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SECTION 482 AND SUBPART F: AN INTERNAL REVENUE CODE DILEMMA

David Myers*

INTRODUCTION

The globalization of business increases cross-border transactions involving United States domestic and multinational corporations.¹ From a United States tax standpoint, transactions which enable United States taxpayers to manipulate their business affairs in a manner which inaccurately reflects their true income in a given year raise a multitude of issues.² Two issues continually resurface in the tax codes and courts: issues relating to transfer pricing between related parties³ and issues relating to income of United States shareholders who control foreign corporations.⁴

The transfer pricing rules and the Internal Revenue Code ("Code") encompass both separate and interlaced spheres of influence over domestic and multinational corporations.⁵ Through adjustments involving

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1. Internal Revenue Service, Industry Specialization Program Coordinated Issue, Construction/Real Estate Industry, *Use of IRC 482 and/or Subpart F for Services to CFC's*, 1992 WL 526256 (1992) (revised April 17, 1995) [hereinafter *Use of IRC 482 and/or Subpart F*].

2. Cym H. Lowell, *International Corporate Transaction Planning and Section 482*, 37 PRAC. L. INST. 637, 638 (1995) [hereinafter *Corporate Transaction Planning*] (discussing that multinational company transactions inevitably raise cross border technical issues involving transfer pricing of commonly controlled entities).

3. Treas. Reg. § 1.482 (1986) (describing the main tool that the Internal Revenue Service uses to allocate transfer pricing issues).

4. Treas. Reg. §§ 1.951-964 (1986) (omitting § 963 (repealed in 1975)) (describing the section of the Internal Revenue Code regulating United States shareholders and controlled foreign corporations).

5. DONALD E. KIESO & JERRY J. WEYGANDT, *INTERMEDIATE ACCOUNTING*

transfer pricing and controlled foreign corporations, the United States potentially loses a vast amount of income, mainly due to lost tax revenue income.⁶

In 1954, Congress enacted § 482 as a tool to allocate income among taxpayers,⁷ and has subsequently amended it twice.⁸ § 482 allocates income among related parties by referencing "how unrelated parties dealing at arm's length would have handled the transactions."⁹

This important Code provision allows the Internal Revenue Service ("IRS") to retroactively police the reporting of United States and multinational companies' tax filings in the United States, which reflect fair allocations of income to related entities.¹⁰ This allocation effectively reduces the ability of such companies to underreport income in the United States and to overreport income of subsidiaries incorporated in low tax jurisdictions, thereby lowering their overall tax assessment.¹¹

Similarly, Subpart F of the Code, encompassing §§ 951-964, contains provisions which tax a United States shareholder¹² of controlled foreign

1400-01 (7th ed. 1992). Transfer pricing rules, for the purposes of the United States corporation, are rules which allocate a price for goods bought and sold between separate entities under common control of a parent company. One commonly refers to these transfers as "intracompany transfers." *Id.* The measurement of performance and profitability between individual business units of a corporation remains the principal reason for the use of transfer pricing. *Id.* See *Corporate Transaction Planning*, *supra* note 2, at 638 (noting the substantive provisions of the Code pick up where the accounting rules end in determining how United States tax laws regard allocation of income).

6. Francis M. Allegra, *Section 482: Mapping the Contours of the Abuse of Discretion Standard of Judicial Review*, 13 VA. TAX REV. 423, 432 (1994) [hereinafter *Abuse of Discretion Standard*] (noting as of the end of 1992, of the cases pending in the tax court, the six largest cases involved tax deficiencies of over \$9.4 billion).

7. Treas. Reg. § 1.482 (1954) (as amended in 1986).

8. *Id.* (as amended Oct. 4, 1976 and Oct. 22, 1986).

9. See *Corporate Transaction Planning*, *supra* note 2, at 638 (discussing that the substantive issues regarding transfer pricing exist to determine how entities, some of which corporations located in low tax rate countries, allocate income and loss among themselves).

10. Treas. Reg. § 1.482 (1986). See *Corporate Transaction Planning*, *supra* note 2, at 638-39 (stating that the Secretary (through the IRS) can redistribute income among entities if necessary to prevent tax evasion).

11. Treas. Reg. § 1.482 (1986). See *Corporate Transaction Planning*, *supra* note 2, at 638-39 (discussing concerns Congress has regarding offshore based companies not paying their fair share of United States taxes).

12. See Treas. Reg. § 1.952 (1986) (defining subpart F of the Code which holds that the IRS considers any United States person who owns, either directly or indirectly, at least 10 percent of the voting rights of a foreign corporation's stock to control

corporations¹³ as if the corporation distributes income to that shareholder as an annual dividend.¹⁴ Congress intended the provisions of Subpart F to accurately reflect income earned by a United States shareholder in the year the taxpayer actually earned the income, rather than allowing that income to remain tax-free (from a United States standpoint) until repatriated into the United States.¹⁵

This Comment argues that in certain instances, the Code allows United States taxpayers to incur international double taxation on income earned during a given year and that § 482 and Subpart F of the Code remain overly subjective to the point of providing an unclear standard for United States taxpayers. Therefore, Congress should amend the Code to include objective standards, to correct the anomalies discussed below, and to employ the concept of national tax harmonization as a goal to bring together international principles of nondiscrimination, neutrality, and reciprocity.

Part I of this Comment briefly discusses the historical developments and the current rule regarding § 482. Part II examines the historical developments and the current rule regarding Subpart F. Part III addresses two major issues raised by the existence of the two rules: the possibility of double taxation and the subjectivity in interpreting the rules. Finally, Part IV presents recommendations for change to the current rules in order to more accurately reflect the true nature of intracompany transactions.

a foreign corporation). See also Robert A. Green, *The Future of Source-Based Taxation of the Income of Multinationals*, 79 CORNELL L. REV. 18, 75-76 (1993) [hereinafter *Source-Based Taxation*] (discussing the applicability of Subpart F income to United States shareholders under the existing Code).

13. Treas. Reg. § 1.951 (1986). The Code also defines a foreign company as a "controlled foreign corporation" if United States shareholders as a group own, either directly or indirectly, more than 50 percent of the voting rights of the corporation or the corporation's stock. *Id.* See *Source-based Taxation*, *supra* note 12, at 78 (describing what constitutes controlling a foreign corporation).

14. Treas. Reg. § 1.951 (1986). See *Source-based Taxation*, *supra* note 12, at 76-78 (describing the threshold whereby a foreign corporation becomes a controlled foreign corporation). See generally Treas. Reg. §§ 1.951-1.964 (1986) (defining Subpart F).

15. Eric T. Laity, *Anatomy of Sections 951(A)(1)(B) and 956 of the Internal Revenue Code*, 14 VA. TAX REV. 71, 76 (1994).

I. § 482 OF THE INTERNAL REVENUE CODE

A. HISTORICAL DEVELOPMENTS

Since the Revenue Act of 1921,¹⁶ tax law has contained provisions similar to § 482. Congress enacted these sourcing provisions in 1921 to counter the "illogical" conclusion of certain administrative interpretations which effectively allocated income of an "essentially United States corporation" to a jurisdiction with lower effective tax rates.¹⁷ Since then, extensive legislative regulations have reshaped this section to place controlled taxpayers on a tax parity with uncontrolled taxpayers, decided according to the arm's length standard.¹⁸ The regulations have articulated the arm's length principle since 1935 as a gauge for testing taxpayer transactions.¹⁹

Commencing with the 1921 Revenue Act, the Tax Commissioner has had the power to reallocate income and expenses among related parties.²⁰ Beginning in the early 1960's, the Treasury Department and Congress became concerned with the significant rise in the formation and use by United States multinationals of foreign subsidiaries located in lower tax jurisdictions.²¹ In the years prior to the 1968 Amendment to the Code, Congress evaluated several amendments to § 482.²² § 482, at

16. Revenue Act of 1921, ch. 85, § 240, 42 Stat. 227 (1921) (current version at 26 U.S.C. § 482 (1986)).

17. See *Corporate Transaction Planning*, *supra* note 2, at 640-42 (describing the general sourcing provisions of the Code). The sourcing rules distribute income to the jurisdiction earning it. The Code has incorporated this rule into two distinct sections, 861 (United States source) and 862 (foreign source) to treat income depending on category of income. Treas. Reg. §§ 1.861 and 1.862 (1986).

18. See John W. Lee & Mark S. Bader, *Contingent Income Items and Cost Basis Corporate Acquisitions: Correlative Adjustments and Clearer Reflection of Income*, 12 J. CORP. L. 137, 166 (1987) (discussing the legislative revisions including the arm's length standard); *Corporate Transaction Planning*, *supra* note 2, at 641-42 (discussing the legislative history behind § 482 and the arm's length provision).

19. See *Corporate Transaction Planning*, *supra* note 2, at 638-42 (discussing the use of the arm's length standard through the revisions of § 482).

20. See ELIZABETH KING, *TRANSFER PRICING AND VALUATION IN CORPORATE TAXATION: FEDERAL LEGISLATION VS. ADMINISTRATIVE PRACTICE* § 2.1.1 (1994) [hereinafter *TRANSFER PRICING AND VALUATION*] (noting that the Commissioner had the right to reallocate income and expenses between related entities since the 1920's).

21. *Id.* at 11-12.

22. See *id.* at 12 n.6 (indicating that between 1943 and 1968, Congress entertained several amendments which would increase the power of the IRS to enforce § 482). Ultimately, Congress concluded that § 482 provided the IRS with sufficient

that time, primarily focused on intracompany transactions dealing mainly with tangible property, loans and services, and to a much lesser degree, intangible property.²³ The 1968 Provisions dictated three possible methods for determining the arm's length price for tangible property.²⁴

The 1968 Provisions also provided for intangible pricing via the comparable uncontrolled transaction method. Due to the high degree of uncertainty in applying the comparable uncontrolled method, however, the Regulations also included a list of twelve factors²⁵ for consideration in establishing a comparable price.²⁶ These twelve factors have since proven problematic.²⁷ Additionally, the 1968 regulations articulated cost-sharing provisions, service provisions, and loan provisions.²⁸ Congress deemed the cost-sharing provisions to sanction cost-sharing agreements among related parties, whereas the service and loan provisions

power to prevent United States multinational's tax evasion activities. *Id.*

23. See Barbara N. McLennan, *Responses to Section 482 Litigation: Advance Pricing Agreements or Arbitration?*, 54 TAX NOTES 431 (1992) (discussing the evolution of section 482 through case law and the legislative process); TRANSFER PRICING AND VALUATION, *supra* note 20, at 13 (discussing the Treasury Department's focus prior to and including the 1968 Regulations).

24. Treas. Reg. § 1.482 (1968) (amended in 1986). The three methods were the comparable uncontrolled price method, the resale price method, and the cost-plus method. *Id.* §§(a)(1) and (b)(1)-(d)(1). See TRANSFER PRICING AND VALUATION, *supra* note 20, at 13 (listing the three methods to determine arm's length prices for tangible property).

