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# Tax Committee Comments and Recommendations, No. 20: Comments on Proposed Regulations Under Section 482 of the Internal Revenue Code Regarding Allocation of Income and Deductions Among Taxpayers, Submitted to the IRS - September 17, 1965

American Institute of Certified Public Accountants. Committee on Federal Taxation

No. 20

# TAX COMMITTEE COMMENTS AND RECOMMENDATIONS

## Comments on Proposed Regulations Under Section 482 of the Internal Revenue Code Regarding Allocation of Income and Deductions Among Taxpayers

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COMMITTEE ON FEDERAL TAXATION

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AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

# Comments on Proposed Regulations Under Section 482 of the Internal Revenue Code Regarding Allocation of Income and Deductions Among Taxpayers

## General Comments

I.

The following statement in Regulations Section 1.482-1(b)(1) is intended to apply to all of the provisions contained and to be contained in Sections 1.482-1 and 1.482-2 of the Regulations:

> "The standard to be applied to every case is that of an uncontrolled taxpayer dealing at arms-length with another uncontrolled taxpayer."

While this standard is appropriate, it should be applied properly so that related taxpayers are not placed in a disadvantageous position in relation to unrelated taxpayers. In part, the proposed regulations appear to do just that.

Many of the paragraphs and subparagraphs are so written that a reader may well be led to believe that total costs incurred partly or wholly for the benefit of another controlled taxpayer must always be allocated, even though the result would be a charge to the controlled taxpayer greater than prevailing in the market place. When expenses are incurred wholly or partly for the benefit of another controlled taxpayer, or when another controlled taxpayer is allowed to use facilities, the resulting charge to the controlled taxpayer should not be more than a nonaffiliated company would have been willing to pay.

If an electronic computer is rented by a parent company from the manufacturer, and if that parent company then permits a subsidiary to use the computer for one hour a day because there is idle time available, the charge to the subsidiary should be no more than the subsidiary would have had to pay to an unrelated person taking into consideration the place and time of the availability of this computer. If the normal working hours of the office in which the computer is located are 40 hours per week and the parent company uses the computer 20 hours a week and its subsidiary 5 hours a week, it would usually not be appropriate to charge the subsidiary 5/25th of the total expenses incurred by the parent company pertaining

to the rental of the computer. Usually that parent company will have rented the computer even though there will initially be a large amount of idle time because it believes that within the foreseeable future it will be able to utilize that idle time. In the interim the cost of such idle time economically is that of the parent company.

It is a rather common practice here in the United States for a manufacturer of heavy equipment to service and assist, without any specific charge, the customer of a distributor who purchases the equipment. The cost incurred is taken into account in fixing the selling price to the distributor. In such an instance, there is no justification for any allocation of such costs from the parent company to the distributor where the distributor is a controlled foreign subsidiary.

II.

It is noted that the proposed regulations have adopted the "total cost" theory for the purposes of making allocations. The incremental theory is specifically denied. The creation of an imputed selling price of goods to a controlled foreign subsidiary based upon a total cost allocation in many instances will result in setting up a purchase price for the subsidiary greater than such subsidiary would have had to pay for similar goods, and in many instances a purchase price greater than the subsidiary can in turn resell the goods for. Here in the United States manufacturers will frequently sell one or two of their products at less than total cost in order to round out a product line. Frequently the manufacturer of a brand name item will sell that same product under a private label to a large merchandising company at less than total cost, but more than incremental cost. In other words, the manufacturer in setting the price of the private label product will take into account the fact that all of his indirect costs have already been absorbed by the production of a brand name product and will than take into account only additional direct costs of labor and material.

III.

We wish to urge strongly that favorable consideration be given to extending the applicability of Revenue Procedure 64-54, CB 1964-2, 1008, to taxable years before the promulgation of regulations under Section 482. While it is true that taxpayers may have been aware of a changed attitude on the part of the Service reflected not only in a more stringent administrative approach but in the provisions of the 1962 Revenue Act as well, until the promulgation of regulations under Section 482 taxpayers will have a complete lack of clear guidance as to the principles of allocation which will be accepted by the Service as reasonable. In the circumstances, and in the absence of cases involving fraud, it would appear desirable in the interest of administrative fairness and equity to allow the foreign tax off-set and other provisions of Revenue Procedure 64-54 to be applied to years after 1962 where taxpayers can demonstrate a reasonable effort after the promulgation of the Section 482 regulations to conform to the principles of these regulations.

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Under Section 482 of the Internal Revenue Code
Regarding Allocation of Income and Deductions Among Taxpayers

Specific Comments



Section

1.482-1(d)(4)

This provision would authorize the Service to "distribute, apportion, or allocate income, deductions, credits, or allowances to reflect the true taxable income of the individual members (of a group of controlled taxpayers) under the standards set forth in this Section and in Section 1.482-2 notwithstanding the fact that the ultimate income anticipated from a series of transactions may not be realized or is realized during a later period."

