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SECTION 482 AND THE "ARM'S LENGTH" STANDARD OF COMMONLY CONTROLLED TAXPAYERS

WILLIAM L. SAX

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I. INTRODUCTION AND BASIC SCOPE OF SECTION 482

By the terms of section 482 of the Internal Revenue Code of 1954,¹ and the regulations thereunder,² the Secretary of the Treasury or his delegate (the Commissioner of the Internal Revenue Service) may prevent the shifting of gross income, deductions, credits or allowances between or among commonly controlled taxpayers by allocation of the improperly shifted items. The Commissioner's authority to allocate extends to any case in which, either by inadvertence or design, there has been a shifting or deflection of income from one controlled unit to another.³ However, the mere existence of the requisite common ownership or control is not sufficient to justify the Commissioner's application of section 482.⁴ Even if there has been the requisite shifting or deflection of income, the use of section 482 is entirely discretionary with the Commissioner.⁵ If the Commissioner decides to exercise his discretion and rely

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

INT. REV. CODE OF 1954, § 482 [hereinafter cited as § 482].

2. Treas. Reg. § 1.482-1(a)-(c) (1962); Treas. Reg. § 1.482-1(d) (1968); Treas. Reg. § 1.482-2(a), (b)(1)-(6), (b)(8), (c), (d) (1968); Treas. Reg. § 1.482-2(b)(7) (1969).

3. *Grenada Indus., Inc. v. Commissioner*, 17 T.C. 231, 254 (1951), *aff'd*, 202 F.2d 873 (5th Cir. 1953).

4. The purpose of section [482] is not to punish the mere existence of common control or ownership, but to assist in preventing distortion of income and evasion of taxes through the exercises of that control of ownership. *Id.*

5. *Cf. Interstate Fire Ins. Co. v. United States*, 215 F. Supp. 586 (E.D. Tenn. 1963), *aff'd per curiam*, 339 F.2d 603 (6th Cir. 1964) (The Commissioner was estopped to deny the

on section 482, he must notify the taxpayer of that reliance either in the notice of deficiency or in his answer in the tax court proceeding.⁶

In many instances, the Commissioner's allocation under section 482 may conflict with another provision of the Code. However, if the facts fall within the provisions of section 482, the allocation will stand.⁷ Therefore, the fact that a tax-free transfer may require a carryover basis⁸ does not bar the Commissioner from reallocating that basis among the controlled taxpayers.⁹ Even though the Commissioner's power to allocate deductions does not extend to the disallowance of a deduction,¹⁰ the allocation of a deduction from one controlled taxpayer to another can create a deduction in the taxpayer to whom it was allocated where none was previously allowed under the Code.¹¹

Prior to the adoption of Regulation 1.482-2, the courts had also held that the Commissioner could not create income where none existed.¹² Despite this attitude in the courts, the Commissioner has provided in a new regulation¹³ for imputed income in specific situations. However, the new regulation was accompanied by a provision for a corresponding deduction for the related party.¹⁴ Therefore, it is doubtful whether the prior case law will have a bearing on the validity of the new regulation, because income is shifted rather than created.

use of § 482 since the taxpayer had expended large sums in making an allocation under circumstances which justified the taxpayer in believing that the results of the allocation would be utilized in making a reassessment of taxes); § 482; Treas. Reg. § 1.482-1(b)(3) (1962).

6. Maxwell Hardware Co. v. Commissioner, 343 F.2d 713 (9th Cir. 1965); United States v. First Sec. Bank, 334 F.2d 120 (9th Cir. 1964); Commissioner v. Chelsea Prods., Inc., 197 F.2d 260 (3d Cir. 1952); Ross v. Commissioner, 129 F.2d 310 (5th Cir. 1942).

7. Rooney v. United States, 305 F.2d 681 (9th Cir. 1962); Tennessee Life Ins. Co. v. Phinney, 280 F.2d 8 (5th Cir. 1960), *aff'd*, 364 U.S. 914 (1960); National Secs. Corp. v. Commissioner, 137 F.2d 600 (3d Cir. 1943).

[Section 482] is directed to the correction of particular situations in which the strict application of the other provisions of the act will result in a distortion of the income of affiliated organizations. In every case in which the section is applied its application will necessarily result in an apparent conflict with the literal requirements of some other provision of the act. If this were not so Section [482] would be wholly superfluous. We accordingly conclude that the application of Section [482] may not be denied because it appears to run afoul of the literal provisions [of the Internal Revenue Code] if the Commissioner's action in allocating under the provisions of Section [482] . . . was a proper exercise of the discretion conferred upon him by the section. *Id.* at 602.

8. See INT. REV. CODE of 1954, § 351.

9. Rooney v. United States, 305 F.2d 681 (9th Cir. 1962); National Secs. Corp. v. Commissioner, 137 F.2d 600 (3d Cir. 1943).

10. Hawaiian Trust Co. v. United States, 291 F.2d 761 (9th Cir. 1961); Hypotheeg Land Co. v. Commissioner, 200 F.2d 390 (9th Cir. 1952).

11. Tennessee Life Ins. Co. v. Phinney, 280 F.2d 8 (5th Cir. 1960), *aff'd*, 364 U.S. 914 (1960).

12. Tennessee-Ark. Gravel Co. v. Commissioner, 112 F.2d 508 (6th Cir. 1940) (use of related corporation's equipment for no charge). *Cf.* Peacock v. Commissioner, 256 F.2d 160 (5th Cir. 1958) (use of personal residence owned by controlled corporation considered gift and not compensation for services).

