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Service Discretion and Burden of Proof in International Tax Cases Involving Section 482

Robert A. Voorhis

SERVICE DISCRETION AND BURDEN OF PROOF IN INTERNATIONAL TAX CASES INVOLVING SECTION 482*

Section 482 of the Internal Revenue Code allows the Internal Revenue Service to "distribute, apportion, or allocate" the "gross income, deductions, credits, or allowances" of organizations under common control between such organizations, whenever necessary "to prevent evasion of taxes or clearly to reflect the income" of any of these organizations.[1] Congress adopted section 482 and its predecessors primarily to deal with cases involving United States corporations and their overseas affiliates,[2] and this has remained the

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1. In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any such organizations, trades, or businesses.

I.R.C. § 482 (1976).

For summaries in English of laws in 15 other countries that resemble section 482, see Andersson, *Finland,* 56b CAHIERS DE DROIT FISCAL INTERNATIONAL II/175, II/175-83 (1971); Bechinie, *Austria, id.* at II/87, II/95-96; Brown, *Canada, id.* at II/97, II/125-26; Casas, *Mexico, id.* at II/243, II/243-49; Cocco, *Italy, id.* at II/227, II/239; Davidson, *United Kingdom, id.* at II/293, II/309; Dequesne, *France, id.* at II/187, II/202-03; Lodin, *Sweden, id.* at II/313, II/326-27; Lopéz, *Argentina, id.* at II/51, II/80-81; Maria de Lourdes Correia e Vale, *Portugal, id.* at II/271, II/287-88; Neeman, *Israel, id.* at II/207, II/222-23; Oberson, *Switzerland, id.* at II/333, II/346; Spierdijk, *Netherlands, id.* at II/251, II/267-68; Strobl, *Germany, id.* at II/1, II/45-49; Valdes de Murúa, *Spain, id.* at II/131, II/142. For a comparison of French and United States law on the taxation of intercompany transfers, see Sokol, *French Taxation of Inter-Company Transfer Agreements: Article 57 v. Section 482,* 12 INT'L LAW. 639 (1978). For United Nations discussion of the taxation of multinational corporations, *see* U.N. DEP'T OF ECONOMIC AND SOCIAL AFFAIRS, THE IMPACT OF MULTINATIONAL CORPORATIONS ON DEVELOPMENT AND ON INTERNATIONAL RELATIONS 88-94 (1974); U.N. DEP'T OF ECONOMIC AND SOCIAL AFFAIRS, MULTINATIONAL CORPORATIONS IN WORLD DEVELOPMENT 66-70 (1973).

2. The earliest direct predecessor of section 482 is section 240(d) of the Revenue Act of 1921, ch. 136, 42 Stat. 227, 260 (1921). Congress intended section 240(d) of the 1921 Act to apply primarily to the foreign subsidiaries of United States corporations. S. REP. No. 275, 6th Cong., 1st Sess. 20 (1921). *See* Hammer, Morrione & Ryan, *Concepts and Techniques in Determining the Reasonableness of Intercompany Pricing Between United States Corporations and Their Overseas Subsidiaries,* 30 INST. ON FED. TAX'N 1407, 1409 (1972) ("The statute is aimed particularly at non-arm's-length intercompany prices which have the effect of shifting profit from a U.S. taxpayer to a foreign affiliate outside the taxing jurisdiction of the United States.")

section's principal purpose.[3] In the early 1960s, after hundreds of United States corporations had established tax haven corporations overseas,[4] the Service began to apply section 482 vigorously to international transactions.[5] Today, many, if not most, large United States corporations with foreign affiliates can expect the Service to allocate income under section 482 at some time.[6]

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3. In 1966, an Assistant Secretary of the Treasury wrote that section 482's current importance "is almost entirely in terms of its application to the foreign income field." Surrey, *The United States Tax System and International Tax Relationships—Current Developments, 1965-1966,* in TAXATION OF FOREIGN INCOME 256, 282 (1966). *See also* Eustice, *Tax Problems Arising From Transactions Between Affiliated or Controlled Corporations,* 23 TAX L. REV. 451, 482 (1968) ("The major recent developments under section 482, both judicial and administrative, have been concerned with the treatment of transactions between domestic and foreign affiliates, for it is here that the tax stakes (and the consequent possibilities for abuse) loom largest."); Plumb & Kapp, *Reallocation of Income and Deductions Under Section 482,* 41 TAXES 809, 820 (1963) ("It is in the area of intercompany pricing of products, on an international stage, that Section 482 is destined to play its next, and perhaps most significant, role.")

4. M. DUERR, TAX ALLOCATIONS AND INTERNATIONAL BUSINESS 4 (Conference Board Report No. 555, 1972).

5. Bischel, *Tax Allocations Concerning Inter-Company Pricing Transactions in Foreign Operations: A Reappraisal,* 13 VA. J. INT'L L. 490, 492 & n.14 (1973); Hilinski, *Some Thoughts on Section 482,* in TAXATION OF FOREIGN INCOME 147, 148 (1966); Plumb & Kapp, *supra* note 3, at 820; Rothkopf, *Section 482 in Perspective: A Review of the Proposed Regulations,* 44 TAXES 727, 728 (1966); Thrower, *Recent developments in international tax administration and enforcement,* 1 TAX ADVISOR 479, 482 (1970); Comment, *I.R.C. § 482 and Intercompany Pricing: A Post 1968 Overview for the International Practitioner,* 8 TEX. INT'L L.J. 219, 219-20 (1973).

In 1958, Commerce Clearing House editors reported that "[t]he provisions of Sec. 482, though sparingly applied in the past, become increasingly important when tax-saving methods become the target of scrutiny, as they are at present." [1958] 3 STAND. FED. TAX REP. (CCH) ¶ 2993.01, at 32,169. As late as 1960, however, Prentice-Hall editors noted that "[a]lthough provisions corresponding to Sec. 482 have been in the law since the 1921 Act, application has been limited and litigated cases have been few." [1960] 1 FED. TAXES (P-H) ¶ 6900.

For information concerning the Service's program for auditing transactions between United States corporations and their foreign subsidiaries, see 1 INTERNAL REVENUE MANUAL—AUDIT (CCH) ch. 4233 [510] to [522], at 7281-57 to -59 (Aug., 1981), 4233 [523] to [500-12], at 7281-61 to 7283-75 (May, 1981); 2 INTERNAL REVENUE MANUAL—AUDIT (CCH) ch. 428(11) [42(10)0] to [42(10)1.5], at 7319 to 7319-2 (Dec., 1981); Bacon, *Compliance Problems in Taxation of International Operations,* in TAXATION OF FOREIGN INCOME 160, 160-61 (1966); Thrower, *supra.*

For background information on The Office of International Operations, see INTERNAL REVENUE MANUAL—AUDIT (CCH) ch. 42(10)(10).4, at 7319-9 (Dec., 1981); 2 R. RHOADES & M. LANGER, INCOME TAXATION OF FOREIGN RELATED TRANSACTIONS (MB) § 8.01-.06 (1971, 1981 printing).

6. A recent study of 62 major United States corporations doing business abroad found that over half had had section 482 allocations between 1965 and 1977. Burns, *How IRS applies the intercompany pricing rules of Section 482: A Corporate Survey,* 52 J. TAX'N 308, 311 (1980). Three other corporations did not participate in the survey, because they were currently undergoing section 482 allocations. *Id.* at 308. An earlier study of 512 companies found that over half had had section 482 alocations relating to international operations during the 1960s. M. DUERR, *supra* note 4, at 6. A Treasury Department study reported that, in calendar years 1968 to 1969, the Service's examining agents considered making 871 section 482 allocations and actually proposed 458 allocations—allocations that aggregated $662 million. [1973] 7 STAND. FED. TAX REP. (CCH)

Congress worded section 482 quite generally. Courts have interpreted this section to provide the Service with considerable discretion in making allocations and to allow taxpayers to overturn the Service's allocations only if the taxpayer can prove the allocation was arbitrary, capricious, or unreasonable.[7] Past regulations accompanying section 482 furnished little substantive guidance, requiring only that the allocation reflect a general arm's length standard.[8] Corporations involved in international business complained that this generality made it difficult to plan the business of their foreign affiliates.[9] The Treasury Department responded by issuing detailed regulations that provided standards to govern allocations under section 482.[10]

The current regulation provides that "[t]he standard to be applied in every case is that of an uncontrolled taxpayer dealing at

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¶ 6419, at 71,195, 71,196, 71,203, 71,205 [hereinafter cited as Treasury Dep't Study] (reprinting U.S. Department of the Treasury, News Release (Jan. 8, 1973), *also reprinted in* 2 R. RHOADES & M. LANGER, *supra* note 5, ch. 7 app. at 7-89, 7-93, 7-108, 7-110).

The study collected much more information than the Treasury Department has released to the public. For example, the study: 1). classified by country the adjustments made; 2). accumulated data for treaty and nontreaty countries; 3). had separate data for Puerto Rican and Western Hemisphere countries; and 4). provided information on the sources of the unrelated comparable pricing data the Service used in making allocations. Kauder, *International Allocations of Income: Problems of Administration and Compliance,* 9 J. INT'L L. & ECON. 1, 23 (1974). Kauder adds, "Treasury has not stated why the additional material has not been published." *Id.*

7. *See infra* note 146 and accompanying text.

8. *See infra* note 126.

9. Rothkopf, *supra* note 5, at 728; *see* Hilsinki, *supra* note 5, at 148; Stewart, *Compliance Problems with Emphasis on Office of International Operations Coverage,* in TAXATION OF FOREIGN INCOME 175, 183-84 (1966).

10. *See infra* notes 130-40 and accompanying text. For general discussions of the regulation's provisions, see Eustice, *Affiliated Corporations Revisited: Recent Developments Under Sections 482 and 367,* 24 TAX L. REV. 101, 101-13 (1968); Hammer, *Section 482—Apportionment and Allocation Guidelines,* 26 INST. ON FED. TAX'N 693 (1968); Holzman, *What are the limits on the Commissioner's power to reallocate income, etc. under Section 482?,* 12 TAX'N FOR ACCT. 350 (1974); Jenks, *Treasury Regulations under Section 482,* 23 TAX LAW. 279 (1970).

During the preparation of the regulation and soon after its release, senior Service officials explained how the Service planned to administer the regulation. *See* Cohen, *How the IRS Intends to Administer the New Regulations Under Section 482,* 28 J. TAX'N 73 (1968); Cohen, *Administration of the Section 482 Regulations,* 19 TAX EXECUTIVE 233 (1967); Rothkopf, *supra* note 5; Surrey, *Treasury's Need to Curb Tax Avoidance in Foreign Business Through Use of 482,* 28 J. TAX'N 75 (1968); *see also* [1968] 7 STAND. FED. TAX REP. (CCH) ¶ 6740 (reprinting U.S. Treasury Department, Release F-1217 (April 16, 1968)) (Service policy in enforcing the regulation); [1966] 7 STAND. FED. TAX REP. (CCH) ¶ 6685 (reprinting U.S. Treasury Department, Release (Aug. 2, 1966)) (Service policy in enforcing the 1966 proposed regulation). Sheldon S. Cohen was then the Commissioner of the Internal Revenue Service. Stanley S. Surrey was then the Assistant Treasury Secretary for Tax Policy. Arthur J. Rothkopf was then the Treasury Department's Associate Tax Legislative Counsel (International).

In the early 1970s, the Treasury Department indicated that it was considering a major revision of the regulation. Aland, *Section 482: 1971 Version,* 49 TAXES 815, 827-28 (1971); Kauder, *supra* note 6, at 27. Nevertheless, no revision has been forthcoming.

arm's length with another uncontrolled taxpayer."[11] The current regulation, however, also provides detailed methods for deriving arm's length prices for five major categories of intercompany transfers: loans or advances,[12] services,[13] use of tangible property,[14] transfers or use of intangible property,[15] and sales of tangible property.[16]

The regulation bases all section 482 allocations on the prices used in transactions between unrelated parties that are most similar to the transaction under examination. Often, however, there are no transactions closely resembling the one under audit.[17] For example, the taxpayer may dominate a particular market, or may sell a unique product. When there are no similar transactions between unrelated parties under comparable market conditions, determining what a taxpayer would have earned is a speculative endeavor, and estimates can vary widely.[18]

Section 482 allocations between foreign and domestic affiliates are often quite large and frequently involve millions of dollars.[19]

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11. Treas. Reg. § 1.482-1(b)(1), T.D. 6595, 1962-1 C.B. 43, 50. The regulation defines the " 'true taxable income' " of a controlled taxpayer as the taxable income the controlled taxpayer would have received had it "dealt with the other member or members of the group [of controlled taxpayers] at arm's length." *Id.* § 1.482-1(a)(6), T.D. 6595, 1962-1 C.B. 43, 50. The regulation provides that the Service may allocate income to reflect an arm's length price even when the taxpayer has unintentionally failed to apply an arm's length price. *Id.* § 1.482-1(c), T.D. 6595, 1962-1 C.B. 43, 51.

12. *Id.* § 1.482-2(a), T.D. 6952, 1968-1 C.B. 218, 223-24, *amended by* T.D. 7394, 1976-1 C.B. 135, 135-36.

13. *Id.* § 1.482-2(b), T.D. 6952, 1968-1 C.B. 218, 224-28, *amended by* T.D. 6998, 1969-1 C.B. 144, 144-47.

14. *Id.* § 1.482-2(c), T.D. 6952, 1968-1 C.B. 218, 228-30.

15. *Id.* § 482-2(d), T.D. 6952, 1968-1 C.B. 218, 230-34, *amended by* T.D. 6964, 1968-2 C.B. 203, 203.

16. *Id.* § 1.482-2(e), T.D. 6952, 1968-1 C.B. 218, 234-42, *amended by* T.D. 7170, 1972-1 C.B. 178, 179. The regulation does not claim that these five categories cover all types of intercompany business transactions. *See id.* § 1.482-1(d)(1), T.D. 6952, 1968-1 C.B. 218, 219-23.

17. M. DUERR, *supra* note 4, at 12-16; Aland, *supra* note 10, at 819; Eustice, *supra* note 3, at 514; Kauder, *supra* note 6, at 25; Mihaly, *Intercompany Pricing, Offset Adjustments and Constructive Dividends Resulting From Section 482 Adjustments,* 25 MAJOR TAX PLAN. 731, 746, 749 (1973); Note, *Multinational Corporations and Income Allocation Under Section 482 of the Internal Revenue Code,* 89 HARV. L. REV. 1202, 1220-21 (1976).

18. In the case that this Note examines later, for example, the Second Circuit noted that the Commissioner's allocation had been $52 million, while the Tax Court's had been $27 million. United States Steel Corp. v. Commissioner, 617 F.2d 942, 951 n.11 (2d Cir. 1980).