25. Treas. Reg. § 1.482(b)(2)(ii)(B)(1)-(12)(1968)(amended in 1986). The twelve factors include: prevailing royalty rates in the same industry for similar property; offers by competing transferors and bids by competing transferees; terms of the transfer; uniqueness of the property and the period during which the property is likely to remain unique; degree and duration of protection of the property in the relevant countries; value of services rendered by the transferor to the transferee; prospective profits realized, or costs saved, through the use or subsequent transfer of the property; capital investment and start-up expenses required of the transferee; availability of substitutes; arm's length rates and prices paid by unrelated parties; costs incurred by the transferor in developing the property; and any other facts or circumstances likely considered by the unrelated parties. *Id.*

26. Treas. Reg. § 1.482 (1968) (amended 1986). Due to the uniqueness of intangible property, a comparable uncontrolled transaction is difficult to determine and therefore poses difficulties in application both for the IRS and the multinational firm.

27. TRANSFER PRICING AND VALUATION, *supra* note 20, at 18 (noting that the application of more than one factor often returned two different transaction prices).

28. Treas. Reg. § 1.482-2(a)-(d) (1968) (amended 1986).

provided a "safe harbor"²⁹ in determining arm's length rates.³⁰ Congress, to date, has not revised the service and loan provisions.³¹

The 1968 regulations proved difficult to effectuate, mainly due to inapplicability of the comparable uncontrolled pricing method³² and litigation involving intangible transfers.³³ The ongoing reformulation of transfer pricing regulations truly began with a major amendment, the 1986 Amendment.³⁴ The recognized difficulties in administering and enforcing § 482³⁵ and the courts problematic guidance of the regulations served as the impetus for this amendment.³⁶ The 1986 Tax Reform Act expanded the provisions to encompass transfer or licensing of

29. See Reuven S. Avi-Yonah, *The Rise and Fall of Arm's Length: A Study in the Evolution of U.S. International Taxation*, 15 VA. TAX REV. 89, 130 (1995) (suggesting that certain pricing arrangements between related parties may fall within a "safe harbor" in terms of § 482 allocations). A "safe harbor" means, for the purposes of this comment, that the IRS deems the price allocated among related parties an arm's length price, which, therefore satisfies § 482's requirement.

30. Treas. Reg. §§ 1.482-2(a)-(d) (1986).

31. TRANSFER PRICING AND VALUATION, *supra* note 20, at 19-20.

32. See *id.* at 21 (explaining that the IRS found the 1968 Regulations to apply when the comparable uncontrolled pricing method used inexact comparables).

33. The courts took the position that one should use only the information available at the time of the transfer to determine the arm's length price paid to the transferor. See *Eli Lilly v. Commissioner*, 84 T.C. 996, 1131-33 (1985) (finding respondent's reallocations of gross income, which reallocated the income attributable to an intangible product to petitioner under § 482, warranted and respondent's adjustments unreasonable); *G.D. Searle & Co. v. Commissioner*, 88 T.C. 252, 341 (1987) (upholding as reasonable, the respondent's application of § 482, which allocated income to the petitioner attributable to the use of income-producing intangibles). But see *Sundstrand Corp. v. Commissioner*, 96 T.C. 226, 230 (1991) (holding that the Commissioner abused his discretion under § 482 when he determined that SunPac acted as a subcontractor of petitioner, even though the royalty contained in the license agreement did not constitute an arm's length consideration for the use of petitioner's intangibles, and was therefore unreasonable); *Westreco, Inc. v. Commissioner*, 64 T.C.M. (CCH) 849 (1992) (determining that the fees paid to petitioner by Nestec for research and development services clearly reflected income under § 482, and therefore fell within an arm's length range); *R. T. French Co. v. Commissioner*, 60 T.C. 836, 837 (1973) (holding that a corporation made royalty payments to an affiliated foreign company pursuant to licensing arrangements at arm's length, and therefore the Commissioners improperly denied the deductions).

34. Tax Reform Act of 1986, Pub. L. 99-514, § 936(h)(3)(B) (codified as amended in § 26 U.S.C.). See TRANSFER PRICING AND VALUATION, *supra* note 20, at 11 (discussing the 1986 Amendment in relation to the other Code amendments).

35. TRANSFER PRICING AND VALUATION, *supra* note 20, at 24.

36. *Id.* (proffering IRS reasons for amending § 482 after the 1968 Amendment).

intangible property within the scope of § 482.³⁷ Along with the 1986 Act, the Conference Committee Report³⁸ introduced the idea of “periodic adjustments” for intracompany charges paid for transferred intangibles.³⁹ The reactions to the Conference Committee Report were the 1988 White Paper,⁴⁰ the 1992 Proposed Regulations,⁴¹ and the 1993 Temporary Regulations.⁴² On July 8, 1994, the IRS released the final

37. Treas. Reg. § 1.482 (1986). The 1986 Amendment amended the provision to include: “[i]n case of any transfer (or license) of intangible property (within the meaning of § 936(h)(3)(B)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible.” *Id.* This amendment had the effect of combining tangible with intangible property to further close the gap on under-reporting or evasion of taxes by United States taxpayers.

38. See S. REP. NO. 313, 99th Cong., 2d Sess., Title IX, at 293-374 (1986) (trying to correctly allocate tax and tax deferrals on intangibles); H.R. REP. NO. 426, 99th Cong., 1st Sess., Title VI, at 329-406 (1986) (directing the Treasury Department and the IRS to study and report the current situation regarding intracompany pricing rules).

39. See TRANSFER PRICING AND VALUATION, *supra* note 20, at 24-25 (claiming that taxpayers were to use the periodic adjustments to adjust the intracompany charges if earnings attributable to the intangible changed significantly after inception). No enactment of this clause occurred in the 1986 statutory changes. *Id.* at 25.

40. A Study of Intercompany Pricing (The White Paper), Notice 88-123, 1988-2 C.B. 458. See TRANSFER PRICING AND VALUATION, *supra* note 20, at 26 (attempting to define the 1986 Amendments “commensurate with income” language, redefining the concept of comparability relating to intangible property, proposing alternative intangible pricing methods, and modifying the 1968 Regulations cost-sharing provisions to further specify the scope of the cost-sharing among related parties).

41. Prop. Treas. Reg. § 1.482, 57 Fed. Reg. 3571 (1992) [hereinafter The 1992 Proposed Regulations]. See TRANSFER PRICING AND VALUATION, *supra* note 20, at 32-33 (stating that several years following the White Paper, concerns grew regarding abuses of the transfer pricing system). The 1992 Proposed Regulations diverged from the White Paper’s direction. *Id.* Specifically, it elaborated on and redefined the arm’s length principle to extend the IRS’s power in determining related party intracompany prices, it concerned itself more with foreign based multinationals with United States subsidiaries than with U.S. multinationals with foreign based subsidiaries, and it modified the 1968 Regulations tangible property provisions by eliminating priorities of the evaluation methods to determine arm’s length prices. *Id.* The 1992 Proposed Regulations specifically dealt with arm’s length intangible property, defining three methodologies applicable to intangibles. *Id.*

42. Temp. Treas. Reg. § 1.482-T (1993) [hereinafter The 1993 Temporary Regulations]. See TRANSFER PRICING AND VALUATION, *supra* note 20, at 40-42 (discussing that due to negative reactions, both in the United States and abroad, to the methodol-

amended transfer pricing regulations which are similar to the 1993 Temporary Regulations.⁴³

A significant line of cases has upheld § 482 allocations.⁴⁴ Since the 1940's, case law involving § 482 interprets this Code as intending to prevent the avoidance or lessening of taxes paid by controlled taxpayers. In addition, the section intends to reflect income clearly as the controlled taxpayer earns it, whether intentionally or merely made improperly in bookkeeping.⁴⁵

B. RULE AND APPLICATION

The courts define § 482, relating to the allocation of income by commonly controlled companies or indirectly by the same interests, as broad

ogies regarding intangibles, the 1993 Temporary Regulations attempted to return to a more common ground by combining aspects of the 1968 Amendment, the 1986 Amendment, the White Paper, and the 1992 Proposed Regulations). The end result of the 1993 Regulations weakened, but did not eliminate, the 1992 Proposed Regulations arm's length range test, formally eliminated a ranking of methods contained in the 1968 Amendment, and clarified or elaborated on issues arising during the years since the 1968 Amendment. *Id.*

43. T.D. 8552, 59 Fed. Reg. 34971 (July 8, 1994). See D. Kevin Dolan & David Bower, *Final Transfer Pricing Regulations*, 361 PRAC. L. INST. 511 (1994) (describing the final transfer pricing regulations as essentially similar to the 1993 Temporary Regulations, and discussing its emphasis on the best method rule).

44. See *supra* note 33 (naming the significant cases upholding § 482 allocations). See also *National Sec. Corp. v. Commissioner*, 137 F.2d 600, 602-03 (3d Cir. 1943) (upholding the allocation as within the IRS discretion); *Northwestern Nat. Bank of Minn. v. United States*, 556 F.2d 889, 891-92 (8th Cir. 1977) (rejecting a taxpayer's assertion that the taxpayer cannot properly apply § 482 to transactions which might not otherwise occur between unrelated parties).

45. See *Interstate Fire Ins. Co. v. United States*, 215 F. Supp. 586, 597 (E.D. Tenn. 1963) (stating that I.R.C. § 482 grants the Commissioner broad and general powers to allocate or redistribute income if necessary to prevent tax evasion or to reflect income clearly); *Tennessee-Arkansas Gravel Co. v. Commissioner*, 112 F.2d 508, 510 (6th Cir. 1940) (allocating income between a Tennessee corporation and a Mississippi corporation, in a manner to reflect the true source of gross income of the respective companies). See also *Ross v. Commissioner*, 129 F.2d 310, 313 (5th Cir. 1942) (indicating the Commissioner's authority to impose Code regulations to prevent tax evasion, even if improperly done in bookkeeping between parties); *Advance Mach. Exch. v. Commissioner*, 196 F.2d 1006, 1008-09 (2d Cir. 1952) (cautioning that although the Commissioner has broad power to allocate income to avoid tax evasion, he cannot disregard valid tax entities in determining the party to be allocated income); *United States v. Berger*, 325 F. Supp. 1297, 1302 (S.D.N.Y. 1971) (discussing the Commissioner's power to prevent tax evasion or the arbitrary shifting of income or deductions among controlling and controlled companies).

in scope with sufficient breadth to cover Treasury regulations enacted thereunder.⁴⁶ As currently written in the Code, § 482 empowers the Secretary and his delegates⁴⁷ to distribute or allocate income between organizations if they determine that such an allocation is necessary to "[P]revent the evasion of taxes" or "[C]learly reflect the income of the . . . businesses."⁴⁸ Congress designed this section of the Code to hinder "[A]rtificial shifting, milking, or distorting" of income and to

46. See *Kerry Inv. Co. v. Commissioner*, 500 F.2d 108, 109 (9th Cir. 1974) (defining § 482 as broad in its scope with sufficient breadth to cover taxpayer attacks on the Treasury Regulations).