13. Treas. Reg. § 1.482-2 (1968). See discussion in section III, DETERMINATION OF THE ARMS LENGTH STANDARD IN SPECIFIC SITUATIONS, p. 835 *infra*.

14. Treas. Reg. § 1.482-1(d)(2) (1968).

II. REQUIREMENTS FOR THE APPLICATION OF SECTION 482

A. *Two or more Organizations, Trades or Businesses.*

Section 482 requires the shifting of income or deductions among two or more organizations, trades, or businesses. By use of the terms organizations,¹⁵ trades, or businesses,¹⁶ this section is designed to cover any conceivable situation. Whether or not the organization, trade, or business is incorporated, affiliated, or organized in the United States has no bearing on the applicability of the section.¹⁷ Therefore, an individual dealing with a controlled corporation, partnership, or even with another individual is equally open to the application of section 482.¹⁸ However, under the literal terms of section 482, an individual could not be covered unless he was involved in a trade or business at the present time or was involved in a related trade or business in recent history.¹⁹ Any other entity would be an organization, as defined in Regulation 1.482-1(a)(1).²⁰

B. *Common Ownership or Control*

The organizations, trades, or businesses involved must be under or subject to common ownership or control. Although section 482 does provide that control may be either direct or indirect, it does not define control; however, the Regulations define control as being either direct or indirect, whether or not legally enforceable, and however exercisable or exercised. The form or modes of exercise which the control ultimately takes does not matter; rather, it is the reality of control which is decisive.²¹

The Regulations provide for a presumption of control if income or deductions have been arbitrarily shifted.²² The fact that the individual or entity has no ownership interest in another individual or entity does not bar a finding of control.²³

15. The term "organization" includes any organization of any kind, whether it be a sole proprietorship, a partnership, a trust, an estate, an association, or a corporation . . . irrespective of the place where organized, where operated, or where its trade or business is conducted, and regardless of whether domestic or foreign, whether exempt, whether affiliated, or whether a party to a consolidated return.

Treas. Reg. § 1.482-1(a)(1) (1962).

16. The term "trade" or "business" includes any trade or business activity of any kind, regardless of whether or where organized, whether owned individually or otherwise, and regardless of the place where carried on.

Treas. Reg. § 1.482-1(a)(2) (1962).

17. § 482.

18. *Ach v. Commissioner*, 358 F.2d 342 (6th Cir. 1966); Treas. Reg. § 1.482-1(a)(1), (2) (1962).

19. Treas. Reg. § 1.482-1 (1962).

20. See Note 15, *supra*.

21. Treas. Reg. § 1.482-1(a)(3) (1962).

22. *Hall v. Commissioner*, 294 F.2d 82 (5th Cir. 1961); Treas. Reg. § 1.482-1(a)(3) (1962).

23. *Charles Town, Inc. v. Commissioner*, 372 F.2d 415 (4th Cir. 1967); *Hall v. Commissioner*, 294 F.2d 82 (5th Cir. 1961). *Contra*, *John L. Denning & Co. v. Commissioner*, 180 F.2d 288 (10th Cir. 1950).

C. Tax Evasion or Unclear Reflection of Income

The final requirement for allocation under section 482 is that it must be necessary in order to prevent tax evasion or to clearly reflect the income of any of the organizations, trades, or businesses involved. However, the regulations have combined these two alternatives into a single standard of "true taxable income,"²⁴ which is basically the comparison of a controlled taxpayer with an uncontrolled taxpayer using an "arm's length standard."²⁵ Once the Commissioner has determined that an allocation is necessary, the taxpayer then has the burden of showing that the determination is arbitrary, unreasonable, and an abuse of the Commissioner's discretion.²⁶ However, the courts have had difficulty in determining when there has been such an abuse of discretion.

Independently of section 482, the courts have set certain standards for behavior. "[Taxes can] not be escaped by anticipatory arrangements and contracts however skillfully devised . . . by which the fruits are attributed to a different tree from that on which they grew."²⁷ However, "[t]he legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted."²⁸ On the other hand, "the Government may not be required to acquiesce in the taxpayer's election of that form for doing business which is most advantageous to him."²⁹ These existing standards have resulted in some belief that section 482 adds nothing to the existing weapons of the Internal Revenue Service.³⁰ However, the service has used section 482 and the "arm's length" standard as independent weapons with some success.

24. The term "true taxable income" means, in the case of a controlled taxpayer, the taxable income . . . which would have resulted to the controlled taxpayer, had it in the conduct of its affairs . . . dealt with the other member or members of the group at arm's length.

Treas. Reg. § 1.482-1(a)(6) (1962).

25. The purpose of section 482 is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer, by determining, according to the standard of an uncontrolled taxpayer, the true taxable income from the property and business of a controlled taxpayer The standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer.

Treas. Reg. § 1.482-1(b) 1 (1962).

26. *Ballentine Motor Co. v. Commissioner*, 321 F.2d 796, 800 (4th Cir. 1963) ("A determination as to whether or not the Commissioner has exceeded or abused his discretion turns upon a question of fact and is subject to limited review"); *Campbell County State Bank v. Commissioner*, 311 F.2d 374 (8th Cir. 1963); *Leedy-Glover Realty & Ins. Co. v. Commissioner*, 184 F.2d 833 (5th Cir. 1950); *G.U.R. Co. v. Commissioner*, 117 F.2d 187 (7th Cir. 1941); *Grenada Indus., Inc.*, 17 T.C. 231, 255, *aff'd*, 202 F.2d 873 (5th Cir. 1953).