Duerr describes a number of instances in which corporations, by supplying additional information, persuaded Service agents to drop proposed allocations. M. DUERR, *supra* note 4, at 14-20. Kauder notes that "nothing like" the Service agents' $662 million in proposed allocations in 1968-69, *see supra* note 6, survived later review. Kauder, *supra* note 6, at 21.

19. A recent study of Fortune 500 corporations reported that the Service's proposed assessments averaged nearly one million dollars for the responding corporations that experienced section 482 allocations from 1966 to 1976. Burns, *supra* note 6, at 311.

These allocations can also have many side effects on the domestic corporation's taxes far beyond the allocation itself.[20] A subsidiary might lose its status as a Western Hemisphere Trade Corporation, for example, or the parent might become classified as a personal holding company.[21] Moreover, an allocation often subjects the foreign affiliate's income to taxation both in the United States and abroad.[22]

Unfortunately, with respect to sales of tangible property, the Service often fails to follow the regulation's prescribed methods for allocating income under section 482,[23] and sometimes acts heavy-

20. For a discussion of the collateral tax effects of section 482 allocations, see Aland, *supra* note 10, at 833-38; Bischel, *supra* note 5 at 504-09; Eustice, *supra* note 3, at 518-24; Seieroe & Gerber, *Section 482—Still Growing at the Age of 50,* 46 TAXES 893, 904-07 (1968); Comment, *supra* note 5, at 241-43. For a description of the adverse effects on business operations, see M. DUERR, *supra* note 4, at 56-63.

21. *See* Aland, *supra* note 10, at 837.

22. A recent study reports that section 482 allocations caused responding companies to pay taxes on the same income both to the United States and to a foreign country in 52% of the cases involving allocations for intercompany export sales. Burns, *supra* note 6, at 312. These companies were unable to obtain refunds, because either the foreign government disagreed with the allocation, the statute of limitations had elapsed, the foreign government had no procedure for refund claims, or applying for a refund claim would have been too costly. *Id. See also* M. DUERR, *supra* note 4, at 61-62 (approximately 47% of the responding companies experiencing allocations reported that the allocations resulted in international double taxation).

The Treasury Department has established a procedure for obtaining refunds from foreign governments with which the United States has an income tax treaty. Rev. Proc. 70-18, 1970-2 C.B. 493. Nevertheless, the procedure presents difficulties, *see* Bischel, *supra* note 5, at 504, and companies rarely take advantage of the procedure. Burns, *supra* note 6, at 312. For taxable years beginning before January 1, 1963, the Treasury Department has allowed companies an offset against their United States taxes to the extent a section 482 allocation caused double taxation. Rev. Proc. 64-54, 1962-2 C.B. 1008. *Cf.* Rev. Proc. 72-22, 1972-1 C.B. 747 (extending the offset of Revenue Procedure 64-54 to United States taxpayers controlled by foreign corporations). Finally, the Treasury Department allows a taxpayer that has experienced a section 482 allocation to treat dividends from its foreign affiliate as a payment toward the allocation, Rev. Proc. 65-17, 1965-1 C.B. 833, if fraud was not responsible for the necessity of an allocation. Rev. Proc. 65-17, amendment I, 1966-2 C.B. 1211. For other minor provisions granting relief, see Comment, *supra* note 5, at 243 n.174.

23. *See infra* notes 141-45 and accompanying text. Treasury Regulation § 1.482-2(e) requires the Service to apply one of three described methods if data on comparable transactions are available. *See supra* notes 36-44 and accompanying text. The following chart presents the findings of three major studies on the frequency with which the Service uses these methods in making section 482 allocations.

	Study		
Method Employed	Treasury Dep't	Burns	Duerr
Comparable Uncontrolled Price	20.7%	24%	28%
Resale Price	10.9%	14%	13%
Cost-Plus	27.6%	30%	23%
Other	40.8%	32%	36%

Treasury Dep't Study, *supra* note 6, at 71,198, 71,207, *reprinted in* 2 RHOADES & M. LANGER, *supra* note 5, ch. 7 app., at 7-89, 7-100, 7-112; Burns, *supra* note 6, at 309; M. DUERR, *supra* note 4, at 12-13.

handedly toward taxpayers.[24] Taxpayers, however, must overcome a difficult burden of production to overturn a section 482 allocation, so often even these Service allocations prevail. By not following the regulation, the Service undermines the protections the regulation is designed to promote. Particularly when no directly comparable transaction exists, taxpayers find themselves vulnerable to potentially large allocations, based on a speculative ad hoc method, with consequent losses of special tax status and double taxation of foreign income.

Two recent cases have addressed the problem of how the regulation should be interpreted to limit the Service's discretion in allocating under section 482. In *E.I. Du Pont de Nemours & Co. v. United States,*[25] the Court of Claims interpreted the regulation to more freely allow the Service to allocate income under section 482 based on ad hoc methods, and required the taxpayer to overcome a very difficult burden of production. In *United States Steel Corp. v. Commissioner,*[26] the Second Circuit imposed a burden of production that was much easier to overcome than courts previously had required.

Many commentators have advocated modifying or repealing that part of section 482's regulation that concerns sales of tangible property.[27] The Treasury Department, however, does not appear

24. *See infra* note 145 and accompanying text.

25. 608 F.2d 445 (Ct. Cl. 1979), *cert. denied,* 445 U.S. 962 (1980).

26. 617 F.2d 942 (2d Cir. 1980).

27. Some commentators have recommended that the regulation include safe haven rules for splitting profits with intercompany prices. *See, e.g.,* Bischel, *supra* note 5, at 511 & n.116; Hammer, Morrione & Ryan, *supra* note 2, at 1437-39; Kauder, *supra* note 6, at 29-30.

The American Bar Association has drafted two proposals for safe haven rules on intercompany pricing. One proposal is for related distributors and manufacturers, and allocates the related companies' total income according to a formula using the manufacturing and marketing costs. W. GIFFORD, INTERNATIONAL TAX PLANNING 157, 157-58 (1974) (reprinting American Bar Association Draft Proposed Text—Safe Haven from Profit Split). The other proposal also concerns related distributors and manufacturers, but sets up a formula using average industry markups. W. GIFFORD, *supra,* at 158, 158-60 (reprinting American Bar Association Draft Proposed Text—Safe Haven from Manufacturer's Cost).

Some commentators have called for generally simpler regulatory guidance for the taxpayer who must set intercompany prices. Cole, *U.S.A.: Progress Report on Taxation of Foreign Source Income,* 26 BULL. FOR INT'L FISCAL DOCUMENTATION 54, 55, 57-58 (1972).

Others would prohibit the Service from allocating income under section 482 as long as the taxpayer comes within the bounds of reasonable profit splits as set out in guidelines. Fuller, *Section 482 Revisited,* 31 TAX L. REV. 475, 514-16 (1976); *cf.* Mihaly, *supra* note 17, at 750-51 (absent comparable transactions, no allocation, if taxpayer has set reasonably fair prices in good faith). A few Tax Court cases have taken this approach. *E.g.,* Lufkin Foundry & Mach. Co. v. Commissioner, 40 T.C.M. (PH) ¶ 71,101, at 422, 459-60 (1971) (upholding 50%-50% profit split between buyer and seller), *rev'd,* 468 F.2d 805

ready to reject the regulation,[28] and the courts have generally followed the regulation to the exclusion of prior case law.[29] This Note

(5th Cir. 1972); PPG Industries Inc. v. Commissioner, 55 T.C. 928, 997 (1970) (upholding 59%-41% and 56%-44% profit splits between domestic seller and foreign buyer).

Others propose that section 482 should apply only to cases of deliberate tax avoidance. *E.g.,* PRESIDENT'S TASK FORCE ON BUSINESS TAXATION, BUSINESS TAXATION 54-57 (1970); Aland, *supra* note 10, at 819; Eustice, *supra* note 3, at 483; Jenks, *Treasury Regulations Under Section 482,* 23 TAX LAW. 279, 312 (1972).

For an excellent critique of the present regulation and an overview of the proposals to modify section 482, see Note, *Multinational Corporations and Income Allocation Under Section 482 of the Internal Revenue Code,* 89 HARV. L. REV. 1202 (1976). The Note suggests that the government ignore the organizational structures of commonly controlled enterprises and tax, instead, their lines of business, each as one unit. The Note would classify these lines of business according to an objective system of industry or product characteristics, such as the Standard Industrial Classification. *Id.* at 1234-38.

28. The Treasury Department is preparing to modify Treasury Regulation § 1.482-2(c)(2), the part of the regulation for section 482 that concerns arm's length rental charges. The Service has prepared a preliminary draft to revise Treasury Regulation § 1.482-2(c)(2), and the Treasury Department is now reviewing it. Telephone interview with Kent Schreiner, Legislation and Regulations Division, Office of the Chief Counsel, Internal Revenue Service (May 20, 1982).

29. Section 482 makes no mention of an arm's length standard. Case law before the 1968 regulations sometimes rejected an arm's length standard in favor of determining whether the profit allocation appeared subjectively reasonable. In Frank v. International Can. Corp., 308 F.2d 520 (9th Cir. 1962), the Ninth Circuit rejected the arm's length standard in favor of a reasonable return standard. *Id.* at 528. The court said, "we do not agree with the Commissioner's contention that 'arm's length bargaining' is the *sole* criterion for applying the statutory language of § 45 in determining what the 'true net income' is of each 'controlled taxpayer.'" *Id.* (emphasis in original). Section 45, of the Revenue Act of 1938, ch. 289, 52 Stat. 447, 474 (1938) (repealed 1954), is section 482's predecessor. The court cited a number of cases that had applied § 45 without using an arm's length standard, *id.* at 529 & nn.8-14: Friedlander Corp. v. Commissioner, 25 T.C. 70, 77 (1955) (full fair value), *acq.* 1956-1 C.B. 3, *withdrawal and nonacq.* 1972-1 C.B. 3, *acq.* 1972-1 C.B. 2; Polak's Frutal Works, Inc. v. Commissioner, 21 T.C. 953, 976 (1954) (fair and reasonable prices), *acq.* 1955-1 C.B. 6, *withdrawal and nonacq.* 1972-1 C.B. 3; Motor Sec. Co. v. Commissioner, 11 T.C.M. (CCH) 1074, 1082 (1952) (method that seems not unreasonable); Palm Beach Aero Corp. v. Commissioner, 17 T.C. 1169, 1176 (1952) (fair consideration that reflects arm's length dealing), *acq.* 1952-2 C.B. 2; Grenada Indus., Inc. v. Commissioner, 17 T.C. 231, 260 (1951) (fair price, including a reasonable profit), *acq.* 1952-2 C.B. 2, *nonacq.* 1952-2 C.B. 2, *withdrawal and acq.* 1972-2 C.B. 2, *aff'd,* 202 F.2d 873 (5th Cir.), *cert. denied,* 346 U.S. 819 (1953); Seminole Flavor Co. v. Commissioner, 4 T.C. 1215, 1232-33 (1945) (fair and reasonable contract, compensation that is fair and fairly arrived at, and contract judged as to fairness), *acq.* 1945 C.B. 6, *withdrawal and nonacq.* 1972-1 C.B. 3.

The Ninth Circuit, in Oil Base, Inc. v. Commissioner, 362 F.2d 212 (9th Cir.), *cert. denied,* 385 U.S. 928 (1966), strictly limited its holding in *Frank v. International Canadian Corp.* The taxpayer in *Oil Base* had argued that section 482 called for basing allocations on a fair and reasonable return rather than an arm's length standard. 362 F.2d at 214. The Ninth Circuit applied the arm's length standard and said that a "permissible departure from the regulation's arm's length standard was, under the facts of [*Frank*], very narrowly limited." *Id.* In a later case, the Ninth Circuit showed that it would rely on the Treasury Department regulation to the exclusion of all other standards. Kerry Inv. Co. v. Commissioner, 500 F.2d 108, 109 (9th Cir. 1974).

Cases from other jurisdictions that have approved of the section 482 regulation include Kahler Corp. v. Commissioner, 486 F.2d 1, 4 (8th Cir. 1973); B. Forman Co. v. Commissioner, 453 F.2d 1144, 1155 (2d Cir.), *cert. denied,* 407 U.S. 934 (1972); Local Finance Corp. v. Commissioner, 407 F.2d 629, 632 (7th Cir.), *cert. denied,* 396 U.S. 956 (1969); Eli Lilly & Co. v. United States, 372 F.2d 990, 1000 (Ct. Cl. 1967).

analyzes how best to interpret and apply the existing regulation. The Note begins by interpreting the *Du Pont* and *U.S. Steel* cases. Later, it analyzes the existing regulation within the framework of section 482 and the purposes that the Treasury Department intended the regulation to promote. It concludes that the best method of interpreting the regulation is a modified version of the Second Circuit's interpretation.

I

CONFLICTING INTERPRETATIONS OF THE REGULATION

The *Du Pont* and *U.S. Steel* cases highlight current problems in interpreting section 482 and its regulation when no closely similar uncontrolled transactions are available for comparison. The two decisions differ significantly in the way they view the regulation for section 482 and in their deference to the Service.

A. THE *DU PONT* CASE

In the late 1950s, E.I. Du Pont de Nemours and Company began a drive to expand its sales in Europe. In 1959, Du Pont organized a Swiss subsidiary, Du Pont de Nemours International S.A. (DISA), which bought Du Pont's chemical products and then marketed them overseas.[30] DISA was exempt from United States taxes and subject to a Swiss tax rate much lower than that of the United States.[31] Du Pont formed DISA primarily for business reasons unrelated to taxation, but internal Du Pont correspondence shows that Du Pont was interested in the possible tax advantages of selling products to DISA at artificially low prices.[32] Using section 482, the

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Courts generally sustain Treasury Department regulations unless unreasonable and plainly inconsistent with the corresponding statute. Commissioner v. South Tex. Lumber Co., 333 U.S. 496, 501 (1948).

For the case law development of the methods for allocations under section 482 and the regulation, see Fuller, *supra* note 27, at 505-16; Lewis, *Section 482: An Eminently Amendable Provision,* 25 ALA. L. REV. 23, 38-46 (1972); Comment, *supra* note 5, at 227-40.

30. E.I. Du Pont de Nemours & Co. v. United States, 78-1 U.S. Tax Cas. (CCH) ¶ 9374, at 83, 895-96 (Ct. Cl., Trial Div., 1978), *sustained on rehearing,* 608 F.2d 445 (Ct. Cl. 1979), *cert. denied,* 445 U.S. 962 (1980).

31. *See* 608 F.2d at 447 & n.4. DISA paid less than nine percent in Swiss Federal and cantonal taxes for 1959 and 1960. 78-1 U.S. Tax Cas. (CCH) ¶ 9374, at 83,912, 83,948 (findings 17 & 94).