47. See *Interstate Fire Ins. Co. v. United States*, 215 F. Supp. 586, 597 (indicating that the provisions of I.R.C. § 482 authorize the Secretary of the Treasury or his delegates to reallocate expenses in order to avoid tax evasion or clearly reflect income). Treasury regulations allow the Secretary to delegate such authority to district directors and district directors may redelegate such authority to a revenue agents. *Id.* Additionally, courts have read into the statute to authorize the Commissioner of the IRS to determine the true taxable income of members of controlled groups of taxpayers in cases where taxable income of a controlled group operating using the arm's length standard and those not using the standard differ. *Fitzgerald Motor Co., Inc. v. Commissioner*, 508 F.2d 1096, 1102 (5th Cir. 1975). The Commissioner's powers of discretion, in IRC § 482 cases, are duly broad and far-reaching, limited only when a situation arises whereby a necessity dictates the Commissioner's action. See also *Peck v. Commissioner*, 752 F.2d 469, 471 (9th Cir. 1985) (confirming the Commissioner's broad powers); *National Sec. Corp. v. Commissioner*, 137 F.2d 600, 602 (3d Cir. 1943) (discussing the authority vested in the Commissioner by Congress). But see *Abatti v. Commissioner*, 644 F.2d 1385, 1389 (9th Cir. 1981) (indicating that when § 482 would surprise the taxpayer at trial, the court will not allow the Commissioner to invoke it).

48. Treas. Reg. § 1.482 (1986). - Allocation of income and deductions among taxpayers.

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 or any of such organizations, trades, or businesses. In the case of any transfer (or license) of intangible property (within the meaning of § 936(h)(3)(B)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible.

correct the reporting among entities under common managerial control;⁴⁹ the end result placing such multinational corporations on a "tax parity" with corporations within the same tax jurisdiction.⁵⁰ This provision requires that the Secretary make a determination as to the necessity of the reallocation, before invoking this section of the Code.⁵¹ In practice, Congress designed this section of the Code as a tool against multinational corporations underreporting taxes in the United States which results in tax avoidance.⁵²

Invoking § 482 involves two essential elements. First, the Secretary determines or indicates that the same interest owns or controls two or more trades, businesses, or organizations. Second, he determines whether allocation among these types of organizations becomes necessary to prevent evasion or misrepresentation of income.⁵³ After the Secretary deems the two elements exist, the Secretary of the Treasury, the Commissioner of the IRS, or their delegates use variations of the arm's length standard to determine whether and how to allocate a transfer pricing issue among commonly controlled interests to properly reflect true income.⁵⁴ The Treasury regulations prescribe six methods for de-

49. See *Commissioner v. First Sec. Bank of Utah, N.A.*, 405 U.S. 394, 400-01 (1972) (citing B. BITTKER AND J. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* 15-21 (3d ed. 1971)) (indicating that the purpose of § 482 is to compare a controlled taxpayer on the same tax parity as an uncontrolled taxpayer).

50. See *Young & Rubican, Inc. v. United States*, 410 F.2d 1233, 1244 (Ct. Cl. 1969) (indicating that I.R.C. § 482 prevents arbitrary shifting of income among commonly controlled companies and can position such companies on a "tax parity" with uncontrolled companies).

51. See *Interstate Fire Ins. Co.*, 215 F. Supp. at 597-98 (discussing that the invocation of § 482 is at the discretion of the Commissioner, and that legislative history and the Treasury Regulations support this assertion).

52. See *Young & Rubican, Inc.*, 410 F.2d at 1244 (illustrating that in practice, the courts authorize the Commissioner to reallocate income so as to prevent tax evasion in cases where taxpayers shift profits among controlled corporations).

53. See *B. Forman Co. v. Commissioner*, 453 F.2d 1144, 1152-53 (2d Cir. 1972) (stating that the term "controlled" includes "[a]ny kind of control, direct or indirect, whether legally enforceable, and however exercisable or exercised"). The court continues to discuss the "reality" of the control, which is not dependent on its form or the "[m]ode of its exercise" and presumes it if taxpayers have arbitrarily shifted income or deductions. *Id.* The two elements must exist to justify sustaining an I.R.C. § 482 application. *Id.* See also *Local Finance Corp. v. Commissioner*, 407 F.2d 629, 632 (7th Cir. 1969) (discussing that the two essential elements of a § 482 inquiry include the existence of commonly controlled companies, and barring the Commissioner's reallocation, income which one of the companies would not otherwise report).

54. Treas. Reg. § 1.482-3(a). See *United States Steel Corp. v. Commissioner*, 617

termining the arm's length price and their respective standards of application.⁵⁵ The six methods, in preferential order of use include: the comparable uncontrolled price method,⁵⁶ the resale price method,⁵⁷ the

F.2d 942, 947 (2d Cir. 1980) (discussing that parties should use the "arm's length standard" in determining § 482 allocations); *Northwestern Nat. Bank of Minneapolis v. United States*, 556 F.2d 889, 891 (8th Cir. 1977) (dictating that the arm's length standard use the "uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer" as the standard). See generally William R. Leighton & T. Richard Sealy III, *Federal Income Tax Issues in the Organization, Financing, and Operation of Maquiladoras*, 23 ST. MARY'S L. REV. 721, 735-37 (1992) [hereinafter *Operation of Maquiladoras*] (exemplifying the arm's length standard as it applies to Mexican Maquiladoras).

55. Treas. Reg. § 1.482-3(a)(1)-(6). See *Operation of Maquiladoras*, *supra* note 54, at 735-37 n.49 (describing the application of three of the six arm's length pricing methods as they could apply to Maquiladoras).

56. Treas. Reg. § 1.482-3(b). "The comparable uncontrolled price method evaluates whether the amount charged in a controlled transaction is arm's length by reference to the amount charged in a comparable uncontrolled transaction." *Id.* The similarity of products generally will have the greatest effect on the comparability under this method. *Id.* Attention must be given, however, to minor differences in quality of the product, contractual terms, level of the market, geographic market in which the transaction takes place, foreign currency risks, alternatives available to the parties to the transaction, or other general economic conditions that could materially alter the price in an uncontrolled transaction. Treas. Reg. § 1.482-3(b)(2)(ii)(B)(1)-(8).

57. Treas. Reg. § 1.482-3(c).

The resale method evaluates whether the amount charged in a controlled transaction is arm's length by reference to the gross profit margin realized in comparable uncontrolled transactions. The resale price method measures the value of functions performed, and is ordinarily used in cases involving the purchase and resale of tangible property in which the reseller has not added substantial value to the tangible goods by physically altering the goods before resale. For this purpose, packaging, re-packaging, labeling, or minor assembly do not ordinarily constitute physical alteration. *Id.*

One makes such determination by subtracting the appropriate gross profit from the applicable resale price. Treas. Reg. § 1.482-3(c)(2)(I).

cost-plus method,⁵⁸ the comparable profits method,⁵⁹ the profit split method,⁶⁰ and other unspecified methods.⁶¹

II. SUBPART F

A. HISTORICAL DEVELOPMENTS

The income taxation of domestic, foreign and multinational corporations has, as an essential substantive element, the source of the income.⁶² Congress, concerned with segregating United States source in-

58. Treas. Reg. § 1.482-3(d).

The cost plus method evaluates whether the amount charged in a controlled transaction is arm's length by reference to the gross profit markup realized in a comparable uncontrolled transaction. The cost plus method is ordinarily used in cases involving manufacture, assembly, or other production of goods that are sold to related parties. *Id.*

The cost plus method measures an arm's length price by "adding the appropriate gross profit to the controlled taxpayer's cost of producing the property involved in the controlled transaction." Treas. Reg. § 1.482-3(d)(2)(I).

59. Treas. Reg. § 1.482-5(a).

The comparable profits method evaluates whether the amount charged in a controlled transaction is arm's length based on objective measures of profitability derived from uncontrolled taxpayers that engage in similar business activities under similar circumstances. *Id.*

Under the comparable profits method, the determination of an arm's length result is based on the amount of operating profit that the tested party would have earned on related party transactions if its profit level indicator were equal to that of an uncontrolled comparable operating profit. Treas. Reg. § 1.482-5(b)(1).

60. Treas. Reg. § 1.482-6(a).

The profit split method evaluates whether the allocation of the combined operating profit or loss attributable to one or more controlled transactions is arm's length by reference to the relative value of each controlled taxpayer's contribution to that combined operating profit or loss. *Id.*

Such relative value of each controlled taxpayer's contribution to the success of the relevant business activity must be determined in "a manner that reflects the functions performed, risks assumed, and resources employed." Treas. Reg. § 1.482-6(b).

61. Treas. Reg. § 1.482-3(e). "An unspecified method should take into account that uncontrolled taxpayers evaluate the terms of the transaction by considering the realistic alternatives to that transaction, and only enter into that transaction if there are no other preferable transactions."

62. See JON E. BISCHER & ROBERT FEINSCHREIBER, FUNDAMENTALS OF INTERNATIONAL TAXATION 9-11 (2d ed. 1985) [hereinafter FUNDAMENTALS OF TAX] (describing the United States taxing provisions and concluding that the source of income is jurisdictional to classes of income). See also Treas. Reg. §§ 1.861-64 (1986) (categorizing income on a source basis).

come from foreign source income in order to properly allocate United States-based income, enacted sourcing of income provisions in 1921.⁶³ During that era, foreign source income of foreign corporations controlled by United States shareholders were not subject to United States tax.⁶⁴ As a result, no taxation of United States shareholders occurred until the corporation repatriated the foreign profits into the United States. Thus theoretically, the shareholder could defer payment of taxes on profits indefinitely.⁶⁵ Forty years later, President Kennedy revived concern over the deferral of taxes in his 1961 presidential message.⁶⁶

Congress again became concerned that companies used controlled foreign corporations to extract United States-source income to lower taxed domiciles, and as a result, enacted the controlled foreign corporation ("CFC") provisions in Subpart F of the Code in the Revenue Act of 1962.⁶⁷ The 1961 proposed Subpart F rules suggested taxing United States shareholders "as if the controlled foreign corporation had distributed a pro-rata portion of all of its earnings each year."⁶⁸ In 1962, Congress enacted Subpart F rules, but narrowed their scope to eliminate only transient income that corporations moved to tax haven countries.⁶⁹ Congress, however, possessed no intention to classify the tax deferrals not accomplished through tax haven vehicles as Subpart F income.⁷⁰

63. See *Corporate Transaction Planning*, *supra* note 2, at 648 (discussing that Congress enacted the source of income provisions as a "tax base defense mechanism.").

64. See *id.* (discussing the pre-1962 Revenue Act environment in which Congress did not tax multinationals on foreign-source income until it became repatriated).

65. See *id.* (alluding to the inevitable conclusion that taxpayers may defer non-repatriated income indefinitely).

66. Special Message to the Congress on Taxation, PUB. PAPERS 290, (Apr. 20, 1961).

67. See *Corporate Transaction Planning*, *supra* note 2, at 648 (echoing the concern of Congress regarding the resurfacing of foreign corporate activities designed to "siphon" income away from United States tax authorities).

68. Special Message to the Congress on Taxation, PUB. PAPERS 294-96, (Apr. 20, 1961). See *Source-Based Taxation*, *supra* note 12, at 76 (discussing the original intent of Congress regarding the operations of the Subpart F provisions).

69. See *Source-Based Taxation*, *supra* note 12, at 76 (discussing the narrowing of Subpart F provisions from the provisions originally proposed).

