or directly by U.S. taxpayers, or simply for purposes of retaining the status quo of exempting such income earned by controlled foreign corporations, inclusion of foreign affiliates in consolidated returns could be linked with exclusion of foreign income.²⁶⁹ There are four leading candidates for a new method:

268. See, e.g., Peroni, Fleming & Shay, *Getting Serious*, supra note 1, at 477.

269. Cf. Dale Wickham & Charles J. Kerester, *New Directions Needed for Solutions of the International Transfer Tax Pricing Puzzle: Internationally Agreed Rules or Tax Warfare?*, 56 *Tax Notes* 339, 359 (Jul. 20, 1992) (not specifically recommending consolidation so much as replacing transfer pricing with identification of foreign source income under a revised, more substantive set of sourcing rules); Monica Brown Gianni, *Transfer Pricing and Formulary Apportionment*, 74 *Taxes* 169, 179 (1996) (reading the Wickham proposal to exclude foreign source income whether earned in a branch or a controlled foreign corporation).

- Global formulary apportionment;
- Current income sourcing rules;
- Revised, more substantive, income sourcing rules;
- Rules based on effectively connected income standards.

1. *Global Formulary Apportionment*

An often discussed alternative to using the existing income sourcing rules to identify non-taxable foreign income is some other apportionment or allocation methodology. These discussions usually begin with a description of the challenges of selecting a method of allocation and the problem of inconsistent allocation by different countries of the same income, with little attention to the threshold step of consolidating the unitary income.²⁷⁰

Most of the commentary has focused on global formulary apportionment. Indeed, the paucity of discussion of consolidating foreign affiliates likely is due in large part to the more heated discussions of formulary apportionment of worldwide income, which tend to assume but not focus on some sort of consolidated calculation of the income to be apportioned. The OECD Guidelines oppose global formulary apportionment because of the twin difficulties of preventing double taxation and insuring single taxation.²⁷¹

It is generally thought that global formulary apportionment would be based on facts such as those used by most states to apportion the income of a multistate corporation: sales, payroll, and property. However, those factors assume a unity of the business operated across state lines; that is why when states require consolidated reporting, they consolidate only the unitary affiliates that have certain business synergies. The argument has been made that since those synergies are not required for a federal consolidation of

270. See, e.g., Stanley Surrey, Reflections on the Allocation of Income and Expenses among National Tax Jurisdictions, 10 *Law & Pol'y Int'l Bus.* 409, 415 (1978); William Wilkins & Kenneth Gideon, Memorandum to Congress: You Wouldn't Like Worldwide Formula Apportionment, 94 *Tax Notes Today* 238-46 (Dec. 5, 1994).

271. OECD Transfer Pricing Guidelines Ch. III. § 1.30 (2010). See Hammer, Lowell & Levey, *International Transfer Pricing* ¶ 4.06; Culbertson, Durst & Bailey, *Transfer Pricing: OECD Transfer Pricing Rules and Guidelines*, BNA Portfolio 894-1st, IV.C. The OECD states: "By disregarding intra-group transactions for the purpose of computing consolidated profits, global formulary apportionment would raise questions about the relevance of imposing withholding taxes on cross-border payments between group members and would involve a rejection of a number of rules incorporated in bilateral tax treaties." OECD Guidelines § 1.30.

foreign affiliates based on control alone, the basis for using those factors breaks down.²⁷²

It is beyond the scope of this article to propose a viable plan for global formulary apportionment, but it seems fair to observe that such a plan is not likely to appear in the foreseeable future.²⁷³ Therefore, other methods that are built on existing domestic tax principles and that can be imposed unilaterally by the United States seem more viable options.

2. Sourcing Rules

The sourcing rules of sections 861-865 have a long history. Admittedly they were not developed for the purposes of ascertaining what income was to be taxed or excluded, except as to foreign persons in some cases, but they have been applied principally for an analogous purpose of determining the foreign tax credit, which effectively excludes foreign income from U.S. tax because the tax has been paid abroad.²⁷⁴

At first it might seem circular and fruitless to apply the sourcing rules to determine the foreign income of a consolidated group including foreign affiliates that Congress may choose to exempt in lieu of deferral: Wouldn't you have to apply section 482 to intra group transactions in order to insure that the sourcing of the gross income was proper in terms of the amount of the income foreign sourced? No. The consolidated return regulations have addressed this issue since the 1995 revision because it is comes up within consolidated groups that are wholly domestic.