32. 608 F.2d at 447. The court found that, by manipulating the prices on the products it sold to DISA, Du Pont had deliberately insulated DISA from any risk of loss and shifted as large a share of the profits to the subsidiary as was possible. *Id.* at 448. One early internal memorandum from Du Pont's tax planning department reviewed the possibility of a Service attack on its pricing method and concluded:

> It would seem desirable to bill the tax haven subsidiary at less than an 'arm's length' price because: (1) the pricing might not be challenged by the revenue

Service allocated to Du Pont eighteen million dollars of DISA's income for the period 1959 to 1960[33]—resulting in a deficiency of more than nine million dollars for Du Pont.[34]

The case fell within that part of the section 482 regulation for intercompany pricing that concerns sales of tangible goods.[35] The regulation specifies three methods for determining an arm's length price, in the following order of preference: first, the comparable uncontrolled price method; second, the resale price method; and third, the cost plus method.[36] The comparable uncontrolled price method derives an arm's length price by comparing similar sales between unrelated parties involving identical or nearly identical goods.[37] The resale price method establishes an arm's length price

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agent; (2) if the pricing is challenged, we might sustain such transfer prices; (3) if we cannot sustain the prices used, a transfer price will be negotiated which should not be more than an 'arm's length' price and might be less; thus we would be no worse off than we would have been had we billed at the higher price.

Id. at 447 n.4 (quoting a Du Pont Treasurer's Department memorandum by W.F. Lewis (Aug. 16, 1957)). Internal memoranda later called the proposed subsidiary a " 'profit sanctuary trading company,' " *id.* (quoting a Du Pont Legal and Treasurer's Departments memorandum by R.A. Wentz and G.W. Morris (Mar. 7, 1958)), and one early draft of a memorandum referred to the " 'artificially" low price' " of the goods to be sold to the proposed subsidiary, *id.* (quoting a Du Pont International and Treasurer's Departments draft memorandum by E. Robinson (Sept. 22, 1958)). For the full texts of these communications, see 78-1 U.S. Tax Cas. (CCH) ¶ 9374, at 83,920-21, 83,925-26, 83,935 (findings 37, 42 & 62).

33. 78-1 U.S. Tax Cas. (CCH) ¶ 9374, at 83,911-12 (findings 2, 5, 10 & 14).

34. *Id.* at 83,911 (finding 2).

In 1974, Kauder estimated that the *Du Pont* case would ultimately cost Du Pont and the Government each as much as one million dollars. Kauder, *supra* note 6, at 27.

35. Treas. Reg. § 1.482-2(e), T.D. 6952, 1968-1 C.B. 218, 234-42, *amended by* T.D. 7170, 1972-1 C.B. 178, 179.

36. If comparable uncontrolled sales exist, the regulation requires the Service to use the comparable uncontrolled price method. *Id.* § 1.482-2(e)(1)(ii), T.D. 6952, 1968-1 C.B. 218, 234-35, *amended by* T.D. 7170, 1972-1 C.B. 178, 179. If no such sales exist and an applicable resale price is available, the Service must use the resale price method, if the controlled sale buyer does not add substantially to the property's value by physically altering the property or by using intangible property. *Id.* § 1.482-2(e)(1)(ii), (3)(ii), T.D. 6952, 1968-1 C.B. 218, 234-35, 238, *amended by* T.D. 7170, 1972-1 C.B. 178, 179. Under the remaining circumstances, the Service must apply either the resale price or the cost plus method, depending on which method can more feasibly and more accurately estimate an arm's length price. *Id.* § 1.482-2(e)(1)(ii), (3)(iii), T.D. 6952, 1968-1 C.B. 218, 234-35, 238-39, *amended by* T.D. 7170, 1972-1 C.B. 178, 179. The regulation suggests using the method that requires fewer and easier calculations. *Id.* § 1.482-2(e)(3)(iii), T.D. 6952, 1968-1 C.B. 218, 238-39. The regulation provides that, in general, the resale price method is more appropriate when the controlled sale seller's functions are more extensive and harder to evaluate than the controlled sale buyer's functions. *Id.*

37. *Id.* § 1.482-2(e)(2)(i)-(ii), T.D. 6952, 1968-1 C.B. 218, 235-36. The physical property and the circumstances involved in the uncontrolled sales must be "identical to the physical property and circumstances involved in the controlled sales [] or . . . so nearly identical that any differences either have no effect on price [] or . . . can be reflected by a reasonable number of adjustments to the price of uncontrolled sales. *Id.* § 1.482-2(e)(2)(ii), T.D. 6952, 1968-1 C.B. 218, 238.

"Uncontrolled sales" include "(*a*) sales made by a member of the controlled group to an unrelated party, (*b*) sales made to a member of the controlled group by an unrelated

by reducing the price the controlled sale buyer obtained on resale by the profit margin that uncontrolled distributors earn in similar transactions.[38] The cost plus method derives an arm's length price by adding the percentage markup that uncontrolled manufacturers earn in similar transactions to the full cost of producing the item.[39] Both

party, and (*c*) sales made in which the parties are not members of the controlled group and are not related to each other." *Id.* § 1.482-2(e)(2)(ii), T.D. 6952, 1968-1 C.B. 218, 236.

38. The resale price method establishes an arm's length price by determining the price that the controlled sale buyer has or would have obtained on resale, called the "applicable resale price," and by reducing it by an appropriate markup. *Id.* § 1.482-2(e)(3)(i), T.D. 6952, 1968-1 C.B. 218, 237.

The applicable resale price is the price "at which it is anticipated" that the buyer in the controlled sale will resell the property in an uncontrolled sale. *Id.* § 1.482-2(e)(3)(iv), T.D. 6952, 1968-1 C.B. 218, 239. If the property is involved in controlled resales, the applicable resale price is the price "at which such property is finally resold in an uncontrolled sale . . . ." *Id.* § 1.482-2(e)(3)(v), T.D. 6952, 1968-1 C.B. 218, 239. (Note the anomalous difference in tenses between the two descriptions of an uncontrolled resale.) "The 'applicable resale price' will generally be equal to either the price at which current resales of the same property are being made or the resale price of the particular item of property involved." *Id.* at § 1.482-2(e)(3)(iv), T.D. 6952, 1968-1 C.B. 218, 239.

The regulation defines the "appropriate markup percentage" in terms of the uncontrolled transaction "most similar" to the sale under scrutiny in which a buyer bought and resold property in uncontrolled transactions. *Id.* § 1.482-2(e)(vi), T.D. 6952, 1968-1 C.B. 218, 239-40. The appropriate markup percentage is the gross profit that the buyer-reseller or another party earned in similar uncontrolled resales divided by the prices obtained in these resales. *Id.* "Whenever possible" the markup percentage should come from similar purchases and resales that the controlled sale buyer has made with independent parties. *Id.* § 1.482-2(e)(3)(vii), T.D. 6952, 1968-1 C.B. 218, 240. The regulation stresses four factors for assessing the similarity of resales: first, the type of property involved; second, the functions the reseller performs with respect to the property; third, the effect the reseller's intangible property, *e.g.,* patents and trademarks, has on the price of the property resold; and fourth, the reseller's geographic market. *Id.* § 1.482-2(e)(3)(vi), T.D. 6952, 1968-1 C.B. 218, 239-40.

In sum, under the resale price method, the formula for deriving the arm's length price, before adjusting for the material differences, is as follows: *applicable resale price* minus *appropriate markup* is equal to *arm's length price,* when the *appropriate markup* is equal to *applicable resale price* multiplied by *appropriate markup percentage*. See *infra* note 42 and accompanying text concerning adjustments for material differences.

39. The cost plus method obtains an arm's length price by adding an appropriate gross profit to the cost of producing the item. *Id.* § 1.482-2(e)(4)(i), T.D. 6952, 1968-1 C.B. 218, 241.

An appropriate gross profit is the cost of producing the property involved as multiplied by an "appropriate gross profit percentage." *Id.* The appropriate gross profit percentage is the gross profit the seller or another party earned in similar, uncontrolled sales divided by the cost of producing the items in these sales. *Id.* § 1.482-2(e)(4)(iii), T.D. 6952, 1968-1 C.B. 218, 241. The regulation mandates that the Service compute the costs of producing the items in question by apportioning costs "in accordance with sound accounting practices . . ., which neither favor [] nor burden [] controlled sales in comparison with uncontrolled sales." *Id.* § 1.482-2(e)(4)(ii), T.D. 6952, 1968-1 C.B. 218, 241. The cost plus method should use "whenever possible" gross profit percentages from similar sales the controlled sale seller has made with independent parties. *Id.* § 1.482-2(e)(4)(iv), T.D. 6952, 1968-1 C.B. 218, 242. For assessing the similarity of sales, the regulation stresses four characteristics that parallel the factors for assessing the similarity of resales under the resale price method, *supra* note 38. *Compare id.* § 1.482-2(e)(4)(iii), T.D. 6952, 1968-1 C.B. 218, 241 (cost plus method) *with id.* § 1.482-2(e)(3)(vi), T.D. 6952, 1968-1 C.B. 218, 239-40 (resale price method).

the resale price method and the cost plus method use gross, not net, profit margins to derive an arm's length price.[40] The comparable uncontrolled price method avoids using profit margins by using only the market prices obtained in comparable sales. All three methods require the Service to make adjustments to reflect "material differences"[41] between the controlled and uncontrolled transactions under comparison.[42] Finally, if the taxpayer can establish that another method "is clearly more appropriate," or if none of the three methods is reasonably applicable, the Service can vary these methods or use some other method,[43] informally called the fourth method.[44]

In sum, under the cost plus method, the formula for deriving the arm's length price, before adjusting for material differences, is as follows: *cost of producing* multiplied by [(one) plus *gross profit percentage*] is equal to *arm's length price*). See *infra* note 42 and accompanying text concerning adjustments for material differences.

40. The resale price method uses the controlled sale buyer's or another party's gross profit margin; the appropriate markup percentage is "equal to the percentage of gross profit (expressed as a percentage of sales)" the controlled sale buyer or another reseller earns in similar, uncontrolled resales. *Id.* § 1.482-2(e)(3)(vi), T.D. 6952, 1968-1 C.B. 218, 239-40; *see supra* note 38. The cost plus method uses the controlled sale seller's or another party's gross profit margin; the appropriate gross profit percentage is "equal to the gross profit percentage (expressed as a percentage of cost)" the controlled sale seller or another seller earns in similar, uncontrolled sales. *Id.* § 1.482-2(e)(4)(iii), T.D. 6952, 1968-1 C.B. 218, 241; *see supra* note 39.

House Bill 10650 would have directed the Service to consider payroll, advertising, selling, and promotional expenses when allocating under section 482—factors that affect net, but not gross, profits. H.R. 10650, 87th Cong., 2d Sess., sec. 6 (1962), *reprinted in* STAFF OF HOUSE COMM. ON WAYS AND MEANS, 90TH CONG., 1ST SESS., LEGISLATIVE HISTORY OF H.R. 10650, 87TH CONGRESS, THE REVENUE ACT OF 1962, PUBLIC LAW 87-834, pt. 1, at 680-86 (Comm. Print 1967); *see infra* note 129. The proposal did not become law, however. The Conference Committee report accompanying the bill stated only that "[t]he conferees on the part of both the House and the Senate believe that the objectives of section 6 of [House bill 10650] as passed by the House can be accomplished by amendment of the regulations under present section 482." H.R. REP. NO. 2508, 87th Cong., 2d Sess. 18-19 (1962), *reprinted in* 1962-3 C.B. 1129, 1146. *See infra* note 130 and accompanying text.

Net profits play only a very limited role in the present regulation. Treas. Reg. § 1.482-2(e)(3)(viii). T.D. 6952, 1968-1 C.B. 218, 240.

41. Treas. Reg. § 1.482-2(e)(3)(ix), T.D. 6952, 1968-1 C.B. 218, 240-41.

42. *Id.* § 1.482-2(e)(2)(ii), (3)(ix), (4)(v), T.D. 6952, 1968-1 C.B. 218, 236, 240-42. Material differences are those differences that "have a definite and reasonable ascertainable effect on price." *Id.* Specific differences the regulations mention that may have this effect include quality, the terms of sale, intangible property—such as patents and trademarks—the time of sale, market levels, and the geographic market involved. *Id.* § 1.482-2(e)(2)(ii), T.D. 6952, 1968-1 C.B. 218, 236.

43. *Id.* § 1.482-2(e)(1)(iii), T.D. 6952, 1968-1 C.B. 218, 235. For a list of some of these other methods that the Service has used in the past, see Feinschreiber, *Intercompany Pricing Rules Show Need for Revision,* 51 TAXES 133, 136-37 (1973).

44. *E.g.,* E.I. Du Pont de Nemours & Co. v. United States, 608 F.2d 445, 452 (Ct. Cl. 1979), *cert. denied,* 445 U.S. 962 (1980); M. DUERR, *supra* note 4, at 24; Seghers, *Intercompany Pricing—Tax Audits,* 5 INT'L TAX J. 437, 438, 440 (1979).

Many articles have explained the mechanics of section 1.482-2(e) of the regulation. *E.g.,* Bischel, *supra* note 5, at 493-99; Fuller, *supra* note 27, at 505-11; Jenks, *supra* note 27, at 306-12; Rothkopf, *supra* note 5, at 731-34; Surrey, *supra* note 10, at 77-78; Comment, *supra* note 5, at 224-27. For an article concerning the accounting aspects of section

In *Du Pont,* the Government[45] used two methods not specified in the regulation to justify the Service's allocation.[46] Du Pont argued that, because the resale price method applied under the circumstances, the regulation precluded the Service from using any other method to allocate income to Du Pont, and moreover, that Du Pont could justify its prices to DISA under the resale price method.[47]

First, Du Pont noted that DISA's gross profit margin[48] for 1960 was well within the range of gross profit margins of those companies the Service had used to determine the Service's 1960 allocation to Du Pont.[49] The court concluded, however, that these other companies were not comparable to DISA and that the Service's use of these companies' statistics did not mean that "the Service must have considered these drug and chemical wholesalers as comparable companies making similar resales."[50]

Second, Du Pont argued that the Government's evidence supported Du Pont's prices to DISA when analyzed under the resale price method. To justify the Service's allocation, the Government had randomly selected six management consulting firms, five advertising agencies, and twenty-one distributors—firms that performed the three kinds of functions that DISA had performed.[51] Du Pont noted, however, that DISA's gross profit margin[52] was well within the range of gross profit margins realized by the twenty-one distributors whose figures the Government had introduced as evidence against Du Pont.[53] The trial judge[54] had found that, of the three types of companies, the twenty-one distributors performed functions

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1.482-2(e) of the regulation, see Kalish, *Intercompany pricing: how to handle an international tax examination,* 9 TAX ADVISOR 196 (1978).