70. See *Corporate Transaction Planning*, *supra* note 2, at 649 (providing reasoning why Congress did not intend for non-tax haven transactions to fall within Subpart

Congress expressly averred that its intended purpose remained not to disallow tax deferrals in general, but only to disallow those deferrals of income earned through "artificial transactions, income without value-added, and without economic activity" of the CFC in the country of incorporation (the lower tax jurisdiction).⁷¹ Congress reiterated its sentiment in many statutory amendments to Subpart F.⁷²

Congress enacted Subpart F provisions to counter controlled foreign corporations' potential abuse of United States tax laws.⁷³ It enacted these provisions as a tax-base defense mechanism to accurately report the income of activities transacted within the United States.⁷⁴ For example, a multinational company can maximize its income by charging a subsidiary (to which it shifted income) artificially low transfer prices and inaccurately reflect true income of the two entities.⁷⁵ Subsequently, Congress has made only cosmetic amendments to Subpart F of the Code.⁷⁶

B. RULES AND APPLICATION

Some taxpayers increased their use of CFC's to minimize or to avoid taxes.⁷⁷ These taxpayers developed schemes in order to disguise or to otherwise conceal evidence of this evasive activity.⁷⁸ Subpart F of the

F scrutiny).

71. *Id.*

72. This sentiment is referred to in the TAX REFORM ACT OF 1969, S. REP. NO. 552, 91st Cong., 1st Sess. 289-91 (1969); THE TAX REFORM ACT OF 1976, S. REP. NO. 841, 94th Cong., 2d Sess. 224-25 (1976); THE TAX REFORM ACT OF 1986, H. REP. NO. 841, 99th Cong., 2d Sess. 608 (1986).

73. *See Corporate Transaction Planning*, *supra* note 2, at 641 (describing the reasoning behind enactment of the Subpart F provisions).

74. H.R. REP. NO. 350, 67th Cong., 1st Sess. 12 (1921). *See Intel Corp. v. Commissioner*, 100 T.C. 616, 624-27 (1993) (describing the underlying concerns voiced in legislative debates after the Revenue Act of 1918).

75. *See Source-Based Taxation*, *supra* note 12, at 76 (illustrating the application of the Subpart F provisions).

76. *See* Treas. Reg. §§ 1.955-1, 1.963-1 (1968) (as amended in 1976) (striking out § 955 and replacing it with an identical item 955 and also striking out § 963, entitled *Receipt of minimum distributions by domestic corporations*).

77. *Use of IRC 482 and/or Subpart F*, *supra* note 1, at 1-2 (noting the methods used to minimize or avoid paying taxes).

78. *See id.* (indicating that the schemes could involve: 1) providing services to a CFC at something less than an arm's length transaction; 2) providing tangibles or intangibles to a CFC at something less than an arm's length transaction would be at arm's length; 3) elective shifting of income or deductions between the controlling and

Internal Revenue Code, entitled *Controlled Foreign Corporations*, encompasses §§ 951-964,⁷⁹ and dictates that if a "United States shareholder"⁸⁰ owns more than 10 percent of the total combined voting power of all classes of voting stock of a CFC,⁸¹ he must report his pro rata share of the CFC's undistributed income as earned income in each taxable year.⁸² The CFC taxes the income attributable to the United States shareholder in the year the taxpayer earned the income.⁸³ When the CFC finally distributes the income as a dividend to that United States shareholder, it levies no additional tax.⁸⁴ Additionally, the CFC grants a foreign tax credit to the United States shareholder for any taxes paid in a foreign tax jurisdiction, on income applicable to the same income reported in the United States.⁸⁵

the controlled companies, and; 4) providing financial assistance to the CFC at something less than an arm's length transaction).

79. 26 U.S.C. §§ 951-964. Subpart F of the Code is found within Title 26, Subtitle A, Chapter 1, Subchapter N, Part III.

80. Treas. Reg. § 1.951-4(b) (1986). A "United States shareholder" for purposes of Subpart F, means, with respect to any foreign corporation, a United States person (as defined in § 957(c)) who owns (within the meaning of § 958(a)), or who the Code considers as owning, by applying the rules of ownership of § 958(b), ten percent or more of the total combined voting power of all classes of stock entitled to vote of such foreign corporation. *Id.*

81. Treas. Reg. § 1.957-1(a) (1986). For purposes of Subpart F, the term "controlled foreign corporation" means any foreign corporation if more than fifty percent of: (1) the total combined voting power of all classes of stock of such corporation entitled to vote, or (2) the total value of the stock of such corporation, is owned (within the meaning of § 958(a)), or is "considered as owned by applying the rules of ownership" of § 958(b), by United States shareholders on any day during the taxable year of such foreign corporation. *Id.*

82. See PAUL R. MCDANIEL & HUGH J. AULT, INTRODUCTION TO UNITED STATES INTERNATIONAL TAXATION 118-20 (2d rev. ed. 1981) (discussing the legislative history of the taxation of income of foreign corporations with United States shareholders as they apply to legitimate deferrals of income and deferrals which manipulate United States tax rules).

83. *Id.* at 119 (discussing the treatment of the United States shareholder). See *supra* note 80 (discussing the meaning of a United States shareholder).

84. AULT, *supra* note 82, at 118-20.

85. See *id.* (addressing the application of § 951 in general and § 951(a)(2) in particular). See *infra* note 86.

The substantive Subpart F sections of the Code applicable to this comment include §§ 951,⁸⁶ 952,⁸⁷ 954,⁸⁸ and 957⁸⁹. Aside from financial services, the Code directs Subpart F provisions at two principle types of income, passive investment income and related party income.⁹⁰ As enacted, Congress designed this Subpart of the Code to discourage United States taxpayers from deferring United States taxes owed. To do so, it used foreign-based corporations located in low tax jurisdictions.⁹¹

86. Treas. Reg. § 1.951(a) (1986). § 951 provides, generally, that if a foreign corporation qualifies as a CFC for a period of thirty days or more during any taxable year, every United States shareholder of the corporation who owns stock in the corporation on the 1st day of such year shall include in gross income, for that taxable year in which or which such taxable year of the corporation ends, a pro rata share of the CFC's Subpart F income. *Id.*

87. Treas. Reg. § 1.952(a) (1986). § 952 defines Subpart F income with regard to CFC's as the sum of:

- 1) insurance income (defined in Treas. Reg. § 1-953), 2) foreign base company income (defined in Treas. Reg. § 1-954), 3) an amount equal to the product of: A) the income of such corporation other than income which is attributable to earnings and profits of the foreign corporation included in the gross income of a United States person under § 951 multiplied by the international boycott factor (determined under Treas. Reg. § 1-999), 4) the sum of the amounts of any illegal bribes, kick-backs, or other payments paid by or on behalf of the corporation during the taxable year of the corporation directly or indirectly to an official, employee, or agent in fact of a government, and 5) the income of such corporation derived from any foreign country during any period during which § 901(j) applies to such foreign country.

88. Treas. Reg. § 1.954(a) (1986). § 954 defines foreign base company (FBC) income as income for any taxable year the sum of:

- 1) the foreign personal holding company income for the taxable year, 2) the FBC sales income for the taxable year, 3) the FBC services income for the taxable year, 4) the FBC shipping income for the taxable year, and 5) the FBC oil related income for the taxable year. *Id.*

89. Treas. Reg. § 1.957(a) (1986). § 957 defines a "controlled foreign corporation" (CFC) as any foreign corporation if more than fifty percent of:

- 1) the total combined voting power of all classes of stock of such corporation entitled to vote, or 2) the total value of the stock of such corporation, is owned, or is considered as owned by applying the rules of ownership (as defined by Treas. Reg. § 1-958(b)), by U.S. shareholders on any day during the taxable year of such foreign corporation. *Id.*

90. See RICHARD L. DOERNBERG, *INTERNATIONAL TAXATION IN A NUTSHELL* §9.02 (West ed., 1989) (stating that multinationals use a base company in a low tax jurisdiction rather subject themselves to taxation in a higher tax jurisdiction on the same income).

91. See *id.* § 9.01 (giving an overview of controlled foreign corporations and

Because Subpart F attacks two types of highly moveable income, one must scrutinize each situation to determine whether Subpart F applies.⁹² One must also keep in mind that § 960 provides foreign tax credit to United States shareholders for income taxed under Subpart F.⁹³

III. ISSUES AND CONFLICTS WITH THE RULES

A. RELATIONSHIP BETWEEN § 482 AND SUBPART F

The provisions in § 482 and Subpart F include two of the many provisions in the Code which attempt to deter United States taxpayers from deferring or avoiding taxation on foreign earnings.⁹⁴ Congress drafted these types of provisions to overlap in scope in order to force taxpayers to recognize income when they earn it.⁹⁵

Throughout the years, Congress focused on whether taxpayers' derived earned income came from the added value activities or from non-economic activities in defining foreign based sales and service income.⁹⁶ Subpart F focuses essentially on the same inquiries as § 482.⁹⁷ Congress codified § 482 in some form since the 1920's. How-

related provisions of the Code).

92. *See id.* § 9.03(a) (discussing the types of highly moveable income applicable to Subpart F inquiries).

93. *See id.* § 9.05 (noting that § 960 of Subpart F allows a foreign tax credit for income taxed in foreign tax jurisdictions, in order to minimize double taxation on the same income).

94. *See id.* § 9.06 (discussing that Congress has attempted, through at least six different tax regimes, to prevent the deferral or avoidance of United States taxation of foreign earnings). The five applicable provisions, aside from the Subpart F provisions, are: "accumulated earnings tax provisions, personal holding company tax provisions, foreign personal holding company provisions, foreign investment company provisions, and personal foreign investment company provisions." *Id.*

95. *See* DOERNBERG, *supra* note 90, § 9.06 (stating that Congress drafted § 482 and Subpart F to overlap and to share as a common goal the forced recognition of income when earned).

96. 2 JOSEPH ISENBERGH, *INTERNATIONAL TAXATION: U.S. TAXATION OF FOREIGN TAXPAYERS AND FOREIGN INCOME* ¶ 25.6.1 (1990) [hereinafter *INTERNATIONAL TAXATION*].

97. *See Corporate Transaction Planning*, *supra* note 2, at 660-62 (discussing the parallel focus of § 482 and Subpart F). *But see* *INTERNATIONAL TAXATION*, *supra* note 96, ¶ 25.3.1 (discussing that § 482 applies gingerly to transactions between for-

ever, when Congress began developing Subpart F provisions in the early 1960's, very few regulations and cases existed which addressed international transfer pricing issues.⁹⁸ The initial legislation proposed in the House,⁹⁹ encompassing Subpart F provisions, included a proposal to change the language of § 482.¹⁰⁰ The House Ways and Means Committee Report¹⁰¹ perceived that § 482 was not an effective device to prevent taxpayers from "siphoning off" income from the United States to lower tax jurisdictions.¹⁰² Although the Committee did not directly address the relationship between § 482 and Subpart F, it did indicate that the two provisions of the Code addressed the same tax base erosion concern.¹⁰³ Unfortunately, the Senate bill¹⁰⁴ did not contain the House's proposed amendments to § 482 because the Senate believed that § 482 already contained stringent language to address and deter improper allocations of income among United States multinationals and their foreign based subsidiaries.¹⁰⁵

The interrelationship between the two sections may act as a tax disincentive, be partially responsible for the decline in the United States trade balance since 1968, and allow the Tax Court or the Commissioner to apply subjective criterion to the allocation of 482 transfer prices or Subpart F distributions.¹⁰⁶ Additionally, one can see the interrela-

eign related parties and therefore Subpart F provisions more readily apply to determinations of economic worth).