Such concepts directly conflict with the statute and numerous court cases, including a number of acquiesced cases. Section 482 clearly requires an allocation of actual gross income, deductions, etc., of the related entities. The courts have consistently held that the Service cannot charge income to one group member if, in fact, no income exists. (See, e.g., Tennessee-Arkansas Gravel Co. v. Comm., 112 F. (2d) 508 (6 Cir.1940), rev'g B.T.A. Memo Op., Docket 86061 (1938); Smith-Bridgeman & Co., 16 T.C. 287, acq. C.B. 1951-1,3; Texsun Supply Corp., 17 T.C. 433, acq. C.B. 1952-1,4; Chicago & Northwestern Railway Co., 29 T.C. 989.)

With respect to the time when the adjustment is to be reflected in the income of the member whose income is to be increased, the two examples given similarly conflict with the underlying concept that items of gross income, deductions etc., actually realized or incurred are to be allocated. It appears that the Service has

taken this view in at least one case, Dillard-Waltermire, Inc. v. Campbell, 255 F.(2d) 433 (CA-5, 1958).

In Dillar-Waltermire, a corporation transferred partially completed drilling contracts to a related partnership. Income from the contracts was reported on the completed contract basis. The transfer to the partnership occurred at a time when contracts were about 65% completed. The court held that when the contracts were completed (the Service did not require accrual at the time of the transfer), the Service properly allocated 65% thereof to the corporation.

In light of the statutory provisions and case law, there should also be deleted the statement that "The provisions of this subparagraph apply even if the gross income contemplated from a series of transactions is never, in fact, realized by the other members."



1.482-1(d)(5) It is not clear how a taxpayer may adopt the "deferred income" method. It seems that the terminology used in this connection is similar in many respects to that of Mim.6475, C.B. 1950-1, 50. However, Mim. 6475 permits a taxpayer to elect or adopt the deferral treatment and contains no requirement that consent be obtained. If the provisions of Section 446(e) and the related regulations are applicable, reference thereto would seem appropriate. However, for reasons indicated below, special provision should be made in Section 482 situations to permit retroactive election of the deferred income method. Alternatively, all taxpayers should be allowed a specified period after issuance of these regulations in final form to apply for permission to adopt that method for all open years.

Failure to permit retroactive election would otherwise restrict unreasonably the availability of the "deferred income" method. Assuming that a Section 482 adjustment is warranted, when tested against the "uncontrolled taxpayer"

standard of Regulation Section 1.482-1(b), it is not appropriate to require income recognition in the controlled group situation, in a year in which it might well not have been taken up in a situation involving uncontrolled taxpayers, merely because the controlled group member has not received permission to adopt the "deferred income" treatment. In this connection it is important to note there was authority prior to the issuance of Mim. 6475 for taxpayers to exclude from gross income any amounts of blocked income. (International Mortgage & Investment Corp. 36 B.T.A. 187, acq. C.B. 1937-2, 15; Foundation Co., 14 T.C. 1333, acq. C.B.1950-2,2; United Artists Corp. of Japan, 3 T.C.M 574) Mim 6475 does not overrule the authority of these cases, and taxpayers have in practice been permitted to defer such income despite failure to elect under Mim. 6475.

3.

1.482-2(b)(1) and(3)

In order to maintain the "tax parity with an uncontrolled taxpayer" concept, it should be made clear that the "costs" and "deductions" referred to are those shown in the financial and operating records, not those computed for tax purposes.

4.

1.482-2(b)(5)

Reconsideration should be given to the incremental cost basis. The flat rejection of this basis in the regulations does not accord with sound business practice. The incremental approach has long been approved by the Service, in at least two areas: namely, travel and entertainment and medical expenses. (See, e.g., Rev.Rul. 56-168 C.B. 1956-1, 93, especially example (3) thereof, and Riach v. Frank, 302 F.(2d) 374 (CA-9, 1962.)

With respect to the very example in this section regarding rental of electronic data processing equipment, it is well known that the incremental approach is used by lessees of such equipment in determining rentals to unrelated sublessees who use the equipment for periods when the lessee does not require it and when it would otherwise be idle. A sublessee often secures quite favorable terms for renting

in the "off-peak" periods because the lessee has incurred a rental which is fixed irrespective (within limits) of the time the equipment is operated. Related interests certainly need not enter into arrangements any less favorable to the lessee.

5.

1.482-2(b)(6) The application of this provision is unclear It would appear to allow discretion to the District Director to use, in the five cases described, the higher of the amounts under this subparagraph or subparagraph (1). Apparently, the basis need not be consistent from year to year with respect to transactions of a member with another group member, or with respect to all transactions in a year which a group member has with all other group members. It is not apparent why such wide discretion should be available to the District Director.

6.

1.482-2(c) The formula set forth in subdivision (iii) applies annually and gives no recognition to the fact that in practice leases are frequently made for long periods of time. In any one period the charge may be substantially different (greater or less) than the amount computed under subdivision (iii). In one period, the rent may be greater than the amount so computed, and no adjustment under the proposed regulations would be necessary. In the next period, however, the rent might be less and an adjustment made, despite the fact that the total rent for the two periods might be equal to the total subdivision (iii) charges for such periods. This fact should be given special recognition in the regulations, either by considering the total rentals charged over the entire lease period or for a specified number of years thereof.