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Interest-Free Loans and Section 482 - Creation of Income?

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INTEREST-FREE LOANS AND SECTION 482–CREATION OF INCOME?

INTRODUCTION

Section 482[1] of the Internal Revenue Code allows the Commissioner of Internal Revenue to "distribute, apportion, or allocate" income between two controlled corporations in order to prevent evasion of taxes, or to more clearly reflect income. Application of this section usually becomes necessary in the situation where a domestic corporation owns or controls a foreign subsidiary in a so-called "tax haven" country. In such cases, the comparatively low or non-existent tax rate in the foreign country creates a profit incentive for the domestic parent corporation to realize as much of its income as possible in its subsidiary.[2] To achieve this result, the domestic parent may sell its product to the foreign affiliate at a price less than the fair market price or buy goods from its foreign affiliate at a higher than fair market price. As can be seen, this procedure has the effect of increasing the income of the subsidiary and decreasing the income of the United States parent corporation subject to Federal tax, the effect being a shifting of income from the parent corporation to the foreign subsidiary with a resultant tax advantage to the controlled group as a whole. Other ways that this income-shifting may be accomplished by the domestic parent include the incurring of expenses for material or services used by the subsidiary, allowing the subsidiary to benefit from intangibles belonging to the parent without adequate consideration, or loaning funds to the subsidiary without charging interest. To rectify this situation, the Commissioner may invoke Section 482, reallocating the improperly shifted income back to the parent to reflect an "arm's length"[3] charge for all

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, 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.

2. "[S]ubsidiary corporations, particularly foreign subsidiaries, are sometimes employed to 'milk' the parent corporation, or otherwise improperly manipulate the financial accounts of the parent company." Report 350, 67th Cong., 1st Sess., p. 14.

3. Factors to be considered in determining the arm's length rate are (a) amount of the loan, (b) security involved, (c) credit standing of the borrower, (d) interest rate

these services, the domestic corporation then being taxed on the increased amount.[4] Thus, the foreign subsidiary is prevented from "milking" the domestic parent;[5] the intent of the act being to put a controlled taxpayer[6] on the same tax parity with an uncontrolled taxpayer.[7]

THE RULE AGAINST CREATING INCOME

Although the provisions of Section 482 are necessarily quite broad, the Commissioner, in reallocating income under this section, has in the past been restricted to allocating only that income which has already been earned by the subsidiary.[8] The total combined income of the two corporations must remain the same, and no new income can be "created" by the allocation process. It is no secret that the Internal Revenue Service has for some time been questioning this concept;[9]

prevailing at the situs of the lender/or creditor, and (e) all other relevant facts. Proposed Treas. Reg., § 1.482-2(a)(2), 31 Fed. Reg. 10396 (1966). However, the section does not apply to an advance intended not as a loan, but as a contribution to capital or a corporate distribution. Proposed Treas. Reg. § 1.482-2(a)(3), 31 Fed. Reg. 10396 (1966).

4. In cases in which the subsidiary has already been taxed on its reported income by the foreign country, a double taxation effect occurs when this income is reallocated back to the domestic parent corporation and taxed again under Section 482. Since seeking refunds from the foreign country involved has proven useless, the IRS has issued Revenue Procedure 64-54, 1964-2 CUM. BULL. 1008, which allows an offset against U. S. taxation in the amount of the foreign tax previously paid on the income reallocated back to the U. S. parent corporation. In addition, Revenue Procedure 65-17, 1965-1 CUM. BULL. 833, allows repatriation of profits by adjustment of accounts and transferring amounts which have been the subject of a Section 482 allocation. Revenue Procedure 65-17 allows this to be done without having the receipt of such amount considered as a taxable distribution for Federal income tax purposes.

5. S. REP. No. 960, 70th Cong., 1st Sess., 24, reprinted in 1939-1 CUM. BULL. 426.

6. "The term 'controlled taxpayer' means any one of two or more organizations, trades, or businesses owned or controlled directly or indirectly by the same interests." Treas. Reg. § 1.482-1(a)(4) (1962).

7. Proposed Treas. Reg. § 1.482-1(b)(1), 31 Fed. Reg. 10394 (1966). Tennessee Life Insurance Co. v. Phinney, 280 F.2d 38 (5th Cir. 1960), *aff'd* 364 U. S. 914 (1960).