98. See INTERNATIONAL TAXATION, *supra* note 96, ¶ 25.3 (describing countermeasures by the Treasury Department prior to enactment of Subpart F provisions). See also *Corporate Transaction Planning*, *supra* note 2, at 660 (discussing the difference between the long legislative history of § 482 and the relatively short history of Subpart F).

99. H. REP. NO. 1447, 87th Cong., 2d Sess. 28 (1962).

100. See *Corporate Transaction Planning*, *supra* note 2, at 661 (explaining the difficulties in determining a fair price under § 482). The House proposed amendments to § 482 which would allocate income proportionally to assets or expenses of the United States and foreign companies, unless the arm's length allocation produced a "fair market price." *Id.*

101. H. REP. NO. 1447, 87th Cong., 2d Sess. 462 (1962).

102. *Id.* See *Corporate Transaction Planning*, *supra* note 2, at 661 (stating that no other explicit correlation seems to exist besides the 1961 Report).

103. H. REP. NO. 1447, 87th Cong., 2d Sess. 462 (1962).

104. S. REP. NO. 1881, 87th Cong., 2d Sess. 78-84 (1962).

105. *Corporate Transaction Planning*, *supra* note 2, at 661.

106. See generally Julia A. Coyne, *United States Taxation of Exports*, 14 SUFFOLK TRANSNAT'L L.J. 547, 551-53 (1991) [hereinafter *United States Taxation*] (noting that because the United States insists on taxing United States entities on their foreign source income, it has put these entities at a competitive disadvantage and possibly

tionship between the two sections in the application of § 482 and Subpart F to Foreign Base Company Sales Income,¹⁰⁷ Foreign Base Company Services Income,¹⁰⁸ and the investment in United States property.¹⁰⁹ An example indicates the ease with which multinationals can arrange their affairs in such a way as to avoid triggering § 482 and Subpart F allocations.¹¹⁰

subjected them to double taxation of their income). The article also proffers the idea that the IRS agents apply subjective criteria in their application of the arm's length standard, citing that only three percent of the 403 cases studied actually applied a "true" arm's length price. *Id.*

107. See *Final Transfer Pricing Regulations*, *supra* note 43, at 555-59 (illustrating that § 954(d) and § 482 co-apply to instances where the IRS interprets controlled foreign corporations as solely used to capture income without any economic activity allocated to the domestic taxpayer).

108. See *id.* at 559-63 (indicating that the relationship between § 482 and § 954(e) is reasonably clear because the IRS uses § 482 as a measuring stick for allocating arm's length costs for services provided and then applies the substantial assistance tests to the controlled foreign corporation if it deems them foreign base companies).

109. See *id.* (indicating that § 956 and transfer pricing issues become related if the taxpayer uses a deferral of earnings not subject to Subpart F application in the United States). Under this scenario, if the corporation had paid a dividend, the IRS would then use § 482 to determine the appropriate rate of interest applicable to the deferred earnings. *Id.*

110. If a company ("Co. A"), for example, owns forty percent of the non-voting stock of a subsidiary ("Co. B"), domiciled in a low-tax jurisdiction, transactions between the two organizations may fall under the umbrella of I.R.C. § 482 and Subpart F. When Co. B sells Co. A widgets at Co. A's retail price, I.R.C. § 482 and Subpart F can come into play.

Under I.R.C. § 482, the Commissioner would look to see if the transaction between Co. A and Co. B took place at arm's length. If it had, no I.R.C. § 482 reallocation of income would ensue. If the transaction were anything but arm's length however, an I.R.C. § 482 reallocation of income would result, since it would allow Co. A (in a higher tax jurisdiction) to report income on the difference between cost (from Co. B, which would equal Co. A's retail price) and income from retail sales. Taking into account overhead of Co. A, Co. A would most likely report a loss in the United States. On the other side of the equation, Co. B would report its income as the difference between its cost and the revenue from sales to Co. A. The profit reported by Co. B would most likely be greater than if it had sold its widgets to a third party. But, remember that Co. B is in a low tax jurisdiction and the income tax levied on Co. B would be much lower than if it had domiciled itself in the United States. Combining loss in the United States by Co. A and forty percent of the income reported by Co. B taxed at current United States tax rates, the total reportable

In practice today, the provisions of § 482 apply the arm's length standard to United States parents and their foreign based subsidiaries.¹¹¹ The income allocated to the foreign subsidiary will then fall under Subpart F interpretation to determine whether the IRS should allocate income attributed to the United States parent currently or qualify it for a deferral.¹¹² The interrelationship between § 482 and Subpart F focuses on whether the earnings of the multinational derive from operations that "add appreciable value," rather than non-economic activities, which only exist to avoid or evade taxation.¹¹³

B. POSSIBILITY OF DOUBLE TAXATION

International tax disputes develop when more than one country claims tax jurisdiction over the same item of earned income.¹¹⁴ Such disputes may result from inconsistent definitions of source income or from uncertainty regarding the residence of the taxpayer. The most substantial sources of the disputes, however, derive from allocation and transfer

income for Co. A. in a given year turns out substantially lower than had it reported income transacting with an uncontrolled third party.

Under Subpart F, the IRS would not include Co. A as a United States shareholder and would not include Co. B as a controlled foreign corporation since Co. A does not own more than ten percent of the voting stock of Co. B, and Co. A, directly or indirectly, does not own more than fifty percent of the voting stock of the corporation. Since Subpart F does not apply to Co. A and Co. B, the respective companies would only report income in their respective domiciles as necessary under current law. The foregoing example illustrates the ease at which companies, like Co. A and Co. B do not fall within the confines of IRC § 482 or Subpart F.

111. See generally *Procter & Gamble v. Commissioner*, 961 F.2d 1255 (6th Cir. 1992) (applying the arm's length standard to Procter & Gamble's Swiss wholly-owned subsidiary); *Central De Gas De Chihuahua, S.A. v. Commissioner*, 102 T.C. 515, 517 (1994) (applying the arm's length standard against two related Mexican parties).

112. See *United States Taxation*, *supra* note 106, at 549-53 (discussing how Subpart F relates to § 482). See also *Ashland Oil, Inc. v. Commissioner*, 95 T.C. 348, 361 (1990) (holding that § 482 and Subpart F deem tax deferral and tax haven implications unacceptable). This holding demonstrates that the Tax Court has accepted the interplay of the two sections.

113. See *Corporate Transaction Planning*, *supra* note 2, at 660 (suggesting a parallel relationship between Subpart F and § 482 to inquiries regarding international operating activities of multinationals).

114. C. David Swenson, *Competent Authority Relief from Double Taxation Caused by Intercompany Pricing Adjustments*, 314 PRAC. L. INST. 475, 479 (1991). See *Johansson v. United States*, 336 F.2d 809 (5th Cir. 1964) (illustrating possible double taxation involving a resident of Switzerland performing services in the United States).

pricing issues.¹¹⁵ Regardless, international tax disputes involving double taxation pose various problems for taxpayers.

International double taxation typically arises when the same entity becomes liable in two different tax jurisdictions for taxes on the same item of earnings.¹¹⁶ Typically, the host country taxes the earnings generated within its boundaries, based upon a territorial connection with the source of the income.¹¹⁷ The foreign domicile then taxes income personally connected with the recipient, taxing them on their world-wide income.¹¹⁸ The concurrence of these two events constitutes double taxation.¹¹⁹

Under international conventional wisdom, the residence country will usually yield tax jurisdiction to the source country, either through domestic tax law or treaty,¹²⁰ in order to prevent double taxation.¹²¹

115. See Paul D. Tutun, *Arbitration Procedures in the United States-German Income Tax Treaty: The Need for Procedural Safeguards in International Tax Disputes*, 12 B.U. INT'L L.J. 179, 183-84 (1994) (introducing the competent authority process with regard to international tax disputes).

116. *Id.* at 184-85. The author illustrates that:

[t]ransfer pricing issues arise when a tax authority of Country X determines that corporation A, within Country X's taxing jurisdiction, has been shifting A's profits to A's [foreign-based subsidiary], corporation B, which is located in another tax jurisdiction. If Country X determines that corporations A and B have been making transactions not at arm's length, or at an unfair advantage to Country X, Country X will then subject A to a price adjustment based on arm's length principles and thereby increasing A's taxable income. However, A's foreign-based subsidiary, in Country Y, will still be subject to Country Y's existing level of tax under Country Y's tax laws. Unless Country Y accepts Country X's upward price adjustment on Country A and implements a corresponding downward adjustment to B's income, the income of A and B will be . . . subject to double taxation. *Id.*

117. See Yves Bonnard, *The "Triangular Case" in the New U.S. Netherlands Tax Treaty: Mechanisms and Tax Planning*, 23 DENV. J. INT'L L. & POL'Y 161, 163-64 (1994) [hereinafter *Triangle Case*] (discussing the basis whereby double taxation occurs internationally).

118. *Id.*

119. See *supra* note 114 (discussing the possibilities of double taxation).

120. See generally Model Double Taxation Convention of Income and on Capital, Report of the OECD Committee on Fiscal Affairs, Arts. 6-21 (1977) (determining the respective rights to tax of the State of Source and of Residence); ADELAIDE PASSOS, TAX TREATY LAW 67 (Juta & Co., Ltd. eds., 1986) (discussing reciprocal rights and

The residence domicile usually employs one of two mechanisms, an exemption system¹²² or a tax credit system,¹²³ in applying the residence principle. Alternatively, a country implementing the source principle need only determine whether a taxpaying entity earns its income from operations derived within that country's tax jurisdiction.¹²⁴ If so, that country taxes the income. While the above-described scenario provides an effective means for avoiding double taxation, without any tax treaty or internal law provision, a United States multinational and/or its foreign subsidiary could incur tax liability in a multitude of tax jurisdictions.¹²⁵

Another complicating factor that occurs, depending on one's view, is the clarity or obscurity of the interplay and distinction between the two

obligations that treaty participants have towards tax jurisdictions and protocol). See Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion With Respect to Taxes on Income and Capital, Aug. 31, 1994, U.S.-Fr., S. TREATY DOC. NO. 103-32 (1994).

121. Hugh J. Ault & David R. Tillinghast, *Federal Income Tax Project, International Aspects of United States Income Taxation II, Proposals on United States Income Tax Treaties*, A.L.I. 5-6 (1992). See Eric J. Smith, *The U.S.-Mexico Tax Treaty*, 8 FLA. J. INT'L L. 97, 98 (1993) (discussing that the avoidance of double taxation remains the most serious tax barrier to income tax treaties).

122. See *Triangle Case*, *supra* note 117, at 162 (claiming that the exemption system, or the "territorial system," exempts residents from foreign source income and illustrating that the Netherlands uses the exemption method as a relief from double taxation). See also Treas. Reg. § 1.911 (1986) (allowing United States citizens living abroad to exclude a portion of foreign earned income applicable to United States taxation).

123. See *Triangle Case*, *supra* note 117, at 164 (stating that the tax credit system grants residents a "tax credit" to counter foreign taxes imposed on income earned in a foreign domicile). See also Treas. Reg. § 1.901-908 (1986) (describing the United States foreign tax credit).

124. See Alvin C. Warren, Jr., *Alternatives for International Corporate Tax Reform*, 49 TAX L. REV. 599, 600 [hereinafter *Corporate Tax Reform*] (discussing the source principle as it pertains to income derived from within jurisdictional borders).