45. The United States Justice Department represents the Service in cases appearing before the Court of Claims. 28 U.S.C. § 518 (1976), *amended by* 28 U.S.C.A. § 518(a) (West Supp. 1982).

46. *See supra* notes 62-67 and accompanying text.

47. *See supra* notes 49-58 and accompanying text.

48. The gross profit margin is equal to the resale price less the price at which the reseller purchased the goods from the manufacturer. 78-1 U.S. TAX CAS. (CCH) ¶ 9374, at 83,968 (finding 123).

49. DISA's gross profit margin for 1960 was 26%. Twenty-one percent was the average gross profit margin of the companies whose statistics the Service had used in allocating income for 1960. These companies' gross profit margins ranged from 9 to 33%. 608 F.2d at 452. The Service had used these companies' net profit figures, however. *Id.*

50. *Id.* at 452. Whether or not the court correctly handled this argument, one should note that the courts seem to uphold section 482 allocations even though derived by an unreasonable method, so long as at trial, the Service can justify the amount under the regulation and the taxpayer cannot show that the amount is unreasonable. *See generally* Jenks, *Procedural Issues in Section 482 Cases,* 25 TAX LAW. 499 (1972); *infra* note 146 and accompanying text.

51. 78-1 U.S. Tax Cas. (CCH) ¶ 9374, at 83,966 (finding 118).

52. *See infra* note 75.

53. 607 F.2d at 451-52. For the trial judge's supportive finding, see 78-1 U.S. Tax Cas. (CCH) ¶ 9374, at 83,967-68 (finding 123).

most similar to DISA's functions,[55] and that DISA's gross profit margin was well within the range of gross profit normally realized by independent operators buying merchandise for resale."[56] The Court of Claims, however, concluded that the twenty-one distributors were not comparable to DISA. The court presumed that "what a business spends to provide services is a reasonable indication of the magnitude of these services."[57] Because DISA's selling expenses were much lower than those of six of the distributors whose services were most like DISA's, the court could not "view these six companies as having made resales similar to DISA's."[58] Here the court closely reviewed the data, not to make adjustments in order to obtain a proper allocation, but to reject data from similar transactions.

The court was less demanding when it reviewed the Government's evidence. In contrast to the narrow reading of the regulation and close evidentiary scrutiny by which it rejected Du Pont's case, the court began its review of the Government's case by remarking that the derivation of "realistic intercompany prices is hardly . . . an economic art susceptible of precision. A 'broad brush' approach to this inexact field seems necessary . . . ."[59] The court then gave its approval to the two ad hoc methods the Government had used to justify the Commissioner's allocation.[60]

First, as noted, the Government had introduced data from six management consulting firms, five advertising agencies, and twenty-one distributors—firms that performed the three kinds of functions that DISA had performed. The Government had shown that the

54. The Court of Claims has fifteen trial judges, or commissioners, who write opinions reporting findings of fact and recommending conclusions of law. 17 C. WRIGHT, A. MILLER & E. COOPER, FEDERAL PRACTICE AND PROCEDURE § 4101, at 201 (1978); *see* 28 U.S.C. § 2503(a) (1976).

55. 78-1 U.S. Tax Cas. (CCH) ¶ 9374, at 83,967-68 (finding 123).

56. 78-1 U.S. Tax Cas. (CCH) ¶ 9374, at 83,909. The trial judge rejected Du Pont's argument, only because Du Pont had not adjusted its prices to DISA in order to take into account DISA's lack of risk. *Id.* at 83,910.

57. 608 F.2d at 452. The trial judge also made this presumption. 78-1 U.S. Tax Cas. (CCH) ¶ 9374, at 83,966 (finding 118).

58. 608 F.2d at 452.

Before the trial judge, Du Pont also attempted to establish the applicability of the resale price method by introducing evidence of agreements between parties dealing at arm's length in which the profit split between the manufacturers and distributors was comparable to the split between Du Pont and DISA. 78-1 U.S. Tax Cas. (CCH) ¶ 9374, at 83,954-61 (findings 103, 105-11). Du Pont also provided expert testimony that the profit split between Du Pont and DISA was comparable to a split between parties dealing at arm's length. *Id.* at 83,952-55 (findings 102 & 104). The trial judge found that the agreements between the unrelated parties were materially different from the Du Pont-DISA arrangement, *id.* at 83,954-61 (findings 103, 105-11), and that the factual assumptions underlying the expert opinions did not correspond to the facts of the Du Pont-DISA arrangement, *id.* at 83,952-55 (findings 102 & 104).

59. 608 F.2d at 455.

60. *Id.* at 456.

three groups of firms had much lower ratios of net profits[61] over sales for the years 1967 to 1972[62] than DISA had had for the years 1959 and 1960.[63] Note that the twenty-one distributors are the same distributors the court found were not comparable to DISA when Du Pont used them for comparison.[64] Second, the Government calculated the average after-tax rate of return[65] for 1,133 companies using data that Standard & Poor's had compiled for the years 1960 to 1969.[66] DISA's rate of return far exceeded those of all the 1,133 companies.[67]

The basic dispute in the case was that Du Pont relied on the resale price method, whereas the Government created its own methods. The Service specifically designed the resale price method to cover situations like Du Pont's, in which "a foreign distributing affiliate acquires property from a United States manufacturing affiliate that sells the property to third parties" without significantly affecting the property's value.[68] The regulation provides, "The resale price method must be used . . . if . . . (*a*) [t]here are no comparable uncontrolled sales . . . (*b*) [a]n applicable resale price [here the actual resale price in Europe] . . . is available," and the buyer has not added substantially to the property's value before resale.[69] The uncontested facts of *Du Pont* showed that all these conditions

61. Net profits are equal to gross income less total operating costs. 78-1 U.S. TAX CAS. (CCH) ¶ 9374, at 83,966 (finding 119). *Compare infra* note 75 (gross profit margin).

62. 78-1 U.S. Tax Cas. (CCH) ¶ 9374, at 83,966 (finding 118).

63. For the five years in question, the average ratio of gross income to total operating costs was 108.3% for the management consulting firms; 123.9% for the five advertising agencies; and 129.3% for the 21 distributors. For DISA, this ratio in 1959 was 281.5% before and 108.6% after the Service's allocation, and in 1960, it was 397.1% before and 179.3% after the allocation. 608 F.2d at 456; 78-1 U.S. Tax Cas. (CCH) ¶ 9374, at 83,966-68 (findings 118-24).

64. *See supra* text accompanying notes 57-58.

65. The trial court defined rate of return as the ratio obtained by dividing "after-tax net income plus interest paid" by the company's "total capital base." 78-1 U.S. Tax Cas. (CCH) ¶ 9374, at 83,969-70 (findings 132 & 133). The court justified using after-tax profits on the grounds that "net income . . . paid out for taxes is not available to the owners of the business." *Id.* at 83,969. The court's view, however, is incorrect. The purpose of the regulation is not to find how much income businesses have available after taxes; it is to find how much income a reseller receives in an arm's length transaction. Many factors unrelated to the market, such as depreciation or tax credits, affect a company's after-tax income. Thus, it is an unnecessary distortion to use after-tax net income in computing the rate of return. As the Tax Court judge in *U.S. Steel* noted: "[A]ny rate of return on cost should not reflect income taxes, either hypothetical or actual, which might apply to the resulting income. The amount of taxes due would depend on varying factors, peculiar to the corporate organization and activities . . . ." United States Steel Corp. v. Commissioner, 36 T.C.M. (CCH) 586, 604 (1977), *rev'd,* 617 F.2d 942 (2d Cir. 1980).

66. 78-1 U.S. Tax Cas. (CCH) ¶ 9374 at 83,969-71 (findings 130-37).

67. *Id.* at 83,971 (finding 138).

68. Rothkopf, *supra* note 5, at 733; *accord* Surrey, *supra* note 10, at 77.

69. The regulation provides in full as follows:

> The resale price method must be used to compute an arm's length price of a controlled sale if all the following circumstances exist:

existed.[70] The resale price method derives the arm's length price by using the "most similar" uncontrolled sale.[71] The regulation allows considerable flexibility in finding a similar uncontrolled sale for use under the resale price method.[72]

Flexibility is necessary, because it can be difficult to find similar uncontrolled transactions. In 1968, Stanley Surrey, then the Assistant Treasury Secretary for Tax Policy, wrote that "tax allocation problems . . . demand a coherent and thought-through set of answers, rather than a seat-of-the-pants, 'let's decide each case on its facts' approach."[73] An overly strict reading of the requirement of similarity would deprive taxpayers of the regulation's protection. Nevertheless, the *Du Pont* court held that the regulation requires

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(*a*) There are no comparable uncontrolled sales as defined in subparagraph (2) of this paragraph.

(*b*) An applicable resale price, as defined in subdivision (iv) or (v) of this subparagraph, is available with respect to resales made within a reasonable time before or after the time of the controlled sale.

(*c*) The buyer (reseller) has not added more than an insubstantial amount to the value of the property by physically altering the product before resale. For this purpose packaging, repacking, labeling, or minor assembly of property does not constitute physical alteration.

(*d*) The buyer (reseller) has not added more than an insubstantial amount to the value of the property by the use of intangible property. See § 1.482-2(d)(3) for the definition of intangible property.

Treas. Reg. § 1.482-2(e)(3)(ii), T.D. 6952, 1968-1 C.B. 218, 238.

70. First, the parties agreed that no "independent organization [was] circumstanced as DISA was during the period in suit and performing the marketing functions that were assigned to it by plaintiff." 78-1 U.S. Tax Cas. (CCH) ¶ 9374, at 83,952 (finding 101). Second, neither party questioned the price DISA obtained in reselling the products in Europe. Third, the Government stressed, without challenge from Du Pont, that "DISA performed no functions that were beyond the overall spectrum of activity represented by management consulting firms, advertising agencies and distributors operating in the United States." *Id.* at 83,966 (finding 118). In other words, DISA did not substantially add to the value of the products by using intangible property or by physically altering them before resale. *See id.* at 83,945-46 (findings 90 & 91); Brief for the United States at 9, E.I. Du Pont de Nemours & Co. v. United States, 608 F.2d 445 (Ct. Cl. 1979), *cert. denied,* 445 U.S. 962 (1980).

71. Treas. Reg. § 1.482-2(e)(3)(vi), T.D. 6952, 1968-1 C.B. 218, 239-40.

72. The item in the similar uncontrolled sale need not bear a close physical similarity to the item in the controlled sale; prevailing markup percentages for the industry are appropriate when the markup percentages of particular sales or groups of sales are unavailable; and markup percentages for resales in the United States are acceptable when resale markups in the foreign market are unavailable. *Id.* § 1.482-2(e)(3)(vi)-(vii), T.D. 6952, 1968-1 C.B. 218, 239-40. For instance, the resale price method permits the use of markup percentages from uncontrolled sales of electric toasters in determining an arm's length price for controlled sales of electric mixers. *Id.* § 1.482-2(e)(3)(ix), T.D. 6952, 1968-1 C.B. 218, 240-41. The regulation also permits the use of "reasonable statistical sampling techniques." *Id.* § 1.482-2(e)(1)(iv), T.D. 6952, 1968-1 C.B. 218, 235.

At the time of the regulation's issuance, senior Treasury Department officials stressed flexible application. *E.g.,* Cohen (1968), *supra* note 10, at 74 ("Legitimate shortcuts, such as application of pricing methods to product lines, and application of average departmental overhead rates, will be recognized"); Cohen (1967), *supra* note 10, at 237.

73. Surrey, *supra* note 10, at 76.

"substantial comparability"[74] under the resale price method.

Further, Du Pont used gross profit under the resale price method whereas the Government's methods were based on net profit.[75] The methods the regulation specifies for determining the arm's length price are based on gross profit.[76] Thus, the regulation tends to support Du Pont's, not the Government's, method of computing the arm's length price.[77]

The court made a concerted effort to interpret the regulation narrowly against Du Pont, yet gave the Service broad discretion. Du Pont used the gross profit margins of companies that the Government introduced as evidence to justify its arm's length prices.[78] The court rejected Du Pont's evidence based on a presumption which the court applied to some of the companies being compared.[79] Yet the Government's evidence, which the court approved, was based largely on the same twenty-one companies that the Government had used to justify its allocation.[80] Moreover, the court rejected Du Pont's analysis which used the same companies the examining agent used to calculate his allocation. The court reasoned that the agent may have been wrong to consider the other companies as comparable.[81] As such, the court's holding severely emasculates any protection the regulation offers businesses and fortifies the Service's already broad discretion.

A primary factor in the court's decision was that Du Pont clearly tried[82] to set its prices without regard to market conditions in

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74. 608 F.2d at 451.

75. Gross profit equals sales revenue minus the cost of goods sold, where cost of goods sold is the direct cost of producing the good (the aggregate of all material, labor, and overhead costs). The gross profit margin percentage equals the gross profit divided by sales revenue. Net profit equals sales revenue minus all direct and indirect costs of producing the goods, including selling and administrative expenses, interest, and taxes. The net profit margin percentage equals net profit divided by sales revenue. Net profit, therefore, equals gross profit minus selling and administrative expenses, interest, and taxes. *See generally,* S. MATULICH & L. HEITGER, FINANCIAL ACCOUNTING 229-30 (1980).

Under the regulations, the Service should use gross profit figures to calculate arm's length prices under the resale-price and cost plus methods. *See supra* note 40 and accompanying text. The regulation permits the use of net sales under the resale price method only "if the comparable markup percentage is based upon net sales." Treas. Reg. § 1.482-2(e)(3)(viii), T.D. 6952, 1968-1 C.B. 218, 240. See *supra* note 38 and accompanying text for a description of how to calculate the arm's length price for the resale price method.

76. *See supra* note 40 and accompanying text.

77. *See supra* notes 68-72 and accompanying text.

78. *See supra* notes 51-56 and accompanying text.

79. *See supra* notes 57-58 and accompanying text.

80. *See supra* notes 61-64 and accompanying text.

81. *See supra* notes 49-50 and accompanying text.