It has been said many times that the Commissioner has considerable discretion in applying section (482), and that the determination required of him under the statutes must be sustained unless that discretion has been abused. Our review of those determinations is not de novo, and we may reverse them only where the taxpayer proves that they are unreasonable, arbitrary, or capricious. *Id.*

27. *Lucas v. Earl*, 281 U.S. 111, 115 (1930). See *National Carbide Corp. v. Commissioner*, 336 U.S. 422 (1949).

28. *Gregory v. Helvering*, 293 U.S. 465, 469 (1935).

29. *Higgins v. Smith*, 308 U.S. 473, 477 (1939).

30. J. CHOMMIE, *FEDERAL INCOME TAXATION* 496 (1968).

The most obvious abuse of the "arm's length" standard is the situation in which the separate controlled entity has no existence other than for tax purposes and therefore falls within the tax evasion provision of section 482.³¹ The Commissioner has had little difficulty in applying section 482 to such fraudulent, colorable, or sham transactions.³² However, if there is a sound business reason for the separation of functions, and if the entity maintains its separate existence³³ (maintenance of separate books and records, bank accounts, *etc.*³⁴), the Commissioner must resort to attacking the transactions between the entities as resulting in an unclear reflection of income.³⁵ However, even if the taxpayer shows that there existed a sound reason not primarily related to tax saving as the motivating force of the transaction, the Commissioner may still allocate to clearly reflect the income of either controlled entity.³⁶

If the transactions involve a shifting of income or deductions which is flagrant and arbitrary, the Commissioner normally has little difficulty with the use of section 482. The Commissioner has had the most success where income was shifted to a loss company for the obvious purpose of making use of a net operating loss.³⁷ However, most of these cases have

31. *J.R. Land Co. v. United States*, 361 F.2d 607 (4th Cir. 1966). The court rejected the taxpayer's arguments that the separate corporations were formed to (1) eliminate cost control problems, (2) simplify presentation of financial data, (3) limit liability and (4) allow for sale of part of the business. In *Advance Mach. Exch., Inc. v. Commissioner*, 196 F.2d 1006 (2d Cir. 1952), the court rejected the taxpayer's argument that allocation of all the income to one entity was an unauthorized consolidation of the entities.

32. In keeping with the decisions, it could be called a "sham," a "disguise," a "masquerade," a "fiction," a "subterfuge," a "make believe," a "mere pretense," a "mask," a "screen," a "veil," an "artifice," a "ruse," or other names, supplied by the dictionary, which indicate that it does not succeed as an insulator of the [taxpayer] from tax liability.

Sidney Kown v. United States, 187 F.2d 707, 708 (2d Cir. 1950) See also *Oppenheims, Inc. v. Kavanagh*, 90 F. Supp. 107 (E.D. Mich. 1950).

33. *Raymond Pearson Motor Co. v. Commissioner*, 246 F.2d 509 (5th Cir. 1957) (partnership had been in commercial paper business before auto dealership corporation formed); *Commissioner v. Chelsea Prods., Inc.*, 197 F.2d 260 (3d Cir. 1952) (sales corporation organized to increase sales and minimize tort liability, and had dealt at "arm's length" with each other); *Vardeman v. United States*, 209 F. Supp. 346 (E.D. Tex. 1962); *Loans and Serv., Inc. v. United States*, 193 F. Supp. 683 (N.D. Ohio 1961); *Idaho Livestock Auction, Inc. v. United States*, 187 F. Supp. 875 (D. Idaho 1960); *Epsen Lithographers, Inc. v. O'Malley*, 67 F. Supp. 181 (D. Neb. 1946) (partnership paid an arm's length and reasonable rental for use of the related corporation's property).

34. *Tillitson v. McCrory*, 202 F. Supp. 925 (D. Neb. 1962).

35. *Cf. W. Braun Co. v. Commissioner*, 396 F.2d 264 (2d Cir. 1968); § 482.

36. *Central Cuba Sugar Co. v. Commissioner*, 198 F.2d 214 (2d Cir. 1952).

37. *Charles Town, Inc. v. Commissioner*, 372 F.2d 415 (4th Cir. 1967) (profits of race meet allocated 90% to loss corporation); *Ach v. Commissioner*, 358 F.2d 342 (6th Cir. 1966) (profits of dress business offset by losses of dairy business); *Spicer Theatre, Inc. v. Commissioner*, 346 F.2d 704 (6th Cir. 1965) (lease of theatre to loss corporation); *Ballentine Motor Co. v. Commissioner*, 321 F.2d 796 (4th Cir. 1963) (transfer of used autos to loss corporation); *Aiken Drive-in Theatre Corp. v. United States*, 281 F.2d 7 (4th Cir. 1960) (purchase of valueless theatre from loss corporation at high price); *cf. Central Cuba Sugar Co. v. Commissioner*, 198 F.2d 214 (2d Cir. 1952) (Net operating loss of predecessor corporation allocated to successor corporation).

also involved additional factors which showed lack of business purpose for the shift in income.³⁸

The Commissioner has also been successful when the taxpayers admittedly allocated income or deductions but claimed a business purpose for the transaction,³⁹ or where the Code allowed such an allocation.⁴⁰ In these situations, the courts have held that a taxpayer will not be allowed to "reduce his income tax by transferring his money from one pocket to another even though he uses a different pair of trousers."⁴¹

The area most open for abuse and yet most difficult to control involves transfers of property and services among related taxpayers. Because of the inability of the courts to set standards of behavior in this area, the Commissioner has issued exhaustive regulations covering many of these transactions.⁴² These regulations are discussed in section III, below, but prior case law will be reviewed before proceeding to that discussion.