125. See generally T. Modibo Ocran, *Double Taxation Treaties and Transnational Investment: A Comparative Study*, 2 TRANSNAT'L L. 131, 131-38 (1989) (illustrating that a United States multinational or its subsidiary can possibly incur tax liability). This liability can be incurred in: 1) the United States, where the IRS taxes income earned through operations worldwide; 2) the domicile of the foreign subsidiary, where the multinational derives income from manufacture or other operations pertinent to the United States multinationals; and 3) another tax jurisdiction which may tax either the United States parent or its subsidiary for transacting business within its jurisdiction. *Id.*; Smith, *supra* note 121, at 99-100 (illustrating circumstances which may bring about double taxation of foreign based earnings).

principles.¹²⁶ The international standard requires deference to the source country when taxing corporate income and to the residence country when taxing investor income.¹²⁷ One view states that the principal justification for corporate income tax is a withholding tax on the individual shareholder.¹²⁸ To justify this theory, scholars state that the costs imposed on the public sector entitle countries to tax in order to get reimbursed.¹²⁹

The prevailing theory of income taxation, however, allocates the costs of government among taxpayers.¹³⁰ Source-based taxation differs from this prevailing theory.¹³¹ Essentially, the taxpayer's tax burden is not dependent on his worldwide income and the source country does not base the tax rate on the taxpayer's total income.¹³² In effect, this view violates the progressivity principle of the prevailing theory on income taxation.¹³³

126. See *Source-Based Taxation*, *supra* note 12, at 27-28 (exemplifying that when the United States imposes a tax on the U.S. subsidiary of a foreign corporation, it considers the subsidiary a domestic resident). It will apply the § 482 arm's length standard to allocate income between the entities so that total income is properly reported. *Id.* As such, the United States appears to use the arm's length standard to implement a residence rather than a source based taxation. *Id.* See also *Use of IRC 482 and/or Subpart F*, *supra* note 1 (illustrating the choices in allocation to be either § 482 or § 954(e) allocation for services provided).

127. Hugh J. Ault, *Corporate Integration, Tax Treaties and the Division of the International Tax Base: Principles and Practices*, 47 TAX L. REV. 565, 567-68 (1992) [hereinafter *Corporate Integration*] (reviewing the contention that working groups under the direction of the League of Nations developed the foundations which became effective in the 1920's).

128. See *Source-Based Taxation*, *supra* note 12, at 28 (explaining the position of withholding tax on the individual shareholder).

129. See RICHARD A. MUSGRAVE & PEGGY B. MUSGRAVE, *PUBLIC FINANCE IN THEORY AND PRACTICE*, 373-74 (5th ed. 1989) (promoting the benefits theory of taxation). The public sector includes the cost of public goods and services used, and "external" costs, such as the cost of pollution and intangibles. *Id.*

130. See *Source-Based Taxation*, *supra* note 12, at 29.

131. See *Corporate Tax Reform*, *supra* note 124, at 603-04 (discussing that source-based taxation and the conventional approach to taxation are no longer based on the same premise).

132. *Source-Based Taxation*, *supra* note 12, at 29.

133. *Id.*

Additionally, most of the industrialized countries no longer base their domestic income tax systems on the premise that they should tax corporate and shareholder income based on separate theories of taxation.¹³⁴ The separation of the two categories of taxable entities produces several undesirable consequences, including disincentive for investment and incentive for corporate earning retention.¹³⁵

Integration of corporate and shareholder taxation would lessen some of the undesirable consequences, including the possibility of double taxation. One, however, must note that concerns over double taxation occur not only between a United States parent company and its foreign subsidiary, but also between a United States multinational, its foreign subsidiary, and its shareholders.¹³⁶ Shareholders, whom the IRS taxes based upon a residence rather than a source theory, may ultimately derive less net income because of this disintegration.

The standard approach to dividing income among jurisdictions possibly is misguided. This misguidance arises primarily because parties may structure international transactions derived through multinational corporations specifically to gain advantages not available through arm's length pricing.¹³⁷ By employing the cost-sharing methodology presently enacted, firms can determine the scope of their shared research projects.¹³⁸ As such, they can define the scope of the cost-sharing agreements narrowly, and "require foreign subsidiaries operating in lower tax jurisdictions to participate only in successful ventures," thereby effectively allocating costs and risks to the United States entity.¹³⁹

134. See *Corporate Integration*, *supra* note 127, at 582-93 (claiming that parties have often termed separation taxation of the corporate and shareholder "classical corporate taxation"). Over the last thirty years, however, most industrialized countries (other than the United States) have integrated their corporate and individual tax schemes as a matter of domestic law. *Id.*

135. See *Corporate Tax Reform*, *supra* note 124, at 604 (illustrating the disincentives of the conventional approach to taxation).

136. See generally *Standing Under Commercial Treaties: Foreign Holding Companies and the Unitary Tax*, 97 HARV. L. REV. 1894 (1984) (discussing the background of the unitary tax controversy which may lead to double taxation of multinationals, foreign companies, and shareholders).

137. See *Corporate Tax Reform*, *supra* note 124, at 605-06 (discussing the operational problems encountered through the current international division of income).

138. TRANSFER PRICING AND VALUATION, *supra* note 20, at 30.

139. *Id.*

C. SUBJECTIVENESS

The language of the Code lends itself to various interpretations by the courts and administrators.¹⁴⁰ The Treasury Department and the IRS must continually explain the sections of the Code itself.¹⁴¹ Nevertheless, Congress and the courts have constantly averred that the IRS has broad authority to allocate taxable income under § 482, and the courts should not reverse those allocations unless "arbitrary, capricious, or resulting from an abuse of discretion."¹⁴² Whether or not the IRS possesses the authority to reallocate income under its discretion, the IRS should have the responsibility to provide an objective standard (to the taxpayer) for the application of income relating to transfer pricing and controlled foreign corporations.

Early in the legislative process of the 1968 Act, Secretary of the Treasury Dillon, in his 1961 testimony before the House, voiced serious concerns about whether "difficulties in determining a fair price under this provision (§ 482)" would limit Congress' power to reallocate income between controlled and controlling parties.¹⁴³ Legislative amendments, including the use of the twelve factors in determining a comparable uncontrolled transaction price, still yield different estimated arm's length prices depending on the factor used.¹⁴⁴ Thus, neither the Legislature nor the Treasury appear to have proffered a clear standard to aid in pricing international transactions.

Prior to 1987, the Tax Court applied various tests to § 482 and Subpart F cases, taking into account the appropriateness of deductions

140. Linda Galler, *Emerging Standards for Judicial Review of IRS Revenue Rulings*, 72 B.U. L. REV. 841 (1992).

141. *Id.* The Treasury Department and the IRS frequently issue regulation and revenue rulings to delineate their position on a Code provision. *Id.* This is evidenced by the "reasonable cause and good faith" exception of § 6662(e)(3)(d), which Congress based on a general subjective standard. Treas. Reg. 1-6662(e)(3)(d) (1993). The 1993 IRS ruling explains this exception as "allowed only if the requirements for excluding adjustments from the threshold are met." *The Accuracy-Related Penalty Under Prior Law and After RRA '93*, 4 J. INT'L TAX'N 568, 569 (1993).

142. *Abuse of Discretion Standard*, *supra* note 6, at 434.

143. H.R. REP. NO. 1447, 87th Cong., 2d Sess. 28 (1962).

144. See generally TRANSFER PRICING AND VALUATION, *supra* note 20, at 21-24 (describing the difficulty in administering the arm's length standard by illustrating that the twelve factors often lead to discrepancies in transaction price).

and credits averred in association with taxpayer filings.¹⁴⁵ The court applied an objective test in some cases in determining whether the business transaction was "a sham" and lacked economic substance.¹⁴⁶ Separate from this objective test, the court also used a subjective business purpose test in numerous other transfer pricing cases.¹⁴⁷ In those cases, the court determined whether the taxpayer had engaged in the subject transaction with an "actual and honest profit objective."¹⁴⁸ In general, the Tax Court failed to apply a precise standard to subjective or objective profit motive cases.¹⁴⁹ In *Rose v. Commissioner*,¹⁵⁰ the court combined subjective and objective tests in an attempt to identify and qualify an objective standard.¹⁵¹ Ultimately, the court has failed to provide an encompassing standard, and instead merely shifted the onus to other sections of the Code.¹⁵²

Two current holdings of the courts confirm the subjectivity by which the IRS allocates taxpayers' income.¹⁵³ As evidenced in *Bausch and*

145. See Kathleen O. Lier, *The Evolution In Tax Shelter Litigation: The Tax Court Closes The Door On Generic Tax Shelters, But A Window Remains Open With Respect To The Additions To Tax And The Increased Interest Under IRC S. 6621(C)*, 36 LOY. L. REV. 275, 275-279 (1990) [hereinafter *Generic Tax Shelters*] (discussing tax shelter cases and the effect of the *Rose* decision on the application of the Code).

146. *Id.* at 279 (noting that the objective test prior to *Rose* incorporated a subjective test to ascertain whether the suspect transaction derived from a valid business reason). If the court objectively thought a valid business reason existed for the transaction, the court would not deem the transaction inappropriate. *Rose v. Commissioner*, 88 T.C. 386, 410 (1987). See *Packard v. Commissioner*, 85 T.C. 397, 417-18 (1985) (defining the first prong of the sham inquiry as a subjective test simply concerned with the taxpayer's motives); *Rice's Toyota World v. Commissioner*, 81 T.C. 184, 203, 209 (1983) (holding that unless the taxpayer structures the transaction solely for tax avoidance considerations, the court cannot treat the transaction as a "sham"); *Frank Lyon Co. v. United States*, 435 U.S. 561, 583-84 (1978) (holding that to treat a transaction as a sham, the transaction must have no economic substance, no possibility for profit, or the taxpayer's motivation stems from the prospect of obtaining tax benefits by entering the transaction).

147. *Rose*, 88 T.C. at 411-12.

148. *Id.* See *Generic Tax Shelters*, *supra* note 145, at 280 (discussing that under separate sections of the Code, including I.R.C. § 183(a)-(c) (1988), the Tax Court relied on numerous subjective factors in determining whether a taxpayer's transaction harbors an illegal or unethical motive).

149. *Generic Tax Shelters*, *supra* note 145, at 281.

150. 88 T.C. 386 (1987).

151. See *Rose*, 88 T.C. at 409-15 (constructing the four-prong objective test).

152. See *Generic Tax Shelters*, *supra* note 145, at 285-92 (stating that since the adoption of the *Rose* four-prong test, the court opened other avenues for tax shelter abuse and shifted the tax litigation "battleground" to other sections of the Code).

153. See generally *Bausch & Lomb, Inc. v. Commissioner*, 92 T.C. 525 (1989)

Lomb, Inc. v. Commissioner,¹⁵⁴ the IRS erroneously reallocated income between the parent company and a foreign subsidiary because it failed to properly determine the transfer price of intangible, as well as tangible, property prior to the allocation.¹⁵⁵ Alternatively, in *United States v. Goodyear Tire and Rubber Co.*,¹⁵⁶ the Court held in favor of the IRS, and thus solidified the IRS' interpretation of the foreign tax credit as it applies to CFC's.¹⁵⁷ The IRS' successful defense of its position in one case and its unsuccessful defense of its allocation in another, especially in light of the apparent clarity of the transfer pricing and controlled foreign corporation statutes, illustrates the subjective nature of the application of the regulations.