The consolidated return matching rule proceeds as follows:

- Even though the amount and location of intercompany transactions tax items are determined on a separate entity basis, and the timing, character, source and other attributes of those transactions are initially determined on a separate entity basis, the latter group (including particularly source) are redetermined

272. Eric J. Coffill & Prentiss Willson, Jr., *Federal Formulary Apportionment as an Alternative to Arm's Length Pricing: From the Frying Pan to the Fire?*, 93 *Tax Notes Today* 113-54 (May 24, 1993). See also Martin Sullivan, *A Middle Path Between Arm's Length and Formulary Methods*, 126 *Tax Notes* 271 (Jan. 18, 2010) (quoting Walter Hellerstein and Peter Merrill as agreeing that formulary apportionment made sense only if the businesses were interdependent). See also Part II.D., *supra*.

273. See, e.g., Fleming, Peroni & Shay, *Worse than Exemption*, *supra* note 5, at 128 ("not a panacea"). But see Michael C. Durst, *It's Not Just Academic: The OECD Should Reevaluate Transfer Pricing Laws*, 57 *Tax Notes Int'l* 247 (Jan. 19, 2010) (optimistic about formulary apportionment).

274. See McDaniel, *supra* note 4, at 292.

- to produce the same result as if the two group members were divisions of a single corporation;²⁷⁵
- As a result of the application of single entity treatment to attributes like source, the activities of both parties to the intercompany transaction can affect the determination of source;²⁷⁶
 - If the buying member's item offsets the selling member's item in amount, then the buying member's attributes control the characterization of the selling member's item;²⁷⁷ the simplest example of offset is rent: the renter's deduction will offset the lessor's rental income in amount and the ordinary character of the renter's deduction will control the characterization of the lessor's income;
 - If the buying member's item does not offset the selling member's item in amount, then the attributes must be determined in a way that carries out the inter divisional approach of the regulations.

Regulation section 1.1502-13(c)(7)(ii), Ex. 14 is as follows:

Example (14). Source of income under section 863.

(a) Intercompany sale with no independent factory price. S manufactures inventory in the United States, and recognizes \$75 of income on sales to B in Year 1. B distributes the inventory in Country Y and recognizes \$25 of income on sales to X, also in Year 1. Title passes from S to B, and from B to X, in Country Y. There is no independent factory price (as defined in regulations under section 863) for the sale from S to B. Under the matching rule, S's \$75 intercompany income and B's \$25 corresponding income are taken into account in Year 1. In determining the source of income, S and B are treated as divisions of a single corporation, and section 863 applies as if \$100 of income were recognized from producing in the United States and selling in Country Y. Assume that applying the section 863 regulations on a single entity basis, \$50 is treated as foreign source income and \$50 as U.S. source income. Assume further that on a separate entity basis, S would have \$37.50 of foreign source income and \$37.50 of U.S. source income, and that all of B's

275. Reg. § 1.1502-13(a)(2).

276. Reg. § 1.1502-13(c)(1)(i).

277. Reg. § 1.1502-13(c)(4)(i)(A).

\$25 of income would be foreign source income. Thus, on a separate entity basis, S and B would have \$62.50 of combined foreign source income and \$37.50 of U.S. source income. Accordingly, under single entity treatment, \$12.50 that would be treated as foreign source income on a separate entity basis is redetermined to be U.S. source income. Under paragraph (c)(1)(i) of this section, attributes are redetermined only to the extent of the \$12.50 necessary to achieve the same effect as a single entity determination. Under paragraph (c)(4)(ii) of this section, the redetermined attribute must be allocated between S and B using a reasonable method. For example, it may be reasonable to recharacterize only S's foreign source income as U.S. source income because only S would have any U.S. source income on a separate entity basis. However, it may also be reasonable to allocate the redetermined attribute between S and B in proportion to their separate entity amounts of foreign source income (in a 3:2 ratio, so that \$7.50 of S's foreign source income is redetermined to be U.S. source and \$5 of B's foreign source income is redetermined to be U.S. source), provided the same method is applied to all similar transactions within the group.

[Comment: If B were a consolidated foreign affiliate, the result would be the same. The \$100 of net income earned by the group on the overall transaction ending in sale outside the group would produce \$50 foreign source income and \$50 U.S. source income.]

...