Where the taxpayer transferred uncompleted contracts to a controlled entity, the Commissioner has been successful in allocating a percentage of the income from those contracts to the taxpayer based upon the percentage of completion when transferred.⁴³ However, where the taxpayer transferred a risky account to a subsidiary, the court held that the subsidiary was entitled to some of the income for assuming the risks involved.⁴⁴ Whenever a transfer is for an "arm's length" price the Com-

38. *Charles Town, Inc. v. Commissioner*, 372 F.2d 415 (4th Cir. 1967) (taxpayer had performed substantial income producing activities, yet had paid out 90% of its income without filing a partnership return); *Ach v. Commissioner*, 358 F.2d 342 (6th Cir. 1966) (mother continued to run dress business after it had been transferred to corporation and received no compensation therefore); *Spicer Theatre, Inc. v. Commissioner*, 346 F.2d 704 (6th Cir. 1965) (lease arrangement calculated to use up net operating loss carry forward within two year period based on prior earning record of leased theatre); *Ballentine Motor Co. v. Commissioner*, 321 F.2d 796 (4th Cir. 1963) (original corporations took over auto business after transferee corporation exhausted net operating loss carry forward); *Aiken Drive-in Theatre Corp. v. United States*, 281 F.2d 7 (4th Cir. 1960) (theatre abandoned shortly after purchased from loss corporation).

39. *National Carbide Corp. v. Commissioner*, 336 U.S. 422 (1949) (all profits in excess of 6% of outstanding capital stock of subsidiary paid to parent); *G.U.R., Co. v. Commissioner*, 117 F.2d 187 (7th Cir. 1941) (taxpayer bought stock from related corporation at its cost so related corporation would not have to show large loss on financial statements); *Birmingham Ice & Cold Storage Corp. v. Davis*, 112 F.2d 453 (5th Cir. 1940) (payment of percentage of income to another corporation as compensation for not operating).

40. *Rooney v. United States*, 305 F.2d 681 (9th Cir. 1962) (income of crop transferred to corporation under INT. REV. CODE of 1954, § 351, while expenses involved therewith remained on the taxpayer's tax return); *National Sec. Corp. v. Commissioner*, 137 F.2d 600 (3d Cir. 1943) (loss on stock transferred to subsidiary using above section).

41. *Alpha Tank & Sheet Mfg. Co. v. United States*, 116 F. Supp. 721, 723 (Ct. Cl. 1953) ("A man with a half-dozen pockets might almost escape liability altogether.").

42. Treas. Reg. § 1.482-2 (1968).

43. *Dillard-Waltemire, Inc. v. Campbell*, 255 F.2d 433 (5th Cir. 1958) (contracts 65% complete when transferred); *Jud Plumbing & Heating, Inc. v. Commissioner*, 153 F.2d 681 (5th Cir. 1946) (income allocated on basis of percentage of total cost expended by each entity).

44. *W. Braun Co. v. Commissioner*, 396 F.2d 264 (2d Cir. 1968).

missioner cannot allocate any of the income to the transferor.⁴⁵ The Commissioner has also required an allocation of the overhead expenses between commonly controlled taxpayers who shared the same premises.⁴⁶ If the Commissioner's allocations were based on a reasonable method of allocation, the courts have upheld him;⁴⁷ however, if there exists a wide diversity in the cost of operations of the related taxpayers and if a large portion of the deductible expenditures are not common to the related taxpayers, an allocation based upon gross income is arbitrary and leads to an unreasonable result.⁴⁸ Along the same lines, rental agreements between commonly controlled taxpayers have been successfully attacked on the basis that the rental charged was not equal to the fair rental value of the property.⁴⁹

An area of concern to the Commissioner has been the pricing of products between domestic corporations and their foreign subsidiaries. If the pricing arrangements can shift income to the foreign subsidiary, that income will escape tax altogether. Therefore, whenever the pricing arrangements allow the subsidiary to purchase at a lower mark-up⁵⁰ or to receive excessive commissions or discounts⁵¹ than would be the result of "arm's length" bargaining, the Commissioner has prevailed in allocating income to the domestic parent. The fact that there was a sound business purpose for the pricing methods used did not bar the Commissioner's allocation.⁵²

On the other hand, where the Commissioner failed to show that the domestic corporation used a different pricing method when dealing with its foreign subsidiary, the ninth circuit allowed a six percent mark-up to stand as a reasonable return to the domestic corporation.⁵³ It is doubtful that the Commissioner will fall into that trap again in allocating under section 482.

45. *Davis v. United States*, 282 F.2d 623 (10th Cir. 1960).

46. *Campbell County State Bank v. Commissioner*, 311 F.2d 374 (8th Cir. 1963) (insurance company using bank premises); *Peacock v. Commissioner*, 256 F.2d 610 (5th Cir. 1958); *Oklahoma Transp. Co. v. United States*, 272 F. Supp. 729 (W.D. Okla. 1966); *Bank of Kimball v. United States*, 200 F. Supp. 638 (S.D. S.D. 1962) (insurance company using bank premises).

47. *Peacock v. Commissioner*, 256 F.2d 160 (5th Cir. 1958) (allocation based on total properties owned).

48. *Campbell County State Bank v. Commissioner*, 311 F.2d 374 (8th Cir. 1963) (case sent back to tax court for reallocation on more reasonable basis); *Oklahoma Transp. Co. v. United States*, 272 F. Supp. 729 (W.D. Okla. 1966) (allocation should have been based on bus mileage run by each entity); *Bank of Kimball v. United States*, 200 F. Supp. 638 (S.D. S.D. 1962) (court allocated as best it could on the evidence shown).