Other Tax Court cases, such as *Exxon Corp. v. Commissioner*,¹⁵⁸ represent a firm rejection of the IRS's attempt to minimize the effect of foreign law on the taxation of "United States income," as dictated in the Supreme Court's decision in *First Security Bank of Utah v. United States*.¹⁵⁹ These cases identify several instances in which the Court re-

(dictating that under § 482, the IRS must establish a transfer price for both intangible royalty payments and tangible property); *United States v. Goodyear Tire and Rubber Co.*, 493 U.S. 132 (1989) (ruling that United States law, not foreign tax principles, governs for purposes of applying a foreign tax credit).

154. 92 T.C. 525 (1989).

155. *Id.* at 598.

156. 493 U.S. 132 (1989).

157. *Id.* at 143-44.

158. *Exxon Corp. v. Commissioner*, 102 T.C. 721 (1994). See *Procter & Gamble v. Commissioner*, 95 T.C. 323 (1990) (illustrating that the IRS misallocated royalty income to a Spanish subsidiary under § 482 instead of another CFC of a United States multinational, and thus generated Subpart F income to Procter's Swiss subsidiary under 954(c)). The Tax Court rejected the IRS's allocation, partly relying on *First Security Bank*, and holding that §§ 482 and 954 do not apply when the law bars a taxpayer from receiving royalty income and only applies when [complete] control over a subsidiary to shift income exists. *Id.*

159. 405 U.S. 394 (1972). The IRS attempted to reallocate insurance commissions from an insurance subsidiary to the parent bank to reflect the true division of profits based on merit. *Id.* at 394-400. The United States Supreme Court rejected the IRS's reallocation argument, holding that: 1) because of legal restrictions they were barred from receiving commissions, and 2) "control," for the purposes of 482 (and Subpart F) could not exist unless the controlling party had exclusive power to shift income among its subsidiaries. *Id.* at 400-07. See Marc M. Levey and James P. Clancy, 482 Allocation Barred in "Aramco Advantage" Cases, 5 J. INT'L TAX 203 (1994) [here-

jected the IRS' arguments that attempted to reallocate income based on literal readings of the Code.¹⁶⁰

Neither the IRS' actions nor the obscurity of the Code can remain the sole basis for the subjective character of the IRS' actions. Sometimes, the problem lies in the access to information or with management at the IRS.¹⁶¹ Many times, as is the case with the application of § 482 or § 954 to intangibles, the taxpayer becomes the only source of the information needed for the IRS to properly allocate income among related taxpaying parties.¹⁶² When the taxpayer refuses to comply with IRS requests for information or cannot explain how it established the intra-company pricing, the IRS is unable to adequately price a transaction.¹⁶³

The resulting allocation sometimes is interpreted as misappropriation in the guise of subjectiveness.¹⁶⁴ Another source of IRS misappropriation of taxpayer income occurs because management at the IRS emphasizes the importance of closing tax cases on a timely basis and not disturbing "established taxpayer relationships."¹⁶⁵ Either way, the end result to the taxpayer is uncertainty in application of sections of the Code.

The 1992 Proposed Regulations and the 1993 Temporary Regulations also do not provide any specific guidance in pricing transfers of tangible and intangible property when the transfer involves a combination of

inafter *Aramco Advantage Cases*] (discussing how Saudi Arabia's price restrictions barred the IRS from redistributing profits under I.R.C. § 482 - the "Aramco advantage").

160. See generally *Aramco Advantage Cases*, *supra* note 159, at 203-210 (illustrating cases which show the rejection of the IRS's allocations under §§ 482 and 954).

161. See Marc M. Levey, et al., *Transfer Pricing of Intangibles After the Section 482 White Paper*, 71 J. TAX'N 38, 47-48 (1989) [hereinafter *Transfer Pricing of Intangibles*] (discussing the White Paper's speculations on the difficulties of obtaining taxpayer information regarding the suspect transfer pricing transactions). See generally Treas. Reg. §§ 7602 and 982 (providing power under the Code to access information for purposes of determining whether taxpayer intracompany allocations were proper).

162. *Transfer Pricing of Intangibles*, *supra* note 161, at 47-48 (discussing the White Paper's speculations that management at the IRS provides for untimely closure of tax cases).

163. See *id.* (claiming the possibility of the IRS's inability to properly price intracompany transaction without the assistance of the taxpayer).

164. See *Eli Lilly & Co. v. United States*, 372 F.2d 990, 997 (Ct. Cl. 1967) (disregarding the Commissioner's subjective considerations in allocating income and concentrating on the ultimate result of the allocation).

165. See *Transfer Pricing of Intangibles*, *supra* note 161, at 47-48 (discussing the emphasis at the IRS to close cases on a timely basis and reluctance to harm existing taxpayer relationships).

tangible and intangible property.¹⁶⁶ Because many transfers involve such a combination,¹⁶⁷ the Regulations contain an apparent deficiency which also leads to a subjective allocation of an arm's length price.

As a result, and if history is any guide, the courts will reverse the Commissioner's allocations in future and pending cases.¹⁶⁸ The reasons for the reversals have included, and will continue to include, application of an overly strict standard of review, application of the incorrect standard of judicial review, and the substitution of the Tax Court's judgment for the Commissioner's.¹⁶⁹

IV. RECOMMENDATIONS

A. NATIONAL TAX HARMONIZATION

Double taxation issues, in relation to tax reform, usually encompass three distinct principles: nondiscrimination,¹⁷⁰ neutrality,¹⁷¹ and reci-

166. INTERCOMPANY PRICING: GUIDE TO THE NEW 1993 UNITED STATES RULES, THE BAKER & MCKENZIE NORTH AMERICAN TAX PRACTICE GROUP 50 (1993).

167. *Id.*

168. *Abuse of Discretion Standard*, *supra* note 6, at 433.

169. *Id.* at 434.

170. *See Corporate Tax Reform*, *supra* note 124, at 601 (noting that nondiscrimination via tax treaties usually involves an agreement for one country not to discriminate against another, including, but not limited to, taxing foreigners in a manner that does not discriminate against them).

171. *See Corporate Tax Reform*, *supra* note 124, at 601-02 (defining neutrality by considering three different views). One view is that an international tax system should be capital export neutral. *Id.* This leads to the assumption that, all things being equal (in a tax context), one will allocate capital to its highest and best use. *Id.* Secondly, the international tax system should become capital import neutral. *Id.* This view assumes that a country should tax all income earned in that country at the same rate regardless of who earned it. *Id.* A final view states the international tax system should become nationally efficient. *Id.* This view assumes that a particular country should concern itself with allocating its own economic welfare to its own needs and thus countries should tax domestic companies equally whether abroad or at home. *Id.* *See also* Yoseph Edrey & Samuel Shani, *The U.S. Taxation of Aliens*, 21 CAP. U. L. REV. 121, 124-26 (1992) (describing the unique dimension of tax neutrality principles).

procity.¹⁷² All three principles, however, have as a common thread the goal of creating a level playing field for taxpayers.¹⁷³

Additionally, problems arise with the international tax system in general, including: incorrect premises,¹⁷⁴ tax differentials,¹⁷⁵ and operational differences.¹⁷⁶ In the end, those who make recommendations to reduce the existence of double taxation encounter difficulty in coming to a consensus about how to rectify the tax law differences among nations.¹⁷⁷

Several people have made recommendations throughout the years as to how Congress should revise the tax laws in order to eliminate double

172. See *Corporate Tax Reform*, *supra* note 124, at 602 (defining reciprocity via treaty as generally involving the equal reduction of taxes paid in a residence country as the taxpayer paid in a source country or vice versa).

173. *Id.* at 601-03 (noting that the three principles illustrate the goal of tax parity by recognizing foreign persons as legitimate taxpayers on par with domestic taxpayers, the concept that capital flows to the least tax base, and that the tax paid in one country can defer taxes paid in another).

174. *Id.* at 603-07 (categorizing three separate problems which arise in double taxation situations). The review continues discussing a fundamental problem of the premise of separate taxation faced by tax reformers. *Id.* at 604. Separate taxation of shareholders and corporations discourages investment by corporations and encourages corporations to restructure their earnings payouts to maximize total income (i.e. lessen the tax burden). *Id.*

175. See Hugh J. Ault, *International Issues in Corporate Tax Integration*, 10 LAW & POL'Y INT'L BUS. 461 (1978) (stating that the interaction of domestic and international tax regimes create tax differentials which may cause the foreign investment to be taxed at a higher tax level than a domestic investment due in part to inapplicability of shareholder credits to foreign investments). See also *Corporate Tax Reform*, *supra* note 124, at 604-05 (noting that income from foreign investments can be taxed more than domestic investments due to unavailability of foreign tax credits or exemptions to shareholders).

176. See *Corporate Tax Reform*, *supra* note 124, at 605-06 (stating that several operational problems exist with international taxation). The current international tax system is very complex (as evidenced by the United States provisions designed to limit foreign tax credit), very formalistic (due in part to its scheduler nature), very inaccurate (due to the overabundance of bilateral tax treaties leading to tax forum shopping), quite unenforceable (due to the sophistication of modern capital markets), and generally referred to as unworkable and unrealistic. *Id.*

177. See generally *Corporate Tax Reform*, *supra* note 124, at 607-13 (discussing the two types of tax reform for the current United States system); Smith, *supra* note 121, at 127-29 (recommending non-discrimination and mutual agreement as solutions to the double taxation dilemma); Paul D. Tutun, *Arbitration Procedures in the United States-German Income Tax Treaty: The Need for Procedural Safeguards in International Tax Disputes*, 12 B.U. INT'L L.J. 179, 193 (1994) (recommending arbitration as a dispute resolution technique).

taxation and, at the same time, maintain the three principles stated above.¹⁷⁸ The alternatives for reform usually fall within two categories: proposals which fall within the concept of separate taxation for corporations and shareholders, and proposals which do not.¹⁷⁹ Legislators and professionals alike have proffered recommendations to cure the current system.¹⁸⁰

The latter view of tax reform includes proposals to eliminate income taxation and replace it with a cash flow taxation, thereby limiting taxation solely to residence countries through both elimination of dual jurisdiction and separation of taxation of corporations and shareholders. These proposals focus more on an international overhaul of taxation rather than a domestic refinement, because the proposal focuses on substance rather than procedure.¹⁸¹

Recommendations involving the former category focus on using the existing statutory structure to improve the tax system, which would simplify and refine the current system.¹⁸² Proposals include either replacement or relaxation of the arm's length standard¹⁸³ or revising the tax system, with competitiveness as the major goal of United States.¹⁸⁴

178. See *supra* note 177 (noting that it is preferable to revise tax laws through non-discrimination and mutual agreement, as well as through arbitration).

179. *Corporate Tax Reform*, *supra* note 124, at 607.

180. See David R. Tillinghast, *International Tax Simplification*, 8 AM. J. TAX POL'Y 187, 188-89 (1990) [hereinafter *Tax Simplification*] (discussing the simplification of the income tax system in terms of international transactions by means of "compromising policy aims" and "accepting degrees of relative inequity.")