(c) Sale of property reflecting intercompany services or intangibles. S earns \$10 of income performing services in the United States for B. B capitalizes S's fees into the basis of property that it manufactures in the United States and sells to an unrelated person in Year 1 at a \$90 profit, with title passing in Country Y. Under the matching rule, S's \$10 income and B's \$90 income are taken into account in Year 1. In determining the source of income, S and B are treated as divisions of a single corporation, and section 863 applies as if \$100 were earned from manufacturing in the United States and selling in Country Y. Assume that on a single entity basis \$50 is treated as foreign source income and \$50 is treated as U.S. source income. Assume that on a separate entity basis, S would have \$10 of U.S. source income, and B

would have \$45 of foreign source income and \$45 of U.S. source income. Accordingly, under single entity treatment, \$5 of income that would be treated as U.S. source income on a separate entity basis is redetermined to be foreign source income. Under paragraph (c)(1)(i) of this section, attributes are redetermined only to the extent of the \$5 necessary to achieve the same effect as a single entity determination. Under paragraph (c)(4)(ii) of this section, the redetermined attribute must be allocated between S and B using a reasonable method. (If instead of performing services, S licensed an intangible to B and earned \$10 that would be treated as U.S. source income on a separate entity basis, the results would be the same.)

[Comment: Because the production activities are all in a foreign country, the source of the income of B would be entirely foreign under regulation 1.863-3(c)(1)(i)(A). Under single entity treatment presumably the result would be the same and so S's \$10 of income would be foreign sourced.]

Just as this interdivisional regime solves the transfer pricing problem as to sourcing income, as between domestic affiliates, it can be applied to do the same as to foreign affiliates. Aside from this example, there has been no published guidance on "transactions involving intercompany royalty payments, interest, or services not required to be capitalized."²⁷⁸ No doubt the regulation would have to be fleshed out to more fully address the cases that would arise.

The Treasury Decision publishing the regulation explained that a redetermination is made only to the extent it is necessary to achieve the effect of treating two group members as divisions of a single corporation and that redetermined attributes are allocated to the members using a method that is reasonable in light of the purposes of regulation section 1.1502-13 and any other affected rule.²⁷⁹ The regulation rejects a pro rata approach as possibly violating treaties and stated that it did not find the final regulation to violate treaties as to sourcing.

If the proposal of this article and the interdivisional regime described above were adopted for consolidated groups only, it might create such disparate treatment for branch versus incorporated foreign operations of consolidated groups that the foreign sourced exemption rule might have to be applied to all consolidated taxpayers' foreign operations.

278. See Hennessey, et al., *supra* note 265, at ¶ 6.02[2][c]; Dubroff et al., *supra* note 10, at ¶ 43.02[2].

279. T.D. 8597 (July 12, 1995). See LTR 200048034.

3. *More Substantive Sourcing Rules*

The income sourcing rules of sections 861-865 are highly mechanistic and recommendations for more substantive rules are common.²⁸⁰ A specific example, of long standing, that would be called into question by the consolidation of foreign affiliates is the 50/50 profit split rule for manufacturing.²⁸¹ Because the sourcing rules are the cumulative result of numerous political compromises, modifying them to be usable to define exempt foreign income might be either a golden opportunity for reform or more trouble than it is worth.

4. *Effectively Connected Income*

A fourth method for identifying the foreign income that Congress might choose to exclude or defer tax on could rely on the current rules for determining effectively connected income, which are largely built on the sourcing rules, under section 864(c).

F. Other Design and Transition Issues; Foreign Corporations in the Consolidated Group

Consolidated returns already accommodate inclusion of a variety of unusual corporations.²⁸² Discussed below are some of the unusual cases most similar to the group of foreign affiliates at which this proposal is aimed. The first issue is whether to deem the affiliate domestic.

1. *Domestic or Includable Foreign Corporation?*

Foreign corporations otherwise eligible to be includable affiliates could be made includable either by treating them as domestic or by repealing section 1504(b)(3) and allowing foreign corporations to join the consolidated return. Section 1504(d) treats electing contiguous country corporations as domestic, but that method no doubt was chosen because the basic exclusion for foreign corporations is the general rule. If all otherwise affiliated foreign corporation were to be includable, that reason would not apply and the

280. See, e.g., Wickham and Kerester, *supra* note 269, at 359 (recommending identification of foreign source income under a revised, more substantive set of sourcing rules).

281. Reg. § 1.863-3(b)(1)(i).

282. See, e.g., Reg. § 1.1502-100 (exempt corporations can form a consolidated group); I.R.S. CCA 201044003 and I.R.S. CCA 200729035 (forcing cooperative to be in the consolidated group).

choice between domestication and including them as foreign corporations could be made on the basis of other factors.