82. Du Pont had designed its pricing policy to leave DISA with 75% of the total profits. Yet Du Pont failed to account for some intercorporate transfers, so that the

order to minimize its United States income taxes.[83] Early in its opinion, the court noted that it mentioned evidence of Du Pont's arrangement with DISA, "not as direct proof . . . [to support] the Commissioner's reallocation," but rather to suggest why the Commissioner could not compare Du Pont's sales to DISA with any unrelated-party sales.[84] Yet Du Pont's arrangement with DISA clearly influenced the court's decision: "[t]hat some reallocation was reasonable is demonstrated by recalling the facts of DISA's operation."[85] Moreover, the court all but admitted that, under the regulations, Du Pont might be able to justify DISA's profit: "it would have been undiluted luck—*which under the regulation it probably could enjoy*—if [Du Pont] had managed to discover comparable resales falling within the resale price method as set forth in the regulation (including adjustments to be made [for material differences])."[86]

Although the court may have reached a correct result in the particular case, it could have achieved the same result without establishing a damaging precedent. The court noted that Du Pont priced its products to DISA in order "to insulate DISA from any loss."[87] The court could have upheld the Service's allocation on the ground that DISA's lack of market risk materially differed from uncontrolled transactions,[88] and that Du Pont offered no evidence to rebut this showing. Instead, by being so receptive to Service discretion at a time when the Service has been applying section 482 without close regard to the regulations,[89] the *Du Pont* case creates a damaging precedent. True, the taxpayer in *Du Pont* deliberately tried to lessen its tax liability.[90] But by stating that Du Pont's motives did not affect the result, the court's interpretation of the regulations could also

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actual division of profits between Du Pont and DISA during the years in question was approximately 50%-50%. 608 F.2d at 448; 78-1 U.S. Tax Cas. (CCH) ¶ 9374, at 83,941 (finding 79).

83. "Instead of allowing each individual producing department to value its goods economically and to set a realistic price, Du Pont left pricing on the sales to DISA with [Du Pont's tax planning and legal departments]. . . . [N]o economic correlation of costs to prices was attempted." 608 F.2d at 448. (footnotes omitted). "Du Pont's prices to DISA were deliberately set high and with little or no regard to economic realities." *Id.* at 455. "[W]e think it . . . undeniable that the tax advantages of such a foreign entity were also an important, though not the primary, consideration in DISA's creation and operation." *Id.* at 447. "On the whole, the pricing system was based solely on [the Du Pont] Treasury and Legal Department estimates of the greatest amount of profits that would be shifted to DISA without evoking IRS intervention." *Id.* at 448 (footnote omitted).

84. *Id.* at 449.

85. *Id.* at 455.

86. *Id.* at 454 (italics added).

87. *Id.* at 448.

88. *See supra* notes 41-42 and accompanying text.

89. *See infra* notes 141-45 and accompanying text.

90. *See supra* note 32 and accompanying text.

apply to corporations acting in good faith.[91]

B. THE *U.S. STEEL* CASE

In 1949, the United States Steel Corporation formed Orinoco Mining Company, a wholly owned corporation, to mine large deposits of iron ore that U.S. Steel had discovered in Venezuela.[92] Orinoco, which was incorporated in Delaware, was subject to Venezuela's maximum tax of fifty percent on net income.[93] Orinoco was also subject to United States income tax, but the United States foreign tax credit[94] offset this amount.[95] U.S. Steel bought the ore from Orinoco F.O.B. Puerto Ordaz.[96]

Initially, U.S. Steel contracted with independent shipping companies to transport the ore to the United States.[97] In 1953, U.S. Steel formed Navios, Inc., a wholly owned subsidiary, to transport the ore for it.[98] Navios, a Liberian corporation, was subject to a 2.5 percent Venezuelan excise tax and was exempt from United States income taxes.[99] Although U.S. Steel was Navios's primary customer, it charged other customers the same price it charged U.S. Steel.[100] U.S. Steel set Navios's shipping charge to equal the difference between the price of iron ore F.O.B. Puerto Ordaz and the market price for iron ore in the United States.[101]

U.S. Steel's investment in Navios was $50,000.[102] By the end of 1960, Navios had accumulated "nearly $80 million in cash and cash

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91. Information about a taxpayer's motivations should be irrelevant in determining whether a taxpayer could justify its prices. There is some support for this position:

> No amount of self-examination of the taxpayer's internal transactions alone could make it possible to know what prices or terms unrelated parties would have charged or demanded. We think it palpable that, if the standard set by these unquestioned regulations is to be met, evidence of transactions between uncontrolled corporations unrelated to [the taxpayer] must be adduced in order to determine what charge would have been negotiated for the performance of . . . services [for the related entity].

Lufkin Foundary & Mach. Co. v. Commissioner, 468 F.2d 805, 808 (5th Cir. 1972).

92. United States Steel Corp. v. Commissioner, 617 F.2d 942, 945 (2d Cir. 1980).

93. *Id.*

94. *See id.*; I.R.C. § 901 (1976).

95. 617 F.2d at 945.

96. *Id.*

97. *See id.*; United States Steel Corp. v. Commissioner, 36 T.C.M. (CCH) 586, 591 (1977), *rev'd,* 617 F.2d 942 (2d Cir. 1980).

98. 617 F.2d at 945. Navios did not own any vessels. Instead, it chartered vessels from the companies that previously had shipped the ore for U.S. Steel. *Id.*

99. *See id.*

100. *Id.; see infra* notes 111-12 and accompanying text.

101. 617 F.2d at 945. Another U.S. Steel subsidiary, Oliver Mining Company, mined ore in the Mesabi range in Minnesota. An annual auction for Mesabi ore set the "Lower Lake Erie" price, a well-known and widely quoted price for iron ore in the United States. *See id.*; 36 T.C.M. (CCH) at 588.

102. 36 T.C.M. (CCH) at 591.

equivalents"[103] but had not paid any dividends to U.S. Steel.[104] The Service used section 482 to allocate $52 million of Navios's income to U.S. Steel for the period 1957 to 1960,[105] and U.S. Steel challenged this allocation in the Tax Court. Although the court found that the Service "may have been 'heavy handed' in [its] allocation,"[106] it held that some allocation was justified.[107] Using a complicated procedure to arrive at an arm's length charge for Navios's services,[108] the court then allocated $27 million of Navios' income to U.S. Steel.[109]

The Second Circuit reversed on appeal.[110] U.S. Steel had showed that Navios charged independent companies the same price that it charged U.S. Steel to deliver ore to the United States.[111] Moreover, the aggregate amount charged to independent companies comprised five percent of Navios's income during the years under scrutiny.[112] The Government made two arguments to rebut this showing. First, it argued that if U.S. Steel, a long-term charterer, had been dealing with Navios at arm's length, it would have obtained a lower rate than these short-term charterers.[113] Second, the Government argued that Navios's charge for shipping ore from Venezuela to its other customers in Great Britain was significantly lower when computed on the basis of distance travelled than Navios's charge for shipping ore to the United States.[114]

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103. 617 F.2d at 945.
104. *See id.*
105. 617 F.2d at 946; 36 T.C.M. (CCH) at 601.
106. 36 T.C.M. (CCH) at 602.
107. *Id.* at 604.
108. *See infra* note 175 and accompanying text.
109. 36 T.C.M. (CCH) at 605.
110. *See* 617 F.2d at 944.
111. *See id.* at 948.
112. *Id.* at 946. The five percent figure represented $20 million of Navios's total gross revenue from shipping to the eastern United States. *Id.* at 945-46.
113. *Id.* at 948-49. The court flatly rejected this argument. First, the court noted that a shipowner might not want to risk locking itself into a long-term rate. Second, the court stressed that Navios's relationship with U.S. Steel was as a carrier, not as a charterer. Thus, the Service's "analogy" to a charterer was unpersuasive. *Id.* at 949. Yet even as a carrier Navios would prefer having long-term customers. Traditionally, courts required a taxpayer to prove that the Service's allocation was arbitrary, capricious, or unreasonable before overturning the Service's allocation. *See infra* note 146 and accompanying text. The Government's evidence should have been enough to show that the amount of the Service's allocation was not arbitrary.
114. 617 F.2d at 949. In rejecting this argument, the court noted that there was nothing in the record to show that charter rates would be an arithmetic multiple of the distance travelled, or to show what the marginal cost of deliveries to Britain were. The Service had suggested that Navios could set higher rates for its ore deliveries to the United States than for its ore deliveries to Europe, because of the different selling prices for ore in the two markets. The court responded that just because "sellers of ore, providers of ore transport, and ore buyers were all influenced by the price of a competing product does not mean that a price is not an arm's length price." *Id.*

The Second Circuit's decision demonstrates a flexible reading of the regulation. Relying on that part of the regulation governing service charges, the court rejected both of the Government's arguments in favor of U.S. Steel's evidence.[115] The regulation provides that "an arm's length charge for services rendered shall be the amount which was charged or would have been charged for the same or similar services in independent transactions with or between unrelated parties under similar circumstances considering all relevant facts."[116] Courts generally require a taxpayer to prove that the Service's allocation was arbitrary, capricious, or unreasonable before it will even consider altering the allocation.[117] The Second Circuit interpreted the regulation under section 482, however, as "insulating" the taxpayer from a section 482 allocation whenever the taxpayer can establish that, based on "independent transactions with or between unrelated parties," its service charges were at arm's length.[118] Because the court found that the taxpayer had satisfied this test, it required the Service to prove that Navios's prices "deviated from a market price."[119] Moreover, the court rejected the Government's argument that the regulation's language allowing for consideration of "all relevant facts" required a determination of whether "Navios's prices were the result of a perfectly competitive market."[120] Instead, the court found that the regulation calls for a "limited approach":[121] once the taxpayer proves it made independent transactions with unrelated parties at the same price as it did in

115. *Id.* at 949-51.

116. Treas. Reg. § 1.482-2(b)(3), T.D. 6998, 1969-1 C.B. 144, 144. In general, the regulation deems an arm's length charge for services performed as "equal to the costs or deductions [the renderer] incurred" in performing the service. *Id.* If, however, the intercompany service is an "integral part of the business activity" of either the renderer or the recipient, then the cost or deduction standard of § 1.482-2(b)(3) does not apply. *Id.*

117. *See infra* note 146 and accompanying text.

118. 617 F.2d at 950.

119. *Id.* at 948.

120. *Id.* at 950. The court, however, did not decide how many " 'independent transactions' at the taxpayer's price would be needed to insulate taxpayer from [section] 482 in a situation where a preponderance of the 'independent' transactions take place at a price far different from the price paid or charged by taxpayer." *Id.* The court reasoned that U.S. Steel had shown that a sufficient number of independent transactions had occurred over a long period of time, and thus, the question did not arise. *Id.*

121. *Id.* at 950. The court gave an example that illustrates the extent to which it would limit its inquiry under the regulation. If all carriers and charterers in the market, including Navios, charged the difference between Orinoco's price F.O.B. Puerto Ordaz and the Lower Lake Erie price, and if U.S. Steel did not control Orinoco, then Navios's price would be arm's length. But if U.S. Steel did control Orinoco and had Orinoco undervalue its ore price, then Navios's prices would increase and, thus, would no longer be arm's length, because U.S. Steel, through Orinoco, would have affected it. Even in this situation, however, the court refused to look beyond proof that Navios charged unrelated parties the same price that it charged U.S. Steel, since this would distort "the kind of inquiry the Regulations direct us to undertake." *Id.* at 949.

controlled transactions, the court's inquiry is over, and it should dissallow the Service's allocation.

The *Du Pont* and *U.S. Steel* cases represent fundamentally different views on how to interpret section 482 and the regulation. The *Du Pont* case interpreted the regulation narrowly and to the taxpayer's disadvantage; *U.S. Steel* interpreted the regulation flexibly to confine the Service's discretion in section 482 allocations. *Du Pont* imposed an onerous burden of production on the taxpayer; *U.S. Steel* allowed the taxpayer easily to overcome a presumption that the Service was correct. *Du Pont* interpreted the regulation to give the Service broad discretion in its section 482 allocation; *U.S. Steel* used the regulation to protect the taxpayer from the Service's allocation. This Note attempts to show that the *U.S. Steel* case represents a better application of the regulation. The Treasury Department issued the regulation to protect taxpayers from unreasonable Service allocations and from double taxation of income from foreign operations.[122] Service agents, however, frequently allocate based on methods other than those the regulation sets out,[123] and the Service is protected by a very favorable burden of production when taxpayers attempt to overcome Service allocations in court.[124] Courts should interpret the regulation so that, whenever possible, the Service abides by the methods that the regulation prescribes.

II

PROBLEMS IN APPLYING THE REGULATION

For over fifty years the Internal Revenue Code has provided for income allocation among related taxpayers.[125] Until 1968, however,

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Moreover, the court refused to examine the possible reasons why some purchasers used other carriers to ship the ore they purchased from Orinoco. The Tax Court, after noting that Bethlehem Steel did not use Navios to ship Orinoco-purchased ore, commented, "[p]resumably, Bethlehem found that it could do the job for less." 36 T.C.M. (CCH) at 602. The Second Circuit dismissed the Tax Court's observation as "irrelevant" to an inquiry under § 482. 617 F.2d at 950. If Navios could charge independent buyers a higher price than other companies charged for comparable services, that was beyond the court's scrutiny: "the test of 'independence' . . . [does not] require that the transaction be one unaffected by the market power of the taxpayer." *Id.*

122. *See supra* notes 20-22 and *infra* notes 132-40 and accompanying text.

123. *See infra* notes 141-45 and accompanying text.

124. *See infra* notes 146-51 and accompanying text.

125. *See, e.g.*, I.R.C. § 482 (1976); Revenue Act of 1928, ch. 852, § 45, 45 Stat 791, 806 (1927-29) (repealed 1939); Revenue Act of 1926, ch. 27, § 240(f), 44 Stat. 9, 46 (1925-27) (repealed 1939); Revenue Act of 1921, ch. 136, § 240(d), 42 Stat. 227, 260 (1921-23) (repealed 1924); Revenue Act of 1918, ch. 18, § 240, 40 Stat. 1057, 1082 (1917-19) (repealed 1921). Section 482 is substantially the same as section 45 of the 1928 Act. H.R. REP. NO. 1337, 83d Cong., 2d Sess. A165 (1954), *reprinted in* 1954 U.S. CODE CONG. & AD. NEWS 4017, 4304; S. REP. NO. 1622, 83d Cong., 2d Sess. 310 (1954), *reprinted in* 1954 U.S. CODE CONG. & AD. NEWS 4621, 4949.

both the statute and the regulations promulgated thereunder were worded very generally. They furnished little practical guidance to taxpayer companies in dealing with their affiliates.[126] Courts also had trouble interpreting the provisions. They applied different, often conflicting, standards in determining a proper allocation among related taxpayers.[127]

In the 1960's, the Government became concerned that United States corporations were selling goods to overseas subsidiaries at artificially low prices "to avoid a U.S. tax on what should be [the domestic company's] full profit for such sales."[128] In 1962, the House of Representatives passed an amendment to section 482 which listed objective factors for the Service to consider when allocating income arising from sales of tangible property between related foreign and domestic corporations.[129] The House-Senate Conference Committee deleted that amendment, and instead invited the Treasury Department to issue regulations to provide "additional guidelines and formulas for the allocation of income and deductions

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James Fuller credits Regulation 41, arts. 77, 78 (1918) under the War Revenue Act of 1917 as the earliest predecessor of section 482. Fuller, *supra* note 27, at 475.