181. This comment does not address these recommendations because, although feasible in the distant future as national infrastructures and procedures become increasingly intertwined, the current state of tax legislation would not allow for such radical change.

182. *Tax Simplification*, *supra* note 180, at 193-97 (suggesting the termination of deferral or a rollback of Subpart F).

183. See *United States Taxation*, *supra* note 106, at 563-65 (recommending the relaxation of the arm's length standard to strengthen the international competitiveness of United States exports since arm's length pricing appears impossible to achieve).

184. See Daniel P. Shepherdson, *The Simplification of Subpart F*, 17 CASE W. RES. J. INT'L L. 459, 465-66 (1985) (discussing that the Subpart F deferral mechanism operates to favor investments in foreign operations over domestic operations); Joel Slemrod, *Effect of Taxation with International Capital Mobility*, in UNEASY COMPROMISE: PROBLEMS OF A HYBRID INCOME-CONSUMPTION TAX, 115-16 (Henry J. Aaron et al. eds., 1988) (discussing the burdens and economic effects of capital income

Nevertheless, the concept of national tax harmonization remains one of the more plausible approaches to double taxation, separating corporate and shareholder taxation.¹⁸⁵

This approach contains the notion that all nations should maintain "substantially similar national tax systems."¹⁸⁶ It would address two-thirds of the principles and problems discussed throughout this comment. This approach addresses harmonization, which would, in the sense of equivalent national tax systems, maintain capital import and export neutrality while maintaining efficiency within a tax jurisdiction. Additionally, because of the similarity and equivalency of the tax systems, reciprocity issues may become irrelevant.¹⁸⁷ Because nations would maintain similar tax systems, problems concerning tax differentials and operational differences also would become irrelevant.

Harmonization as an approach to double taxation, however, still does not address the principle of nondiscrimination and the problem of incorrect premises. Harmonized national tax systems still will not address discriminatory issues one nation applies to foreigners because it is unlikely that "one nation's government will yield national control over tax policies in the interest of harmonization."¹⁸⁸ In addition, nations may view issues such as national competitiveness differently.¹⁸⁹ As such, internal premises may end up forcing legislators to take domestic views of tax policy, thus forsaking international goals.

In summary, of all the proposals listed above, harmonization as a goal for the reduction of double taxation would most clearly incorporate the principles an international tax system should retain, while simultaneously reducing problems associated with international tax systems. Thus, harmonization stands out as the most workable theory in today's legislative climate.

taxation).

185. *Corporate Tax Reform*, *supra* note 124, at 609.

186. *Id.* See Brian J. Arnold & Neil H. Harris, *NAFTA and the Taxation of Corporate Investment: A View from Within NAFTA*, 49 TAX L. REV. 529, 577-79 (1994) (recommending that countries should harmonize tax treaty provisions for direct cross-border investments).

187. Since countries tax and calculate income in the source and residence country at similar rates, similarly, the need for bilateral tax treaties which reduce taxes in one country for sake of another may not be applicable once nations harmonize their tax systems.

188. *Corporate Tax Reform*, *supra* note 124, at 609.

189. *Id.*

B. OBJECTIVENESS, EVEN WITH SUBJECTIVENESS

Some may consider the Code subjective, as it applies to the taxation of multinationals with respect to § 482 and Subpart F.¹⁹⁰ A portion of the subjective character of the Code lies in the difficulty of determining an applicable foreign law.¹⁹¹ Another element that adds subjectiveness to the Code is the existence of multiple tests for allocating the arm's length standard price.¹⁹² The subjectiveness manifests itself in many forms, from Tax Court decisions¹⁹³ to the Commissioners misallocations.¹⁹⁴

As stated earlier, courts have rejected the Commissioner's determinations in many cases, due in part to the Tax Courts' overly strict judicial review and its application of incorrect standards of judicial review.¹⁹⁵ Legislation envisions that the Commissioner retain a large amount of discretion to determine comparable transactions, in lieu of an appropriate comparable transaction.¹⁹⁶ The discretion on the part of the Commis-

190. See *Abuse of Discretion Standard*, *supra* note 6, at 510 (discussing the way the Code, through the courts, can "inject vulnerability" into transfer pricing allocations; *Aramco Advantage Cases*, *supra* note 159, at 205-06 (illustrating the subjectiveness of the IRS in pricing intracompany transactions).

191. *Aramco Advantage Cases*, *supra* note 159, at 206 (noting that the Tax Court and the IRS both agreed that foreign law legitimately influenced the reasoning of the Court).

192. See generally Treas. Reg. § 1.482 (providing at least six different methods of allocating an arm's length price to related parties). See also *Transfer Pricing of Intangibles*, *supra* note 161, at 39 (noting that the White Paper recommended retaining the comparable uncontrolled price method and also suggested using the basic arm's length rate of return method (BALR method) and the profit split basic rate of return method (BALR Plus method) if comparables were not available).

193. See generally *Abuse of Discretion Standard*, *supra* note 6, at 432 (discussing cases tried before the Tax Court).

194. See *Procter & Gamble Co. v. Commissioner*, 961 F.2d 1255 (6th Cir. 1992) (disallowing the Commissioner's allocation of income from a United States parent to a Spanish subsidiary); *Commissioner v. First Sec. Bank*, 405 U.S. 394 (1972) (holding that § 482 does not apply to income distortions not caused by the controlling party, but rather by governing law).

195. See *Abuse of Discretion Standard*, *supra* note 6, at 433-34 (discussing that the Tax Court has effectively substituted its own judgment for that of the Commissioner and that subjectiveness in the application of the Code has resulted).

196. Treas. Reg. § 1.482-2(a)(2). See *Gold v. United States*, 552 F. Supp. 66, 70

sioner has, in itself, the makings of subjective standards.¹⁹⁷ Recent Treasury Department regulations attempted to introduce a degree of flexibility and comparability among allocations, thereby lessening the subjectiveness of the Commissioner.¹⁹⁸

Practitioners proffer recommendations involving the application of the "abuse of discretion" standard to § 482 and Subpart F inquiries as a panacea to the arbitrary nature of the Commissioner's allocations.¹⁹⁹ While arguably effective in curing the misallocation, the subjective nature of the two sections of the Code remain intact.²⁰⁰ A more objective standard, while still not effective in curing the subjective nature of the Code, is the "reasonable mind of the Commissioner" standard.²⁰¹

The *Rose* decision demonstrates one solution to the subjective character of the two sections of the Code.²⁰² As discussed above, the Court

(D. Colo. 1982) (holding that § 482 gives the Commissioner the power to reallocate expenses and income among related parties); *Atlas Tool Co., Inc., v. Commissioner*, 614 F.2d 860, 868 (3d Cir. 1980) (allowing the Commissioner's discretion in disallowing an attempt to categorize income earned as capital gains, rather than ordinary income); *Echols v. Commissioner*, 935 F.2d 703, 707-08 (5th Cir. 1991) (indicating that the "worthlessness" of interests between related parties is one of not only objective, but subjective indicia for the Commissioner).

197. Stanley S. Surrey, *Treasury's Need to Curb Tax Avoidance in Foreign Business Through the Use of 482*, 28 J. TAX'N 75, 76 (1968). Assistant Secretary of the Treasury Surrey stated:

A typical suggestion is that the Regulations should supply a "mechanical safe haven" in the area of the pricing of goods The reason is that no satisfactory device has yet been suggested or worked out. The variation in profit from industry to industry, among companies within an industry and even among product lines within a company is much too great to permit a single percentage, or a series of percentages . . . in establishing transfer prices The safe haven will have to lie in a sensible, reasonable administration of the Regulations themselves.

198. *Abuse of Discretion Standard*, *supra* note 6, at 452. See *supra* notes 37 and 38 and accompanying text (suggesting that The 1992 Proposed Regulations and The 1993 Temporary Regulations are viewed as more flexible than prior regulations in that they eliminate the prioritization of methods for evaluating an arm's length transaction). Additionally, the new regulations contain language indicating a comparability aspect to the regulations. *Id.*

199. *Abuse of Discretion Standard*, *supra* note 6, at 504.

200. *Id.* at 504-505.

201. *Id.* at 513.

202. See *Rose v. Commissioner*, 88 T.C. 397, 408 (1987) (holding that when the taxpayer entered into the transaction solely for tax reasons, rather than if a taxpayer

in *Rose* defined a new four-prong objective test, using subjective factors to determine whether it believed the test to be applicable to a particular transaction.²⁰³ The attractiveness of this approach is that it does not require the legislature to rewrite the two sections of the Code in order to eliminate their subjective character. The Court simply can use the subjective factors as a screening process, thereby allowing fewer transactions to escape the grasp of the Code that allows multinationals to avoid paying taxes on income earned. Although the existence of multiple tests allows the Commissioner to "best allocate" a transaction price depending on the situation, a unified test will surely help to eliminate the subjectiveness of the two sections.²⁰⁴ Additionally, Congress has proposed codification of such a solution in the Code.²⁰⁵

The enactment of specific objective tests for determining arm's length transaction prices and deferrals of income which controlled foreign corporations generate, even if containing subjective subtests, will provide much needed clarity to the application of § 482 and Subpart F of the Code.

V. CONCLUSION

§ 482 and Subpart F of the Internal Revenue Code provide the Internal Revenue Service and the Treasury Department with strong weapons

mistakenly believes there existed a potential for profit, the court may use both subjective and objective analysis to determine the proper allocation of § 482 and Subpart F).

203. See *id.* at 409-22 (describing in detail the objective four-prong test). See also *Generic Tax Shelters*, *supra* note 145, at 282-84 (discussing that the Court in *Rose* combined objective and subjective tests to develop a "unified approach" in evaluating generic tax shelters).

204. Applying a unified objective test rather than a subjective test should have the effect of providing a clear direction to the IRS and multinationals as to the standard to administer in Subpart F and § 482 cases.

205. See Prop. Treas. Reg. § 1.6662(e)(3)(D), 58 Fed. Reg. 5304 (1993) (demonstrating that Congress changed the definition of the reasonable cause and good faith exception from a subjective standard to an objective standard). See also Raymond Turner, *Foreign Taxation Highlights of the Tax Reform Act of 1986*, 21 INT'L LAW. 487, 515 (1987) (indicating that the Act replaced the subjective test used by a shareholder to establish whether the controlled foreign corporation was used to avoid taxes with an objective test designed to flag potential abusers).

in the fight against the abuse of foreign-domiciled entities for the purpose of avoiding or evading income taxation in the United States. These two sections of the Code have deep-rooted legislative history behind them and Congress has revised or amended them on several occasions. Through these two sections, the IRS may duly tax billions of dollars. Without the sections, those dollars could elude the taxing authorities domestically.

Unfortunately, the existence of these two sections has, on occasion, caused double taxation on income from legitimate operations. It has also provided unclear, subjective standards which the taxing authorities fail to apply appropriately at the cost of the taxpayer.

National tax harmonization, whereby similar tax systems apply similar treatment to taxpayers, remains one of the more plausible recommendations for curing the double taxation problem domestically. Developing objective standards, even if they incorporate subjective subtests, should lead to a more consistent application of the Code. These two recommendations should help the taxing authorities implement the complex Tax Code in such a way as to make it more consistent for the taxpayer.