49. *Baldwin Bros., Inc. v. Commissioner*, 361 F.2d 668 (3d Cir. 1966) (an uncontrolled taxpayer would not have accepted a lease so burdened with the prospect of loss); *South Tex. Rice Warehouse v. Commissioner*, 366 F.2d 890 (5th Cir. 1966); *Alpha Tank & Sheet Metal Mfg. Co. v. United States*, 116 F. Supp. 721 (Ct. Cl. 1953) (total rentals paid reallocated to income of lessee corporation).

50. *Asiatic Petroleum Co. v. Commissioner*, 79 F.2d 234 (2d Cir. 1935); *Eli Lilly & Co. v. United States*, 372 F.2d 990 (Ct. Cl. 1967).

51. *Oil Base, Inc. v. Commissioner*, 362 F.2d 212 (9th Cir. 1966).

52. *Eli Lilly & Co. v. United States*, 371 F.2d 990 (Ct. Cl. 1967).

53. *Frank v. International Canadian Corp.*, 308 F.2d 520 (9th Cir. 1962).

Whenever the Commissioner has succeeded in showing that a transaction is not "arm's length," the courts have approved a standard of fair market value;⁵⁴ however, the new regulations allow a different standard under certain circumstances.⁵⁵

III. DETERMINATION OF THE ARM'S LENGTH STANDARD IN SPECIFIC SITUATIONS

A. *Loans or Advances*

Because of the difficulty the courts have had in determining an "arm's length" standard, the Commissioner has issued regulations which set guidelines in specific situations.⁵⁶ The first of these situations involves an "arm's length" interest rate where there are loans or advances between related taxpayers.⁵⁷ If the creditor is regularly engaged in the business of making loans, the rate to be charged "shall be the rate . . . which was charged, or would have been charged at the time the indebtedness arose, in independent transactions with or between unrelated parties under similar circumstances."⁵⁸ If the creditor is not regularly engaged in the business, an "arm's length" rate shall be five percent, but if the actual rate charged is between four percent and six percent, no adjustment will be made. However, if the loan represents the proceeds of a loan obtained by the lender at the situs of the borrower, the "arm's length" rate shall be the rate paid by the lender plus any expenses involved in obtaining the loan. In either of these two situations, the lender may establish that the rate a person in the business of making loans would charge would be a better reflection of an "arm's length" rate.⁵⁹ The Regulation does not apply to normal accounts receivable unless they are outstanding for longer than six months or the normal period in the industry if that period is longer than six months.⁶⁰

B. *Performance of Services for Another*

Of all the regulations covering specific situations, those relating to what one controlled taxpayer should charge another when it performs services for the other are the longest and most involved.⁶¹ Therefore, it is important to know when allocations or charges must be made for services rendered. If a service is merely a duplication of a service which the re-

54. *National Sec. Corp. v. Commissioner*, 137 F.2d 600 (3d Cir. 1943); *G.U.R. Co. v. Commissioner*, 117 F.2d 187 (7th Cir. 1941).

55. *Treas. Reg.* § 1.482-2 (1968).

56. *Treas. Reg.* § 1.482-2 (1968).

57. *Treas. Reg.* § 1.482-2(a) (1968).

58. *Treas. Reg.* § 1.482-2(a)(2) (1968).

All relevant factors will be considered, including the amount and duration of the loan, the security involved, the credit standing of the borrower, and the interest rate prevailing at the situs of the lender or creditor for comparable loans.

59. *Treas. Reg.* § 1.482-2(a)(2) (1968).

60. *Treas. Reg.* § 1.482-2(a)(3) (1968).

61. *Treas. Reg.* § 1.482-2(b) (1968).

lated party has independently performed or is performing for itself, an allocation need not be made,⁶² but if services are undertaken for the joint benefit of a group of controlled entities or by one controlled entity for the exclusive benefit of another controlled entity, an allocation or charge must be made.⁶³ However, if the services rendered are merely ancillary or subsidiary to a transfer of property from one related entity to another, the charge for the services is to be part of the charge involved in the transfer of the property.⁶⁴

Once it has been determined that a charge must be made, the determination of what charge will be considered "arm's length" depends on whether the services are an integral part of the business of either the recipient or the party rendering the services.⁶⁵ Services are considered an integral part of the business activity of a member of a controlled group in any one of four specific fact situations.⁶⁶

First, if either the renderer or the recipient of the services is engaged in the trade or business of rendering similar services to unrelated parties, the services will be considered to be an integral part of the business activity.⁶⁷

Second, if the renderer of the services has as one of its principal activities the rendition of services to one or more related parties, the services will also be considered an integral part of the business activity.⁶⁸ Whether the rendering of services in a particular situation is a principal activity is determined by the facts and circumstances of each particular case.⁶⁹ However, if the services do not constitute a manufacturing, production, extraction or construction activity,⁷⁰ they will not be considered a principal activity if in any taxable year the cost of rendering all such services does not exceed twenty-five percent of the operating expenses⁷¹ of the renderer.⁷²

Third, services are to be considered an integral part of the business

62. Treas. Reg. § 1.482-2(b)(2)(ii) (1968). "[T]he ability to independently perform the service (in terms of qualification and availability of personnel) shall be taken into account."