126. Regulations under early predecessors of Section 482 did little more than echo the statute's wording. *Compare, e.g.,* Revenue Act of 1926, ch. 27, § 240(f), 44 Stat. 9, 46 (1926) (repealed 1928) *with* Treas. Reg. 69, art. 636 (1926), T.D. 3922, 28 Treas. Dec. Int. Rev. 558, 741 (1927); Revenue Act of 1921, ch. 136, § 240(d), 42 Stat. 227, 260 (1921) (repealed 1926) *with* Treas. Reg. 62, art. 637 (1924), T.D. 3295, 24 Treas. Dec. Int. Rev. 207, 389 (1922). The regulations under the Revenue Acts of 1928 and 1932 included no provision interpreting section 45. [1936] 1 STAND. FED. TAX SERV. (CCH) ¶ 435.01.

The 1934 regulations provided that a controlled taxpayer's true income should be determined according to the standard of "an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer." Treas. Reg. 86, art. 45-1 (1934), BUREAU OF INTERNAL REVENUE, U.S. TREASURY DEP'T, REGULATIONS 86 RELATING TO THE INCOME TAX UNDER THE REVENUE ACT OF 1934, at 123 (1935), *reprinted in* [1935] 1 STAND. FED. TAX SERV. (CCH) ¶ 435A.

Succeeding regulations continued to prescribe the same standard. *See, e.g.,* Treas. Reg. 101, art. 45-1 (1938), 4 Fed. Reg. 616, 680 (1939); Treas. Reg. 118, § 39.45-1 (1953), 18 Fed. Reg. 5771, 5886-87 (1953); Treas. Reg. § 1.482-1 (1962), T.D. 6595, 1962-1 C.B. 43, 49-51.

127. *See supra* note 29.

128. H.R. REP. No. 1447, 87th Cong., 2d Sess. 28 (1962), *reprinted in* 1962-3 C.B. 405, 432.

129. H.R. 10650, 87th Cong., 2d Sess. § 6 (1962). The bill provided that when making allocations between related foreign and domestic taxpayers, the Service should consider among other factors the location of the tangible property used in the operation, the source of payroll funds attributable to the operation, and the source of funds for advertising, selling, and promotional expenses. The bill also included special rules for valuing the assets involved, for treating foreign taxes paid, for allocating sales commissions, and for adjusting for material differences in quantity, marketing conditions, import duties, and transportation costs. *Id. See also* H.R. REP. No. 1447, 87th Cong., 2d Sess. 29-30 (1962), *reprinted in* 1962-3 C.B. 405, 432-34.

Kauder reports that corporations objected to this amendment primarily because (1) they doubted that accurate allocations of net income based on location of property were possible, and (2) they believed that the general arm's length standard offered greater protection. *See* Kauder, *supra* note 6, at 31.

in cases involving foreign income."[130] The Treasury Department responded by proposing regulations in 1965 and 1966, and issuing a final regulation in 1968.[131] The regulation furnished detailed guidance for various types of section 482 allocations, not necessarily involving international transactions.

The Treasury Department intended the regulation to "provide as much guidance as possible to taxpayers and Internal Revenue Agents as to the standards to be applied in the administration of the section."[132] The Treasury Department wanted to allow businesses to "achieve . . . stability in business planning and arrangements."[133] With these goals in mind the regulation created safe havens, such that, if the price that a taxpayer charges its affiliate is within a specified margin, the Service will accept the transaction as being at arm's length.[134]

The Treasury Department did not create safe havens for all categories of intercompany transactions.[135] It specifically avoided safe havens for intercompany sales of tangible goods because such transactions encompass a wide variety of business practices, factual patterns, and market situations. Any mechanical formula "would produce arbitrary results far removed from economic reality."[136] The regulation instead defined three specific methods for calculating an acceptable arm's length price. The regulation specifies an order of priority, so that "a taxpayer is protected from an arbitrary choice of method by the examining Agent."[137]

The Treasury Department stressed that it would enforce the new regulation in "a spirit of reasonableness,"[138] taking an "objective, even-sided approach to [the] guidelines."[139] When the Service issued the regulation, Internal Revenue Commissioner Cohen promised that, "[i]n reviewing transactions, every reasonable effort will be

130. H.R. REP. No. 2508, 87th Cong., 2d Sess. 19 (1962), *reprinted in* 1962-3 C.B. 1129, 1146-47. *See supra* note 40.

131. Treas. Reg. § 1.482, 26 C.F.R. § 1.482 (1981); Proposed Treas. Reg. § 1.482, 31 Fed. Reg. 10,394 (1966); Proposed Treas. Reg. § 1.482, 30 Fed. Reg. 4256 (1965).

132. Rothkopf, *supra* note 5, at 728. "In general, the principle was to provide as much certainty and precision in the Regulations as was feasible within the framework of the statute and the appropriate policy and administrative considerations." *Id.*

133. Surrey, *supra* note 10, at 76.

134. [1968] 7 STAND. FED. TAX REP. (CCH) ¶ 6740. *See also* Cohen (1968), *supra* note 10, at 73; Rothkopf, *supra* note 5, at 728. The taxpayer is not confined to a safe haven if he can show that his transactions meet the arm's length standard outside the safe haven. Surrey, *supra* note 10, at 78.

135. Cohen (1968), *supra* note 10, at 73; Rothkopf, *supra* note 5, at 732.

136. Rothkopf, *supra* note 5, at 732.

137. Surrey, *supra* note 10, at 77.

138. Cohen (1968), *supra* note 10, at 74; Cohen (1967), *supra* note 10, at 237; [1968] 7 STAND. FED. TAX REP. (CCH) ¶ 6740. *See also* Surrey, *supra* note 10, at 77.

139. Surrey, *supra* note 10, at 76.

made by Agents to find the prevailing price or profit in comparable uncontrolled transactions, as opposed to choosing a figure at the extreme end of a range of figures."[140]

The Service, however, often appears to ignore the regulation, particularly the subsection dealing with intercompany sales of tangible goods. That subsection sets out three specific methods to be applied in all but extreme cases;[141] yet studies of Service allocations consistently show that the Service applies the fourth, catchall method, more often than it applies any of the first three.[142] The manual relied upon by examining agents when making section 482 allocations fails to mention the regulation's first three methods. Instead, it advises agents to apply an ad hoc "functional analysis" to the transactions in question.[143] Critics of the Service claim that the Service often knowingly disregards the regulation,[144] and several court decisions reveal instances where the examining agent's original allocation was based on an arbitrary method.[145]

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140. Cohen (1968), *supra* note 10, at 74; Cohen (1967), *supra* note 10, at 237.

141. *See supra* notes 36-44 and accompanying text.

142. *See supra* note 23 and accompanying text.

143. *See* 1 INTERNAL REVENUE MANUAL—AUDIT (CCH) ch. 4233 [523.2], at 7281-61 (April, 1981).

This functional analysis allocates income based on the "economic value" attributable to the "economically significant functions" involved in the transaction under scrutiny. An economically significant function can be attributable to personnel activities, for example, or capital, such as patents and other intangibles. *Id.* ch. 4233 [523.2(2)-(4)], at 7281-62. This method presumes that section 482 allocations should be based on the relative contributions made by the parties involved in an uncontrolled transaction, rather than based only on the relative market position of the buyer and seller in a controlled sale, which would result from the regulation's arm's length standard.

144. *E.g.,* PRESIDENT'S TASK FORCE ON BUSINESS TAXATION, *supra* note 27, at 56-57; M. DUERR, *supra* note 4, at 70-75; Mihaly, *supra* note 17, at 752 n.24.

145. United States Steel Corp. v. Commissioner, 36 T.C.M. (CCH) 586, 602 (1977) ("At the outset, petitioner contends that the allocations made by the respondent were 'without support in the record, duplicative, inconsistent with stipulated facts, and arbitrary and capricious.' When viewed in the light of the existing record, the Court might be inclined to agree with petitioner."), *rev'd on other grounds,* 617 F.2d 942 (2d Cir. 1980); Cadillac Textiles, Inc. v. Commissioner, 34 T.C.M. (CCH) 295, 305 (1975) ("While the court agrees that some allocation is fully warranted, in our opinion the method followed by the [Service] can best be described as 'heavy handed.' ") In American Terrazzo Strip Co. v. Commissioner, the examining agent testified at trial:

> Well, I can just sit back and say that it appeared to me that twenty percent profit, net profit on an operation such as this was more than reasonable. I figured if the taxpayer were willing to accept that, I thought we would be getting away with a very good deal, and if not, he would prove otherwise, and he never proved otherwise.

American Terrazzo Strip Co. v. Commissioner, 56 T.C. 961, 971 n.7 (1971), *acq. in,* 1973-2 C.B. 1.

Courts have found the examining agent's method unreasonable in a number of cases. *See* Eli Lilly & Co. v. United States, 372 F.2d 990, 996-97 (Ct. Cl. 1967) (per curiam) (agent's method was arbitrary, though result was reasonable); PPG Indus. v. Commissioner, 55 T.C. 928, 993 (1970) (agent's reliance on Service's Source Book of Statistics of Income, without knowing whether the companies included therein were comparable, was

Taxpayers in section 482 cases have difficulty challenging an agent's choice of method. In all courts, taxpayers have the initial burden of proving that the Service's allocation was arbitrary, capricious, or unreasonable.[146] In the Tax Court, once the taxpayer sustains this burden, the court alone determines the proper

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arbitrary and unreasonable); Baldwin-Lima-Hamilton Corp. v. United States, 69-1 U.S. Tax Cas. (CCH) ¶ 9269, at 84,183 (N.D. Ill. 1967) (Service acted arbitrarily in making a total allocation), *aff'd in part and rev'd in part,* 435 F.2d 182, 183 (4th Cir. 1970); Johnson Bronze Co. v. Commissioner, 24 T.C.M. 1542, 1556 (1965) (Service acted arbitrarily in making a total reallocation); Ach v. Commissioner, 42 T.C. 114, 126 (1964) (same), *aff'd,* 358 F.2d 342 (6th Cir.), *cert. denied,* 385 U.S. 899 (1966); Oil Base, Inc. v. Commissioner, 23 T.C.M. 1838, 1847 (1964), *aff'd,* 362 F.2d 212 (9th Cir.), *cert. denied* 385 U.S. 928 (1966) (same); Grenada Indus. v. Commissioner, 17 T.C. 231, 255 (1951) (any allocation from Hosiery or Industries to National was arbitrary), *aff'd,* 202 F.2d 873 (5th Cir.), *cert. denied,* 346 U.S. 819 (1953).

Courts in other cases have found that the Government failed to justify its allocation when presenting its case. *See, e.g.,* Dallas Ceramic Co. v. United States, 598 F.2d 1382, 1388 (5th Cir. 1979), *rev'g* 74-2 U.S. Tax Cas. (CCH) ¶ 9830, at 1388 (N.D. Tex. 1974); Ross Glove Co. v. Commissioner, 60 T.C. 569, 605-06 (1973), *acq.* 1974-1 C.B. 2; Woodward Governor Co. v. Commissioner, 55 T.C. 56, 65 (1970), *acq.* 1971-2 C.B. 20.

146. *Tax Court cases and appeals therefrom: E.g.,* Wisconsin Big Boy Corp. v. Commissioner, 452 F.2d 137, 140 n.2 (7th Cir. 1971), *aff'g* 52 T.C. 1073 (1969); Philipp Bros. Chems., Inc. (N.Y.) v. Commissioner, 435 F.2d 53, 57 (2d Cir. 1970), *aff'g* 52 T.C. 240 (1969); Oil Base, Inc. v. Commissioner, 362 F.2d 212, 214 (9th Cir. 1966), *cert. denied,* 385 U.S. 928 (1966), *aff'g* 43 T.C. 928 (1964); Ballentine Motor Co. v. Commissioner, 321 F.2d 796, 800 (4th Cir. 1963), *aff'g* 39 T.C. 348 (1962); Campbell County State Bank v. Commissioner, 311 F.2d 374, 379 (8th Cir. 1963), *rev'g* 37 T.C. 430 (1961); Hall v. Commissioner, 294 F.2d 82, 87 (5th Cir. 1961) (interpreting § 45 of 1939 Code), *aff'g* 32 T.C. 390 (1959).

Board of Tax Appeals: National Sec. Corp. v. Commissioner, 137 F.2d 600, 602 (3d Cir.), *cert. denied,* 320 U.S. 794 (1943) (§ 45 of 1939 Code), *aff'g* 46 B.T.A. 562 (1942).

Court of Claims cases: E.g., Young & Ribicam, Inc. v. United States, 410 F.2d 1233, 1244-45 (Ct. Cl. 1969); Eli Lilly & Co. v. United States, 372 F.2d 990, 997 (Ct. Cl. 1967) (per curiam).

District court cases and appeals therefrom: E.g., Engineering Sales, Inc. v. United States, 510 F.2d 565, 569 (5th Cir. 1975), *rev'g* 74-1 U.S. Tax Cas. (CCH) ¶ 9211 (N.D. Ala. 1974); Baldwin-Lima-Hamilton Corp. v. United States, 435 F.2d 182, 185 (7th Cir. 1970), *aff'g in part and rev'g in part* 69-1 U.S. Tax Cas. (CCH) ¶ 9269 (N.D. Ill. 1969); West Indies Transp. Co. v. Dep't of Finance, Government of the Virgin Islands, 13 V.I. 301, 319-20 (D.V.I. 1976).

Eustice claims that this burden of proof on taxpayers "gives the Service a formidable tactical advantage in the section 482 area." Eustice, *supra* note 3, at 494. *But cf.* 1 INTERNAL REVENUE MANUAL—AUDIT (CCH) ch. 4233[521(5)], at 7281-59 (Aug., 1981) ("When necessary information is not obtained at the audit stage, the Service is at a most serious disadvantage if the taxpayer takes the case to court and, indeed, may even be forced to concede the deficiency to avoid an almost certainly adverse court decision which would then be damaging precedent.")