There are two principal factors that dictate treating the foreign members as domestic, or at least as both foreign and domestic: the dual consolidated loss rules and tax treaties. The dual consolidated loss rules under section 1503(d) attempt to prevent the losses of a dual incorporated corporation (and a single incorporated domestic corporation with a foreign branch in most cases) from being used to offset income of other entities.²⁸³ By definition, inclusion of foreign corporations in the consolidated return would potentially allow their losses to offset the income of other corporations. Therefore, in order for the DCL rules to apply properly, the simplest approach is to treat the foreign affiliate as a dual incorporated corporation.

Paragraph 1 of Article 4 of the United States Model Income Tax Convention of November 15, 2006 states that resident means any person that is liable for tax in the state by reason of a variety of criteria; certainly inclusion in a consolidated return would qualify. Therefore, under paragraph 4 of that Article the corporation would be a dual resident and specific agreements apply, which should apply to includable foreign corporations. The Model Treaty also has a tie breaker rule that assigns the residence for treaty benefit purposes to the country of incorporation. Thus the foreign affiliate would be entitled to treaty benefits as a foreign resident as to dealings with non-group members.²⁸⁴

2. *Inclusion Alternatives upon Domestication*

Assuming the foreign affiliate will be treated as domestic, the major choices for treatment of the accumulated untaxed earnings and profits include:

- Immediate inclusion/credits: If the all earnings and profits toll charge were applied to the inclusion of the foreign affiliates under the proposal of this article, then deemed paid foreign tax credits also should be available. But to the extent the earnings and profits have been earned in relatively low tax jurisdictions, taxable earnings and profits could remain.

283. The 1992-Rostenkowski-Gradison bill specifically addressed dual consolidated losses of foreign corporations joining the affiliated group. See Staff of Joint Comm. on Tax'n, 102d Cong., Explanation of H.R. 5270, Title II.2. (Joint Comm. Print 1992), reprinted at 92 Tax Notes Today 113-2 (May 29, 1992).

284. For problems of corporations claiming benefits as both domestic and foreign, see I.R.S. TAM 200509023 (Nov. 17, 2004).

- Four-year inclusion: When Congress considered a similar proposal in 1992, it proposed inclusion of the prior earnings and profits over four years; alternately the prior earnings could simply be taxed when paid as dividends, with credits claimed then.²⁸⁵
- Forgive: Congress could choose to forgive taxation of that portion of the all earnings and profits amount as an offset to the forced inclusion of the foreign affiliates. It would be akin to the repatriation benefit in section 965. Previously earned foreign tax credits would be eliminated.²⁸⁶
- Forgive and reduce asset basis or some other positive tax attribute.
- Forgive if the group took some specified action.

3. Compare Other Consolidated Foreign Corporations

a. Section 1504(d)

Section 1504(d) allows certain contiguous country foreign corporations to join in the consolidated return.²⁸⁷ This provision is quite old, being adopted as section 141(h) in 1928. A variety of benefits can flow from consolidation of such corporations including most importantly the ability to deduct the foreign corporation's losses (subject to section 1503(d)), the deferral of intercompany gain on sales to the foreign affiliate, and elimination of dividends.²⁸⁸ The group must own all of the stock and the countries are limited to Canada and Mexico. The use of a foreign corporation must be required by foreign law and the IRS has been stingy in applying this definition.²⁸⁹

285. See Oosterhuis & Cutrone, *supra* note 214, at 766.

286. See Peroni, Fleming & Shay, *Getting Serious*, *supra* note 1, at 520-521 (proposing forgiving taxation of the accumulated earnings and profits and citing as a similar case the transition from the DISC to the FSC in 1984; alternately basis in depreciable assets could be reduced in lieu of income inclusion); see *id.* at 521-523 (evaluating policy bases of various transition relief options).

287. See Jack L. Kramer & G. Fred Streuling, *Inclusion of a Foreign Subsidiary in a Consolidated Return Produces Both Benefits and Pitfalls*, 55 *Taxes* 100 (1977); Kuntz & Peroni, *U.S. International Taxation* ¶ B2.05[2][a] (2010).