63. Treas. Reg. § 1.482-2(b)(2)(i) (1968).

64. Treas. Reg. § 1.482-2(b)(8) (1968).

65. Treas. Reg. § 1.482-2(b)(3) (1968).

66. Treas. Reg. § 1.482-2(b)(7) (1969).

67. Treas. Reg. § 1.482-2(b)(7)(i) (1969).

68. Treas. Reg. § 1.482-2(b)(7)(ii)(a) (1969).

69. Such facts and circumstances may include the time devoted to the rendition of the services, the relative cost of the services, the regularity with which the services are rendered, the amount of capital investment, the risk of loss involved, and whether the services are in the nature of supporting services or independent of the other activities of the renderer. *Id.*

70. Services which are essentially supporting in nature are not considered as constituting a manufacturing, production, extraction or construction activity. *See* Treas. Reg. § 1.482-2(b)(7)(v), example (8) (1969).

71. Operating expenses do not include any "amounts properly reflected in the cost of goods sold of the renderer." Treas. Reg. § 1.482-2(b)(7)(ii)(b) (1969).

72. Treas. Reg. § 1.482-2(b)(7)(ii) (1969). For the possibility of combining the operating expenses of members of a controlled group who file consolidated returns, *see* Treas. Reg. § 1.482-2(b)(7)(ii)(c) (1969).

activity of the renderer when "the renderer is peculiarly capable of rendering the services and such services are a principal element⁷³ in the operations of the recipient of the services."⁷⁴ To be "peculiarly capable" of rendering such services (1) the value of the services must be substantially in excess of the costs involved and (2) the renderer must make use of a particularly advantageous situation or circumstance such as special skills, reputation or relationships with customers, or utilization of its intangible property.⁷⁵

The fourth and final fact situation is "where the recipient has received the benefit of a substantial amount of services from one or more related parties during its taxable year."⁷⁶ An entity is considered as having received a substantial amount of services only if the costs to the renderers for all such services received exceed twenty-five percent of the recipient's operating expenses.⁷⁷

If the services are determined to be an integral part of the business activity of either the renderer or the recipient of the services, the charge therefor "shall be the amount which was charged or would have been charged for the same or similar services in independent transactions with or between unrelated parties"⁷⁸ However, if the services are not considered an integral part, the charge shall be equal to the costs involved in rendering such services.⁷⁹ The costs to be included in the "arm's length" charge shall be all direct costs plus any related indirect costs.⁸⁰ Both the direct and the indirect costs are to be calculated on the basis of the total costs of the department or departments involved, as opposed to the incremental cost of rendering the particular service.⁸¹ If the related parties already have existing methods for allocation of costs within a

73. The element should be other than supporting in nature. Treas. Reg. § 1.482-2(b)(7)(v) example (14) (1969).

74. Treas. Reg. § 1.482-2(b)(7)(iii) (1969).

75. *Id.* Intangible property is defined as:

(a) Patents, inventions, formulas, processes, designs, patterns, and other similar items;

(b) Copyrights, literary, musical, or artistic compositions, and other similar items;

(c) Trademarks, trade names, brand names, and other similar items;

(d) Franchises, licenses, contracts, and other similar items;

(e) Methods, programs, systems, procedures, campaigns, surveys, studies, forecasts estimates, customer lists, technical data, and other similar items.

Treas. Reg. § 1.482-2(d)(3) (1968).

76. Treas. Reg. § 1.482-2(b)(7)(iv) (1969).

77. *Id.* For purposes of applying the 25% test, the operating expenses of the recipient are adjusted to include the costs to the renderers of all such services and to exclude any amounts paid by the recipient for such services.

78. Treas. Reg. 1.482-2(b)(3) (1968).

79. *Id.* If the Taxpayer establishes that a more appropriate charge would be that charge if the services were considered an integral part of the business activity, he may calculate the charge upon that basis.

80. Treas. Reg. § 1.482-2(b)(4) (1968).

Indirect costs do not include (1) unrelated interest expense, (2) expenses of capital stock transactions and (3) unrelated expenses of compliance with government regulations. Treas. Reg. § 1.482-2(b)(5) (1968).

81. Treas. Reg. § 1.482-2(b)(4) (1968).

department or among departments, the Commissioner must allow them to be applied if they have a reasonable basis.⁸²

C. Use of Tangible Property

If one member of a controlled group transfers tangible property other than by sale to another member of a controlled group, an "arm's length" charge must be made for the use of the property.⁸³ If either the lessor or lessee of the property is engaged in the trade or business of renting the same general type of property, the "arm's length" charge must equal the amount of rent that would have been charged if unrelated parties had been dealing at "arm's length."⁸⁴ If neither the lessor nor the lessee is engaged in the rental business, a proper "arm's length" charge is based upon who owns the property.⁸⁵ Therefore, if the lessor does not own the property but rents it from someone else, the "arm's length" charge shall be equal to the deductions claimed by the lessor in connection with the property transferred.⁸⁶ This charge will normally be equal to the rent paid by the lessor. However, if the lessor owns the property transferred, the "arm's length" charge shall be equal to all direct and indirect expenses incurred by the lessor in connection with the property or its possession, use, or occupancy by the lessee. This cost must also be increased by (1) the depreciation expense for the property calculated on a straight line basis and (2) three percent of the cost of the property.⁸⁷ This formula is calculated in order to allow the lessor to recover all his costs in connection with the property and also receive a small (three percent) return on his investment in the property. Whenever the transfer is for less than an entire year or for less than all the property, the charge under any of the above methods must be ratably reduced to reflect such reduced use by the lessee.⁸⁸

D. Transfer or Use of Intangible Property

When one member of a controlled group transfers to or allows another member to use intangible property,⁸⁹ an "arm's length" charge