For information about the burden of proof in section 482 cases, see Jenks, *supra* note 50, at 506-10 (1972); Lewis, *supra* note 29, at 63-70; Plumb & Kapp, *supra* note 3, at 830-31 (1963); ALLOCATIONS (SEC. 482)—GENERAL COVERAGE, 327 TAX MGMT. (BNA), A-23 to A-27 (1975 & Supp. 1981). For information on taxpayer's burden of proof generally, see Forman, *The Burden of Proof,* 39 TAXES 737 (1961); Marcosson, *The Burden of Proof in Tax Cases,* 29 TAXES 221 (1951); Piper & Jerge, *Shifting the Burden of Proof in Tax Court,* 31 TAX LAW. 303 (1978); Whitfield & McCallum, *Burden of Proof and Choice of Forum in Tax Litigation,* 20 VAND. L. REV. 1179 (1967); Comment, *Burden of Proof in Tax Litigation: Offset and Equitable Recoupment,* 15 BUFFALO L. REV. 616 (1966).

allocation.[147] Neither the Service nor the taxpayer benefits from any presumption.[148] In the Court of Claims and district courts, however, taxpayers have the additional burden of establishing the correct allocation before they can recover.[149] Some commentators challenge the application of a burden of production that is higher in the Court of

147. *E.g.,* W. Braun Co. v. Commissioner, 396 F.2d 264, 270 (2d Cir. 1968), *rev'g* 26 T.C.M. 342 (1967) (remanding case to Tax Court to determine proper allocation after finding Commissioner's allocation arbitrary); Ross Glove Co. v. Commissioner, 60 T.C. 569, 602 (1973), *acq.* 1974-1 C.B. 2; Cadillac Textiles, Inc. v. Commissioner, 34 T.C.M. 295, 306 (1975); American Terrazzo Strip Co. v. Commissioner, 56 T.C. 961, 973-75 (1971); Nat Harrison Assoc. v. Commissioner, 42 T.C. 601, 617-18, 621-22 (1964); Ach v. Commissioner, 42 T.C. 114, 126-27 (1964), *aff'd,* 358 F.2d 342 (6th Cir. 1966), *cert. denied,* 385 U.S. 899 (1976); Johnson Bronze Co. v. Commissioner, 24 T.C.M. 1542, 1556 (1965); Oil Base, Inc. v. Commissioner, 23 T.C.M. 1838, 1847 (1964), *aff'd,* 362 F.2d 212 (9th Cir.), *cert. denied,* 385 U.S. 928 (1966). *See generally* Helvering v. Taylor, 293 U.S. 507, 515 (1935).

148. Nat Harrison Assoc. v. Commissioner, 42 T.C. 601, 617-18 (1964).

149. Engineering Sales, Inc. v. United States, 510 F.2d 565, 569 (5th Cir. 1975), *rev'g* 74-1 U.S. Tax Cas. (CCH) ¶ 9211 (N.D. Ala. 1974); United States Gypsum Co. v. United States, 452 F.2d 445, 450 (7th Cir. 1971), *aff'g in part and rev'g in part* 304 F. Supp. 627 (N.D. Ill. 1969); Baldwin-Lima-Hamilton Corp. v. United States, 435 F.2d 182, 185 (7th Cir. 1970), *aff'g in part and rev'g in part* 69-1 U.S. Tax Cas. (CCH) ¶ 9269 (N.D. Ill. 1969); Eli Lilly & Co., 372 F.2d 990, 997 (Ct. Cl. 1967). *See generally* Wiles v. United States, 312 F.2d 574, 577 (10th Cir. 1962), *aff'g* 61-1 U.S. Tax Cas. (CCH) ¶ 9429 (D. Kans. 1961) (taxpayer also has burden of proving facts to prove a correct allocation); Alvary v. United States, 302 F.2d 790, 795 (2d Cir. 1962), *rev'g* 61-2 U.S. Tax Cas. (CCH) ¶ 9501 (S.D.N.Y. 1961) ("Although in the Tax Court a taxpayer need only prove that a deficiency is erroneous, in a suit for a refund in the district court he must prove the amount of the error by showing what the value was.") *But cf.* Ross Glove Co. v. Commissioner, 60 T.C. 569 (1973) (Government has burden of proving reasonableness of § 482 allocations if it fails to give timely notice of reliance on § 482 in trial proceedings), *acq.* 1974-1 C.B. 2.

The different burden of proof in district courts and the Court of Claims from that of the Tax Court derives from dictum in Helvering v. Taylor, 293 U.S. 507 (1935). *Taylor* affirmed a court of appeals's decision to remand a case to the Board of Tax Appeals to determine a proper deficiency after the court of appeals found the Commissioner's determination arbitrary. The Commissioner argued that proof of arbitrariness requires proof that a different allocation is accurate. *Taylor,* in dictum, rejected the Commissioner's argument on the ground that the case involved a deficiency claim by the Service, rather than a refund claim by the taxpayer. The Court's reasoning, however, does not support this distinction:

> [W]here as in this case the taxpayer's evidence shows the commissioner's determination to be arbitrary and excessive, it may not reasonably be held that he is bound to pay a tax that confessedly he does not owe, unless his evidence was sufficient also to establish the correct amount that lawfully might be charged against him.

Id. at 515.

In two appeals from district court cases, the Seventh Circuit held that the court may proceed to determine a proper allocation. *See* United States Gypsum Co. v. United States, 452 F.2d 445, 450 (7th Cir. 1971), *aff'g in part and rev'g in part* 304 F. Supp. 627 (N.D. Ill. 1969); Baldwin-Lima-Hamilton Corp. v. United States, 435 F.2d 182, 187 (4th Cir. 1970), *aff'g in part and rev'g in part* 69-1 U.S. Tax Cas. (CCH) ¶ 9269 (N.D. Ill. 1967).

For a discussion of the differing burdens of proof, see ALLOCATIONS (SEC. 482)—GENERAL COVERAGE, 327 TAX MGMT. (BNA), at A-25 to A-27.

Claims and district courts than in the Tax Court,[150] but the distinction has become well established.[151] Thus, a taxpayer faced with this difficult burden of production may find it impossible to overcome even unreasonable Service allocations when no comparable transactions exist.

The higher burden of production is particularly inappropriate when the most similar transaction is one between unrelated third parties.[152] Normally other companies will be unwilling to reveal their costs, markups, or profit margins to their competitors. The Service, however, can obtain such data from other companies and require them to testify as expert witnesses under I.R.C. § 7602.[153]

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150. *See, e.g.,* Lewis, *supra* note 29, at 66-69; Marcosson, *supra* note 146, at 222; ALLOCATIONS (SEC. 482)—GENERAL COVERAGE, 327 TAX MGMT. (BNA), *supra* note 146, at A-25 to A-27.

One justification for the distinction is that the taxpayer is the plaintiff in refund suits, and the plaintiff should prove all the essential elements of his claim. *See* Taylor v. Commissioner, 70 F.2d 619, 620-21 (2d Cir. 1934) (L. Hand, J.), *aff'd sub nom.,* Helvering v. Taylor, 293 U.S. 507 (1935). Yet, once the taxpayer has shown that the Service's allocation was unreasonable, he has proved that the Service's allocation should not stand.

A second possible justification for the higher standard is that district courts lack the time or expertise to make these adjustments on their own. Even if district courts cannot make precise adjustments, however, they could at least reduce the allocation by some reasonable estimate. Such an estimate would fulfill the regulation's purpose better than would a requirement that taxpayers pay amounts they have proved to be unreasonable. In the *Du Pont* case, for example, the applicable regulation provides, "[i]n determining an arm's length price appropriate adjustment must be made to reflect any material differences . . . ." Treas. Reg. § 1.482-2(e)(3)(ix), T.D. 6952, 1968-1 C.B. 218, 240-41. District courts and the Court of Claims could interpret this wording to provide that they themselves determine a reasonable allocation if neither party can prove the precise amount.

151. *But see* Dallas Ceramic Co. v. United States, 598 F.2d 1382, 1384, 1391 (5th Cir. 1979). There, the taxpayer received contradictory judgments in the Tax Court and the district court based on identical facts. After affirming the Tax Court's finding that no allocation was justified, Brittingham v. Commissioner, 598 F.2d 1375 (5th Cir. 1979) (per curiam), the Fifth Circuit simply reversed the district court rather than remand for additional findings. "There seems little question but that the Tax Court case and the district court case should come out the same." 598 F.2d at 1384.

152. The Tax Section of the New York State Bar Association Committee on International Taxation recommends that the Service should be unable to use third party data that is unavailable to taxpayers. *See* Simon, *Section 482 Allocations* 46 TAXES 254, 280-82 (1968).

153. Section 7602 provides:

> For the purpose of ascertaining the correctness of any return, making a return where none has been made, determining the liability of any person for any internal revenue tax or the liability at law or in equity of any transferee or fiduciary of any person in respect of any internal revenue tax, or collecting any such liability, the Secretary is authorized—
>
> (1) To examine any books, papers, records, or other data which may be relevant or material to such inquiry;
>
> (2) To summon the person liable for tax or required to perform the act, or any officer or employee of such person, or any person having possession, custody, or care of books of account containing entries relating to the business of the person liable for tax or required to perform the act, or any other person the Secretary may deem proper, to appear before the Secretary at a

The Service also has sole access to old audits of other corporations.[154]

Courts frequently compensate for the difficulties taxpayers face under section 482 by interpreting the regulation liberally in favor of the taxpayer.[155] The *Du Pont* case is particularly damaging as precedent because it both construes the regulation narrowly and imposes an extremely difficult burden of production on taxpayers. Under the uncontested facts of *Du Pont,* the court should have applied the resale price method to the transaction.[156] That method calculates an arm's length price based on the "most similar" uncontrolled sale after adjusting for all "material differences" between the two sales.[157] The parties in *Du Pont* agreed that no independent organization had performed the functions that DISA had performed.[158] Under those circumstances, finding a sufficiently similar transaction and adjusting for all the material differences based solely on market information would be extremely difficult. Yet *Du Pont* held that the regulation requires "substantial comparability"[159] between the two sales even under the resale price method.[160] *Du Pont* also held that taxpayers bear the burden of proving the validity of all the material adjustments between the sales,[161] reasoning that "the [material] adjustments called for . . . are integral to the determination of an 'arm's length price.' "[162]

The *Du Pont* court's interpretation of the regulation under section 482 does not comport with the regulation's intended purpose. Provisions in the regulation and statements that senior Treasury

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time and place named in the summons and to produce such books, papers, records, or other data, and to give such testimony, under oath, as may be relevant or material to such inquiry; and

(3) To take such testimony of the person concerned, under oath, as may be relevant or material to such inquiry.

I.R.C. § 7602 (1976). *See also* 1 INTERNAL REVENUE MANUAL—AUDIT (CCH) 4233[53(15)], at 7281-74 (Aug., 1981).

154. 1 INTERNAL REVENUE MANUAL—AUDIT (CCH) ch. 4233[53(16)] at 7281-75 (May, 1981). In the *Du Pont* case, for example, the examining agent had used data in the Service's SOURCE BOOK OF STATISTICS OF INCOME for 1960 to determine Du Pont's § 482 allocation for its 1960 tax return. 608 F.2d at 452-53. During pretrial discovery, Du Pont tried to obtain the names of the corporations relied on by the agent. The trial judge refused to grant the discovery requests, however, on the ground that the identity of the companies was irrelevant. Brief for Plaintiff at 27 n.**. The Court of Claims noted that the Service is precluded by statute from disclosing the names of companies contained in the Source Book. 608 F.2d at 452 n.19.

155. *See* Fuller, *supra* note 27, at 507 & n.133; Mihaly, *supra* note 17, at 754-55.

156. *See supra* notes 68-71 and accompanying text.

157. *See supra* note 42 and accompanying text.

158. 78-1 U.S. Tax Cas. (CCH) ¶ 9374, at 83,952 (finding 101).

159. 608 F.2d at 451.

160. *Id.* at 450-51.

161. *Id.* at 454.

162. *Id.*

Department officials made when the regulation was issued show that the regulation should be applied flexibly.[163] The resale price method should not require substantially comparable transactions to apply. Material differences should not be used to defeat the application of an appropriate method under the regulation; instead, adjustments should be made to obtain better estimates of taxable income. Although district courts and the Court of Claims normally require taxpayers to prove the amount of their refund to prevail over an arbitrary Service allocation under section 482, only *Du Pont* goes so far as to require taxpayers to prove the amount of each material adjustment.

III

REVITALIZING THE REGULATION'S PROTECTIONS

The regulation attempts to define the limits of the Service's broad power under section 482 to allocate income and deductions between taxpayers under common control. Allocations are based on arm's length transactions under market conditions. For intercompany sales of tangible property, the regulation provides specific methods for calculating an arm's length price, based on transactions similar to the transaction under audit.[164] The arm's length standard breaks down, however, if similar transactions are unavailable to compare with the audited transaction. Any price is speculative and possible estimates can vary widely. Absent a closely comparable transaction, the regulation should be applied flexibly to compensate for the difficulties in comparing available uncontrolled transactions. In practice, the Service often has ignored the regulation, and in some instances, has acted harshly toward taxpayers.[165] Furthermore, courts have required taxpayers who challenge section 482 allocations not only to overcome the general presumption that the Service is correct, but also to prove that the allocation was arbitrary, capricious, or unreasonable.[166]

No adequate reason exists for placing this additional burden on the taxpayer. Early predecessors of section 482 were designed to prevent the deliberate and improper allocation of income and deductions between organizations under common control.[167] Today the

163. *See supra* note 72.
164. *See supra* notes 36-39, 43 and accompanying text.
165. *See supra* notes 144-45 and accompanying text.
166. *See supra* note 146 and accompanying text.
167. The legislative history of one of § 482's predecessors illustrates that the section's purpose is to prevent businesses from evading taxes "by the shifting of profits, the making of fictitious sales, and other methods frequently adopted for the purpose of 'milk-

Service extends the application of section 482 to inadvertent cases of income shifting.[168] Taxing the inadvertent shifting of income is reasonable, both because of the difficulties in proving the taxpayer's motive, and because the shifted income is properly attributable to United States operations. Imposing a burden of production on the taxpayer that is more onerous than a presumption that the Service is correct, however, is inappropriate when the taxpayer has not intentionally evaded its income tax obligation. In such a case, the allocation simply should be the best estimate of the proper amount of income attributable to the operation. A best estimate allocation is particularly appropriate when employing an objective standard, such as the arm's length standard of the regulation. The regulation calls for an allocation based on market prices, not one which necessarily corresponds to the Service's sense of justice. Courts sometimes justify this additional burden by reasoning that Congress provided the Service with wide discretion[169] in allocating income and deductions between related corporations.[170] The Treasury Department promulgated the regulation, however, to define the limits of the Service's power to allocate, not to expand that power.[171]

A taxpayer that is unable to refer to similar transactions can overturn an arbitrary Service allocation only if a court is willing to apply the regulation's methods broadly. A broad application enables the court to account for the difficulty in obtaining price estimates based on market conditions. If a court interprets the regulation narrowly, as did the court in *Du Pont,* a taxpayer will rarely succeed in overturning even an arbitrary Service allocation.[172]

The Tax Court in the *U.S. Steel* case also interpreted the regulation narrowly. The regulation's provision regarding the performance of services defines an arm's length service charge as the charge "for the same or similar services in independent transactions"

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ing.'" H.R. REP. No. 2, 70th Cong., 1st Sess. 16-17 (1927), *reprinted in* 1939-1 (pt. 2) C.B. 384, 395.