8. Although it has been in the Code since 1928, Section 482 produced very little litigation until 1962, when a program of intensive enforcement was begun. Under Section 45 of the Revenue Act of 1928, the Commissioner was authorized to distribute, apportion, or allocate solely "gross income or deductions." In 1944, his authority was extended to "credits or allowances" as well, which is how the section reads today.

9. A good example is the Service's change of position on the so-called "split-dollar" life insurance plan. Under this type of plan, an employer pays life insurance premiums for his employee, then later withdraws the funds he has invested, leaving the earnings for the employee. In Revenue Ruling 55-713, 1955-2 CUM. BULL. 23, these plans were treated as interest free loans and declared not taxable. However, this ruling was revoked

but so far it has been satisfied with merely attempting to prove that the income to be allocated has already been earned, rather than claiming authority to invoke section 482 whether income has been earned or not. Proving that income has been earned is relatively easy if the reason for applying Section 482 is a non-arm's length sale of products, services, or intangibles; but when the Commissioner attempts to reallocate interest on an interest-free loan, the task of circumventing the rule against creating income becomes more formidable.[10] The difficulty arises because the value of money is certain, and the transfer of funds in exchange for a note bearing no interest appears to be a more commensurate transaction than the transfer of goods or services for less than adequate compensation. In addition, bases for comparison in this field are diminishing, as now even a bank loan may often carry no interest.[11] Nevertheless, on March 31, 1965, this issue was met head-on with the first installment of the Proposed Regulations under Section 482.[12]

Section 1.482-1(d)(4) of the Proposed Regulations authorizes the District Director to distribute, apportion or allocate income, deductions, credits or allowances in transactions among members of a controlled group regardless of whether or not the anticipated income from the transaction is realized at or after the time of allocation.[13] The second

by Revenue Ruling 64-328, 1964-2 CUM. BULL. 11, which stated that Revenue Ruling 55-713 had incorrectly analyzed the insurance:

". . . [T]he substance is that the employer provides the funds representing the investment element in the life insurance contract, which would in arm's length dealings entitle it to the earnings accruing from that element. . ."

The 1964 ruling concludes that the employee realizes taxable income measured by the difference between the term cost of the amount of insurance required to be paid by him for such protection pursuant to the split-dollar plan.

Revenue Ruling 64-328 and the revocation of Revenue Ruling 55-713 was one of the initial indications that the Service intended to impute interest income to employees receiving interest-free loans from their employers on the theory that the employee had gained an economic benefit. Its effect was to clear the way for the future taxation of all forms of interest-free loans.

10. The imputed interest theory has spread to other areas. *See*, Johnson v. U. S., 254 F. Supp. 73 (D. C. Tex., 1966) (no imputed interest where a parent makes an interest-free loan to a child); Rev. Rul. 65-199, 1965-2 CUM. BULL. 20 (policy-holder who pays premiums in advance realizes taxable income at the time the prepaid funds are made available for withdrawal or are applied to payment of premiums).

11. In recent years bank financing has made increased use of devices such as convertible debentures and profit participations rather than interest charges.

12. Proposed Treas. Reg. § 1.482, 30 Fed. Reg. 4256 (1965).

13. Proposed Treas. Reg., § 1.482-1(d)(4), 31 Fed. Reg. 10394 (1966):

If the members of a group of controlled taxpayers engage in transactions example under this section involves an interest-free loan from controlled taxpayer A to controlled taxpayer B. In this situation, according to the example, the District Director may allocate an arm's length interest charge to A, even though B may realize no income at all during the year of the loan. Not only is there a complete absence of judicial support for Section 1.482-1(d)(4) of the Proposed Regulations, but in addition, the example mentioned is in direct conflict with a solid body of case law holding that only pre-existing income may be allocated under Section 482. In fact, the most notable of these decisions, *Smith-Bridgeman and Company*[14] and *Tennessee-Arkansas Gravel Co. v. Commissioner*[15] had been previously acquiesced in by the Commissioner.[16]

Recognizing the possibility of controversy on this point, the IRS issued TIR 838 on August 2, 1966, the same day the final installment of the Proposed Regulations appeared. In this TIR, the Service recognized that its outstanding acquiescences in *Smith-Bridgman* and *Tennessee-Arkansas Gravel Co.* "have been cited by some as authority for the proposition that income may not be attributed under Section 482 to a member of a controlled group involved in a transaction with another member, if the latter had no gross income, or if no income was realized outside the group as a result of the particular arm's length transaction." However, the Service went on to say that these acquiescences were "intended only to concur in the proposition that appropriate adjustments are to be made to the incomes of both members of the groups affected to reflect the Section 482 allocation." [17] This was followed by Revenue Ruling 67-79,[18] which contained similar language to that used in TIR 838, and reemphasized the IRS position that it could use Section

with one another, the District Director may distribute, apportion, or allocate income, deductions, credits or allowances to reflect the true taxable income of the individual members 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 . . . . [I]f one member of a group lends money to a second member of the group in a taxable year, the District Director may make an appropriate allocation to reflect an arm's length charge for interest during such taxable year even if the second member does not realize income during such year. 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.