82. Treas. Reg. § 1.482-2(b)(6) (1968).

83. Treas. Reg. § 1.482-2(c)(1) (1968).

84. *Id.*

85. If the taxpayer established that a more appropriate charge would be that charge if either the lessor or lessee were in the renting business, he may calculate the charge on that basis. *Id.*

86. Treas. Reg. § 1.482-2(c)(2)iii (1968).

87. Treas. Reg. § 1.482-2(c)(2)(ii) (1968).

88. Treas. Reg. § 1.482-2(c)(2) (1968).

89. Intangible property is defined as:

(a) Patents, inventions, formulas, processes, designs, patterns, and other similar items;

(b) Copyrights, literary, musical, or artistic compositions, and other similar items;

(c) Trademarks, trade names, brand names, and other similar items;

(d) Franchises, licenses, contracts, and other similar items;

(e) Methods, programs, systems, procedures, campaigns, surveys, studies, fore-

shall be made for such transfer.⁹⁰ However, no charge is to be made until the developer⁹¹ of the intangible property makes the property available to another member of the controlled group.⁹² The charge must (1) be in a form which would be used by unrelated parties and (2) be an amount which an unrelated party would have paid for the same intangible property under the same circumstances.⁹³ If sufficiently similar transactions involving an unrelated party cannot be found upon which to base the charge, the regulations list twelve factors to be considered in arriving at an "arm's length" charge.⁹⁴ These factors are basically the same factors any businessman would consider in setting a price for an unrelated purchaser or user. An exception to the application of the above rules is when there is a bona fide cost-sharing agreement in existence with respect to the development of the intangible property concerned. In this situation no charge must be made. However, to be considered bona fide, the agreement must be in writing and must reflect a good faith effort by the related parties to "bear their respective shares of all the costs and risks of development on an 'arm's length' basis."⁹⁵

E. Sales of Tangible Property

The last, but probably the most important, area of transactions between commonly controlled entities is the sales of tangible property between them. An "arm's length" price is considered to be "the price that an unrelated party would have paid under the same circumstances for the property involved Since unrelated parties normally sell products at a profit, an 'arm's length' price normally involves a profit to the seller."⁹⁶ The Regulations list three methods of arriving at the correct selling price. These three methods are referred to in descending order of preference and reliability as: (1) the comparable uncontrolled price method, (2) the resale price method, and (3) the cost plus method.⁹⁷ If

casts, estimates, customer lists, technical data, and other similar items.

Treas. Reg. § 1.482-2(d)(3) (1968).

90. Treas. Reg. § 1.482-2(d)(3) (1968).

91. The determination as to which member of a group of related entities is a developer and which members of the group are rendering assistance to the developer in connection with its development activities shall be based upon all the facts and circumstances of the individual case.

Treas. Reg. § 1.482-2(c)(1)(ii)(c) (1968).

92. Treas. Reg. § 1.482-2(d)(1)(ii)(a) (1968).

93. Treas. Reg. § 1.482-2(d)(2)(i) (1968).

To the extent appropriate, an arm's length consideration may take any one or more of the following forms:

(a) royalties based on the transferee's output, sales, profits, or any other measure; (b) lump-sum payments; or (c) any other form, including reciprocal licensing rights, which might reasonably have been adopted by unrelated parties under the circumstances, provided that the parties can establish that such form was adopted pursuant to an arrangement which in fact existed between them. *Id.*

94. Treas. Reg. § 1.482-2(d)(2)(iii) (1968).

95. Treas. Reg. § 1.482-2(d)(4) (1968).

96. Treas. Reg. § 1.482-2(e)(1)(i) (1968).

97. Treas. Reg. § 1.482-2(e)(1)(ii) (1968).

the standards for applying one of the above methods of pricing are met, that method must be applied unless the taxpayer can establish a more appropriate method.⁹⁸

The "comparable uncontrolled price method" is the most desirable since it is based on the price paid in comparable uncontrolled sales (sales to, from, or between unrelated parties).⁹⁹ If there are differences in circumstances between the controlled sale involved and the uncontrolled sales which are being used to establish the "arm's length" price, adjustments may be made to reflect such differences.¹⁰⁰ One very important adjustment which the Regulation allows is an adjustment to allow the seller to lower the selling price in order to establish or maintain a market for his products.¹⁰¹ However, a taxpayer should be very careful when trying to establish this reasoning as a basis to lower the sales price to a related party. He must accumulate sufficient evidence to overcome the appearance of evil.

If there are insufficient comparable uncontrolled sales from which to determine an "arm's length" selling price, the "resale price method" is considered the next most preferable. It must be used if:

- (a) There are no comparable uncontrolled sales
- (b) An applicable resale price . . . is available with respect to resales made within a reasonable time before or after the time of the controlled sale.
- (c) The buyer (reseller) has not added more than an insubstantial amount to the value of the property by physically altering the product before resale. . . .
- (d) The buyer (reseller) has not added more than an insubstantial amount to the value of the property by the use of intangible property.¹⁰²

Since the "cost plus method" is the most difficult to apply, the resale price method may be used even if the above criteria are not met, but only if such method is more feasible and more likely to result in an "arm's length" price.¹⁰³

The calculation of the price under the resale price method requires a determination of an "applicable resale price" which is then reduced by the "appropriate mark-up percentage."¹⁰⁴ The applicable resale price

98. Treas. Reg. § 1.482-2(e)(2)(i) (1968).

99. Treas. Reg. § 1.482-2(e)(2)(ii) (1968).

100. Treas. Reg. § 1.482-2(e)(2)(ii) (1968).

Some of the differences which may affect the price of property are differences in the quality of the product, terms of sale, intangible property associated with the sale, time of sale, and the level of the market and the geographic market in which the sale takes place. *Id.*