288. Kramer and Streuling, *supra* note 287, at 107-108.

289. See Rev. Rul. 69-182, 1969-1 C.B. 218 (Mexico prohibited foreign corporation to advertise or take title to property); Rev. Rul. 70-379, 1970-2 C.B. 179 (similar), revoked by Rev. Rul. 2001-39, 2001-2 C.B. 125; Rev. Rul. 71-523, 1971-2 C.B. 326 (need to obtain Canadian grant insufficient reason); I.R.S. Gen. Couns. Mem. 38,119 (Oct. 1, 1979) (approving a strict interpretation); *Kohler Co. v. United*

The treatment of these contiguous country cases is instructive of how a transition to the proposal of this article might occur. The IRS originally treated them in letter rulings as inbound section 368(a)(1)(D) nondivisive reorganizations in which no gain or loss is recognized.²⁹⁰ However, the U.S. parent had to represent:

International agrees to include in its gross income as a dividend deemed paid in money for the taxable year in which the section 1504(d) of the Code election occurs all of the accumulated earnings and profits, if any, of Services for all the taxable years of such corporation, subject to the following tax credit provisions (section 78, and 901-905 of the Code).²⁹¹

Now regulation section 1.367(b)-2(i) treats the section 1504(d) election as an inbound reorganization under section 368(a)(1)(F), unless made at the creation of the foreign subsidiary. As an F reorganization, the domestic parent is required to include all of the foreign corporations accumulated earnings and profits under regulation section 1.367(b)-3.²⁹²

b. Foreign Insurance Companies

Section 953(d) allows certain foreign insurance companies to elect to be treated as domestic. The regulations contemplate that such a corporation may be the common parent of a consolidated group.²⁹³

c. Dual Incorporated Corporations

Dual incorporated corporations may join a consolidated group and are subject to special limits on dual consolidated losses in section 1503(d), which largely negate the ability of the foreign corporation to offset its losses against the income of other members of the consolidated group. If foreign affiliates were made includible by being deemed domestic, then they would be dual incorporated and the DCL rules would apply

States, 124 F.3d 1451 (Fed. Cir. 1997) (rejecting taxpayer's claim that Canadian incorporation was required).

290. See, e.g., I.R.S. Priv. Ltr. Rul. 7721018 (Feb. 24, 1977); I.R.S. Priv. Ltr. Rul. 7822009 (Mar. 1, 1978).

291. I.R.S. Priv. Ltr. Rul. 7721018 (Feb. 24, 1977).

292. See, e.g., I.R.S. Priv. Ltr. Rul. 200803005 (Jan. 18, 2008) (not involving § 1504(d)). See Hennessey, et al., *supra* note 265 at 2.03[2][c][ii] and [iii].

293. Reg. § 1.1502-77(j)(1) (may require designation of another member to perform functions).

d. Stapled Foreign Corporations

Section 263B governs two corporations whose stock is "stapled." Notice 89-94 provided that even though a foreign corporation stapled to a domestic corporation will be treated as domestic, it cannot join in a consolidated return.²⁹⁴

e. Expatriated Corporations

Section 7874(b) treats certain inverted corporations as domestic corporations.²⁹⁵ The regulations contemplate that such a corporation may be the common parent of a consolidated group.²⁹⁶

V. CONCLUSION

Section 482 transfer pricing rules as applied to cross border transactions are the most important tax issue to multinational corporations.²⁹⁷ The reason surely lies in the potential found there for tax reduction (usually referred to as reducing the worldwide effective tax rate) by those corporations. Much of the heat and light surrounding transfer pricing for U.S. owners of foreign corporations could be eliminated by consolidating the foreign affiliates of domestic parents, whether or not Congress chose to tax currently (or ever) foreign source active business income earned in branches or in foreign corporations.

At least the merits of this alternative should be considered by decision makers, rather than continuing with the current regime that just happened, is built on the skimpiest of formalities, and requires use of a second-best solution to transfer pricing abuses between affiliates.

294. Notice 89-94, 1989-2 C.B. 416. This was modified but not as to exclusion from the consolidated return. Notice 2003-50, 2003-2 C.B. 295.

295. See Cummings and Hanson, American Jobs Creation Act of 2004 ¶ 4.13 (2005).

296. Reg. § 1.1502-77(j)(1) (may require designation of another member to perform functions).

297. See Ernst & Young, 2007-2008 Global Transfer Pricing Survey (2007), reprinted at 2008 WTD 26-17 (Dec. 1, 2007); Transfer Pricing Is the Top Issue in North American Client Service Poll, Int'l Tax Rev., Mar. 2008, at 17.