168. *See, e.g.,* Treas. Reg. § 1.482-1(b)(3), T.D. 6595, 1962-1 C.B. 43, 51 (current regulation); Treas. Reg. 86, art. 45-1(*c*) (1934), BUREAU OF INTERNAL REVENUE, U.S. TREASURY DEP'T, REGULATIONS 86 RELATING TO THE INCOME TAX UNDER THE REVENUE ACT OF 1934, at 124 (1935), *reprinted in* [1935] 1 STAND. FED. TAX SERV. (CCH) ¶ 435A.

169. Section 482 gives the discretion to reallocate to the Secretary of the Treasury or his delegate. *See* I.R.C. § 482, 7701(a)(11)(B) (1976). The Secretary has delegated his powers under section 482 to the district director. *See* Treas. Reg. § 1.482-1(b)(1) (1962), T.D. 6495, 1962-1 C.B. 43, 50; Cohen (1967), *supra* note 10, at 239.

170. *See, e.g.,* Young & Rubicam, Inc. v. United States, 410 F.2d 1233, 1244 (Ct. Cl. 1969); Spicer Theatre, Inc. v. Commissioner, 346 F.2d 704, 706 (6th Cir. 1965); Ballentine Motor Co. v. Commissioner, 321 F.2d 796, 800 (4th Cir. 1963); Campbell Ctr. State Bank, Inc. v. Commissioner, 311 F.2d 374, 377 (8th Cir. 1963); Ach v. Commissioner, 42 T.C. 114, 126 (1964).

171. *See supra* notes 132-37 and accompanying text.

172. *See supra* notes 141-62 and accompanying text.

involving "similar circumstances."[173] The Tax Court rejected using the rates that Navios charged unrelated parties; the court apparently believed that U.S. Steel had greater bargaining power with Navios than Navios had with Navios's unrelated customers.[174] Concluding that no similar transactions with or between unrelated parties could possibly exist, the court devised its own method of allocation based on what the court determined to be a "reasonable" rate of return for Navios's risk.[175]

The Second Circuit rejected the Tax Court's approach. In the appellate court's view, section 482 is "a broadly drawn statute" which attempts only to ensure that intercompany prices approximate market prices.[176]

> To say that [an unrelated party] was buying a service from Navios with one set of expectations about duration and risk, and Steel another, may be to recognize economic reality; but it is also to engraft a crippling degree of economic sophistication onto a broadly drawn statute, which . . . would allow the taxpayer no safe harbor from the Commissioner's virtually unrestricted discretion to reallocate.[177]

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173. Treas. Reg. § 1.482-2(b)(3), T.D. 6998, 1969-1 C.B. 144, 144. *See supra* note 116 and accompanying text. The Tax Court incorrectly referred to language in Treas. Reg. § 1.482-1(d)(3), which refers to "independent transactions with unrelated parties under the same or similar circumstances." 36 T.C.M. (CCH) at 602. This provision, however, applies to setoffs the Service should make after determining a non-arm's length price. *See* Treas. Reg. § 1.482-1(d)(3), T.D. 6952, 1968-1 C.B. 218, 220-21. The language in the two provisions, however, is similar, so this Note compares the Tax Court's analysis with the provisions of Treas. Reg. § 1.482-2(b)(3).

174. *See* 617 F.2d at 950-51; 36 T.C.M. (CCH) at 602-03.

175. The Tax Court's allocation was refined and complex. The court began with the actual rates Navios charged for shipping goods to the United States. The court then reduced these rates to compute that part of the rate attributable to Navios's ocean freight operations. That computation required the court to subtract Navios's costs for inland freight expense, but not its costs for idle vessel expense, from the full rate.

The Tax Court used two methods to compare the resulting ocean freight expense to amounts that the court felt Navios should have received for purposes of § 482. First, the court determined that, based on Navios's risk, a "reasonable profit" for Navios would be 20% over Navios's costs. The court subtracted Navios's ocean shipping costs plus 20% from Navios's ocean shipment rates, for the years 1957 to 1960, to calculate Navios's excess profit.

Second, the court attempted to recreate an arm's length price for Navios based on prices that U.S. Steel paid to Universe Tankships, Inc., an independent shipper, in 1954. The court took Universe's price and computed cost increases for each of the years 1957 to 1960 for fuel escalation, wage escalation, port expense, idle vessel expense, cargo insurance, management fees, and stevedoring costs. As with the first method, the court subtracted Navios's total costs, plus 20% to reflect a reasonable return for Navios, from Navios's actual ocean shipment rates to calculate Navios's excess profit under this method.

After these calculations, the court had two estimates of Navios's excess profit for each year from 1957 to 1960. The court took the lower figure for each year, rounded to the nearest hundred thousand, and allocated it to U.S. Steel. The court's total allocation from Navios to U.S. Steel was twenty-seven million dollars. *See* 36 T.C.M. (CCH) at 604-05; Brief for the Commissioner at 13-15.

176. 617 F.2d at 951.

177. *Id.*

The Second Circuit said that the regulation calls for a "limited approach" in calculating a hypothetical arm's length service charge.[178] The court reasoned that the regulation should be applied liberally when attempting to find comparable transactions between unrelated parties; independent transactions should not be rejected for comparison by requiring that those transactions be closely comparable to the controlled transaction.[179]

The Second Circuit allowed U.S. Steel to justify its price to Navios without first showing that the Service's allocation was arbitrary, capricious, or unreasonable. U.S. Steel only had to show that the fees it paid to Navios were equivalent to the fees the nine unrelated corporations paid to Navios—charges accounting for five percent of Navios's income during the period under scrutiny.[180] The court then required the Government to make a "counter showing" that the price Navios charged *all* of its customers was not an arm's length service charge.[181] The regulation provides that an arm's length charge for services rendered is "the amount which was charged or would have been charged for the same or similar services in independent transactions with or between unrelated parties."[182] The court stated that once the taxpayer can establish that others were charged the same price, "it has earned the right, under the Regulations, to be free from a § 482 reallocation despite other evidence tending to show that its activities have resulted in a shifting of tax

178. *Id.* at 950.
179. *Id.* at 950-51.
180. *See supra* note 112 and accompanying text.
181. 617 F.2d at 948.
182. Treas. Reg. § 1.482-2(b)(3), T.D. 6998, 1969-1 C.B. 144, 144; *see supra* note 116 and accompanying text.

liability among controlled corporations."[183] This holding goes against precedent, but it is in accord with the regulation's purpose.[184]

183. 617 F.2d at 947. The various burdens of proof can be summarized as follows:

			AND THE GOVERNMENT'S ALLOCATION WAS	
			Reasonable	Unreasonable
TAXPAYER	If Taxpayer's Original Prices Were Reasonable		Tax Ct.: Service Prevails *U.S. Steel*: Taxpayer Ct. of Claims & District Ct.: Service *Du Pont*: Service	All courts: Taxpayer Prevails
	If Tax-Payer's Original Prices Were Unreasonable	And It Can Prove Reasonable Amount	Tax Ct.: Service *U.S. Steel*: ? Ct. of Claims & District Ct.: Service *Du Pont*: Service	Tax Ct.: Taxpayer *U.S. Steel*: Taxpayer Ct. of Claims & District Ct.: Service* *Du Pont*: Service
		And It Cannot Prove Reasonable Amount	All courts: Service	Tax Ct.: Ct. determines proper allocation *U.S. Steel*: Ct. determines proper allocation Ct. of Claims: Service District Ct.: Service* *Du Pont*: Service

*In *Baldwin-Lima-Hamilton Corp.*, however, the Seventh Circuit held that district courts may determine a proper allocation. *See supra* note 149.

See *supra* notes 146-48 and accompanying text for the burden of production taxpayers face in Tax Court cases. See *supra* notes 146, 149-51 and accompanying text for the burden taxpayers face in Court of Claims cases. See *id.* for the burden taxpayers face in district court cases. See *supra* notes 118-19, 180-82 and accompanying text for the burden the Second Circuit imposed in the *U.S. Steel* case. See *supra* notes 161-62 and accompanying text for the burden the Court of Claims imposed in the *Du Pont* case.

184. *See supra* notes 167-69 and accompanying text. Compare the recommendation of the President's Task Force on Business Taxation:

> [T]he Task Force recommends that Section 482 be amended to provide that the burden of proof with respect to a determination made by the Commissioner under Section 482 shall be on the Commissioner if the taxpayer submits to the Service in due course a statement of the grounds (together with facts sufficient to show the basis thereof) on which he relies to establish that the amount of the item in question was fair and reasonable under all the circumstances.

PRESIDENT'S TASK FORCE ON BUSINESS TAXATION, *supra* note 27, at 56-57.

Taxpayers arguing for adoption of the *U.S. Steel* approach in the Seventh Circuit will have to deal with mixed precedent. The district court in *United States Gypsum Co.* found for a taxpayer that showed that its controlled prices were a reasonable estimate of an arm's length price, though the court implied the Service's allocation was also reasonable. *See* United States Gypsum Co. v. United States, 304 F. Supp. 627, 634-35 (N.D. Ill. 1969), *aff'd* 452 F.2d 445 (7th Cir. 1971). The Seventh Circuit found that the district court had incorrectly followed the arm's length standard. 452 F.2d at 449. The Seventh Circuit, however, upheld the court's finding: "[W]e treat the district court's finding as equivalent to a finding that the administrative decision that the charges were not arm's

By requiring the taxpayer to make an initial showing that its prices were arm's length, the court still recognizes the general presumption that the Service is correct.[185]

The Second Circuit, however, overlooked the effect of material adjustments. *U.S. Steel* held that the Service could overcome U.S. Steel's prima facie case only by showing that Navios's charges to its other customers also deviated from a market price that the Commissioner could prove existed.[186] The court stressed that " 'independent transactions with or between unrelated parties' are enough to *insulate* a taxpayer's price from § 482."[187] At another point the court stated:

> We think it clear that if a taxpayer can show that the price he paid or was charged for a service is "the amount which was charged or would have been charged for the same or similar services in independent transactions with or between unrelated parties" it has earned the right, under the Regulations, to *be free from a § 482 reallocation despite other evidence tending to show that its activities have resulted in a shifting of tax liability among controlled corporations*.[188]

These statements ignore the regulation's requirement that adjustments be made for all material differences between the transactions under comparison, a requirement that the regulation stresses.[189] Assuming, for example, that Navios had insured U.S. Steel's ore, but not other customers' ore, from the risk of loss during transit, Navios's price to U.S. Steel should be adjusted upward by an amount equal to the cost of insuring the ore during transit. The material adjustment requirement should not be interpreted woodenly, however. In *Du Pont,* the court placed an onerous burden on the taxpayer by requiring that it prove the amount of each adjustment before it could obtain any refund. Instead, the courts should

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length charges was unreasonable, arbitrary, and capricious, and deem the finding not clearly erroneous." *Id.* at 449.

Taxpayers in the Fifth Circuit will have the precedent of *Dallas Ceramic Co.* in their favor. *See supra* note 151. Taxpayers in the Court of Claims, of course, would be faced with the hurdle of *Du Pont* and *Eli Lilly*. *See supra* note 149 and accompanying text.

185. *See* Welch v. Helvering, 290 U.S. 111, 115 (1933); Lucas v. Kansas City Structural Steel Co., 281 U.S. 264, 271 (1930); Williamsport Co. v. United States, 277 U.S. 551, 559 (1928); Wickwire v. Reinecke, 275 U.S. 101, 105 (1927).

186. 617 F.2d at 948.

187. 617 F.2d at 950 (emphasis added).

188. *Id.* at 947 (emphasis added). At another point the court states:

> The Regulations make it clear that if the taxpayer can show that the amount it paid was equal to "the amount which was charged . . . for the same or similar services in independent transactions" he can *defeat* the Commissioner's effort to invoke § 482 against him. . . . [If the prices paid were the same] *[t]he only question,* then, is whether the transactions were "independent."

Id. at 949 (emphasis added).

189. *See supra* note 42 and accompanying text.

allow reasonable estimates for material adjustments when reviewing section 482 allocations.

The Second Circuit may have been reacting to the Tax Court's extremely detailed adjustments[190] when it said that a taxpayer's price would be "insulated" from any allocation under section 482. The Tax Court used an incorrect method for determining the proper allocation.[191] When using a proper method, the Tax Court should adjust for material differences as the regulation dictates. The Second Circuit should affirm the adjustments, if not clearly erroneous, as it would in reviewing any other factual determination. Under the Second Circuit's apparent interpretation of the regulation, a taxpayer can create controlled sales with preferential provisions so long as it charges the same fee to all customers. This reading would allow a taxpayer to avoid paying its full United States tax obligation by including preferential terms in its controlled sales.

CONCLUSION

Since the early 1960's the Internal Revenue Service has vigorously applied section 482 to major United States corporations doing business with foreign affiliates. The Treasury Department designed the current regulation for section 482 to protect these corporations from arbitrary Service allocations and double taxation of foreign income. For sales of tangible goods, the regulation bases allocation of income and deductions on transactions between unrelated parties dealing at arm's length. The regulation defines the arm's length price as the price agreed on in the transaction most similar to the transaction being examined, after accounting for material differences. Often, however, there are no similar uncontrolled transactions for comparison, thus making the regulation difficult to apply. Taxpayers are then particularly vulnerable even to unreasonable Service allocations. A liberal interpretation of the regulation is therefore essential.

190. *See supra* note 175 and accompanying text.

191. The Tax Court allowed a profit margin of 20% over Navios's costs. *See supra* note 175. Instead of determining a profit margin based on gross profit margins from uncontrolled transactions, the court calculated a "reasonable profit" margin for Navios, based on subjective expectations of Navios's management:

> [T]he management of Navios selected a return of 10 percent of costs, and later a return of 20 percent of costs, as a basis for providing a reasonable profit. . . . Suffice to say, that both Navios and the petitioner contemplated a return of from 10 to 20 per-percent [sic] on cost as a basis for justifying the freight charges.

36 T.C.M. (CCH) at 604. This allocation is reminiscent of the reasonable profit test that the 1968 regulations and the courts have rejected. *See supra* note 29 and accompanying text. The Second Circuit rejected the Tax Court's use of a "reasonable charge," because the Second Circuit found that there were comparable uncontrolled transactions. *See* 617 F.2d at 950-51.

The Court of Claims in *E.I. Du Pont de Nemours & Co. v. United States* narrowly interpreted the regulation and imposed an onerous burden of production on the taxpayer. The case threatens to deprive taxpayers of any protection from the Service's broad discretion whenever closely comparable transactions are unavailable for comparison. In *United States Steel Corp. v. Commissioner,* the Second Circuit interpreted the regulation more broadly, thereby reviving the protections that the regulation was designed to provide. *U.S. Steel* is precedent for a fairer burden of production than has previously existed. Courts in other jurisdictions should follow the Second Circuit's broad reading of the regulation and adopt the burden of production it espoused. The Service, however, should be allowed to adjust for any material differences between the transactions under comparison.

Robert A. Voorhis