101. Treas. Reg. § 1.482-2(e)(2)(iv) (1968).

102. Treas. Reg. § 1.482-2(e)(3)(ii) (1968).

103. Treas. Reg. § 1.482-2(e)(3)(iii) (1968).

In general, the resale price method is more appropriate when the functions performed by the seller are more extensive and more difficult to evaluate than the functions performed by the buyer (reseller). *Id.*

104. Treas. Reg. § 1.482-2(e)(3) (1968).

is normally equal to either (1) the price at which the particular item of property is resold or (2) the price at which current resales of the same general type of property are being made.¹⁰⁵ The determination of the applicable resale price will normally be simple, but the determination of the appropriate mark-up percentage will be a chore. Ideally, the percentage should be based upon the buyer's normal gross profit percentage in uncontrolled purchases and resales most similar to the one involved. However, if that percentage is not available, the gross profit percentage of other members of the same market will be used.¹⁰⁶ In determining the applicable gross profit percentage, the same factors and costs must be used in order to maintain a comparable basis.¹⁰⁷ Once the appropriate percentage has been obtained, it may be adjusted to reflect differences in functions or circumstances which have a definite and reasonably ascertainable effect on the price of the particular item being sold.¹⁰⁸

The least preferable and most difficult method to apply is the "cost plus method." The calculation of the "arm's length" price under this method requires a determination of the cost of producing the particular property. This cost is then increased by the normal mark-up on cost.¹⁰⁹ The cost of production must be calculated using the same factors and costs as are used in calculating the cost of all property produced in order to maintain a comparable basis.¹¹⁰ The normal mark-up on cost should be determined the same as under the "resale price method" with the same adjustments for any differences which have a definite and reasonably ascertainable effect on price.¹¹¹ If the products which are the subject of the controlled sale are purchased instead of produced, the same methods must be applied, but it is obvious that their application will be simplified.

IV. PROCEDURE UPON ALLOCATION

Once the Commissioner has determined that an allocation is necessary under section 482, he must make correlative adjustments to all members of the group involved in the allocation.¹¹² However, before making an allocation, the Commissioner must consider any existing ar-

105. Treas. Reg. § 1.482-2(e)(3)(iv) (1968).

106. Treas. Reg. § 1.482-2(e)(3)(vii) (1968).

107. Treas. Reg. § 1.482-2(e)(3)(viii) (1968).

108. Treas. Reg. § 1.482-2(e)(3)(ix) (1968).

109. Treas. Reg. § 1.482-2(e)(4)(i) (1968).

110. Treas. Reg. § 1.482-2(e)(4)(ii) (1968).

111. Treas. Reg. § 1.482-2(e)(4)(iii)-(iv) (1968).

112. Treas. Reg. § 1.482-1(d)(2) (1968). The adjustment need not be made until the earliest of the following events:

(i) The date of assessment of the tax following execution by the taxpayer of a Form 870 (Waiver of Restrictions on Assessment and Collection of Deficiency in Tax and Acceptance of Overassessment) with respect to such adjustment,

(ii) Acceptance of a Form 870-AD (offer of Waiver of Restriction on Assessment and Collection of Deficiency in Tax and Acceptance of Overassessment),

(iii) Payment of the deficiency,

(iv) Stipulation in the Tax Court of the United States, or

(v) Final determination of tax liability by offer-in-compromise, closing agreement, or court action. *Id.*

rangements for reimbursement of the allocated items within a reasonable time.¹¹³ He must also consider any set-offs the other party to the reallocation may have due to other non arm's length transactions, but the taxpayer is required to notify the Commissioner of any such proposed set-offs within thirty days from transmittal of the audit report to the taxpayer.¹¹⁴ In any case in which restrictions imposed under the laws of any foreign country prevent or would have prevented the payment or reimbursement involved on an "arm's length" basis, the taxpayer may defer the item of income or deduction until it would be reportable under a deferral method of accounting.¹¹⁵ If the taxpayer does not have an appropriate method of accounting under which he can defer the items, he may elect such an accounting method as to those items.¹¹⁶ However, the election may not occur after the earliest of the following events:

(i) Execution by the taxpayer of Form 870 (Waiver of Restrictions on Assessment and Collection of Deficiency in Tax and Acceptance of Overassessment);

(ii) Expiration of the period ending 30 days after the date of a letter by which the [Commissioner] transmits an examination report notifying the taxpayer of proposed adjustments reflecting such adjustments . . . ; or

(iii) Execution of a closing agreement or offer-in-compromise.¹¹⁷

V. CONCLUSION

Due to the inability of the courts to set guidelines for behavior under the "arm's length" standard, the Commissioner has set standards of behavior in five specific fact situations: (1) intercompany loans or advances; (2) intercompany performance of services; (3) intercompany use of tangible property; (4) intercompany transfer or use of intangible property; and (5) intercompany sales of tangible property. It is difficult to conceive of any intercompany transactions which would not fall into one of the above five classifications. Therefore, any prior case law is of very limited value. However, because of the complexity of the new regulations, it is doubtful that the Commissioner will enforce them to their fullest extent, and it is certain that minor allocations will not be made. In any event, any related taxpayers who fail to conform their intercompany transactions to the new regulations will, in the author's opinion, be acting very foolishly.

113. Treas. Reg. § 1.482-1(d)(3) (1968).

114. *Id.*

115. Treas. Reg. § 1.482-1(d)(6) (1968).

116. *Id.*

117. *Id.*