14. 16 T.C. 287 (1951), *acquiesced in* 1951-1 CUM. BULL. 3.
15. 112 F.2d 508 (6th Cir. 1940).
16. 1951-1 CUM. BULL. 3.
17. TIR 838, August 2, 1966.
18. 1967 INT. REV. BULL. No. 11, at 7.

482 to create interest or rent within a controlled group. The next step appears to be for the Commissioner to withdraw his acquiescence in the two cases and substitute a non-acquiescence, thus indicating his intent to reopen the issue.[19]

Since it is obvious that the Commissioner intends to challenge the creation of income doctrine, the possible tax consequences inherent in a Section 482 allocation require a close examination of the issue and precedents involved.[20] A determination as to whether or not the Commissioner is violating the rule against creating income by allocating interest to the domestic parent corporation on an interest-free loan would be unproductive. From an examination of court precedents there would appear to be no doubt that the concept is transgressed if

19. Withdrawal of prior acquiescences appears to be part of the Commissioner's plan for a revamping of procedures under Section 482. The Commissioner withdrew his acquiescence in one Tax Court decision affecting this section which had held that no allocation of part of the gross income of two other corporations may be made to the taxpayer for tax purposes because neither corporation, considered separately, owns a controlling interest in the taxpayer and they do not share the same stockholders. The Lake Erie and Pittsburgh Railway Company v. Commissioner, 5 T.C. 558 (1945) *acquiesced in* 1945 CUM. BULL. 5, *withdrawn and nonacquiescence substituted* 1965-1 CUM. BULL. 5.

20. The Proposed Regulations provide that if a creditor is regularly engaged in the business of lending money, the arm's length rate will be the going rate. If the creditor is not in the business of lending money, the arm's length rate is that actually charged if it is between 4% and 6%, and 5% in all other cases "unless the taxpayer establishes a more appropriate rate . . ." Proposed Treas. Reg. § 1.482-2(a)(2)(ii), 31 Fed. Reg. 10396 (1966). There are several interpretations of this phrase. One interpretation is that the Service reallocates interest if the taxpayer has loaned money interest-free and reallocates deductions if the taxpayer is a borrower and claims deductions for interest payments in excess of the arm's length rate. The second interpretation is that the Service has its choice of whether it wants to reallocate income or reallocate deductions. Either procedure would achieve the desired result, i.e., a proper increase of income; however, each may have a different tax consequence.

For example, addition of an interest allocation to the gross income of a closely held U. S. corporation might cause it to become taxable as a "personal holding company." In addition, inclusion of the interest charge in gross income might cause the taxpayer to have omitted more than 25% of its gross income, thereby becoming subject to the six-year period of limitation for assessment of additional deficiencies. This effect could be avoided by the subtraction of interest charges from the taxpayer's deductions for interest paid.

Most importantly, a 482 allocation may have certain tax consequences for subpart F corporations. For example, a controlled foreign corporation may have subpart F income which is less than 30% of its total gross income, and is therefore not taxable under INT. REV. CODE OF 1954, § 954(b)(3). A Section 482 allocation, then, could transfer a part of the non-subpart F income to another foreign corporation, in which case, the 30% requirement would no longer be satisfied and the corporation's subpart F income would become taxable to its U. S. stockholder.

the borrowing subsidiary has earned no income in the taxable year. The better question concerns the validity of the rule itself.

Origin of the Rule in the Courts

The initial case involving creation of income under Section 482 was *Tennessee-Arkansas Gravel Co. v. Commissioner.*[21] Here, the taxpayer and a Mississippi corporation were owned by the same interests. The taxpayer rented equipment to the Mississippi corporation during 1933 at a stipulated price of $1000 per month, but due to operating losses, this rental was never paid. Then, in 1934, the taxpayer allowed the Mississippi corporation to use the equipment rent-free. Under Section 45 (later Section 482 in the 1954 Code), the Commissioner sought to impute income of $12,000 to the taxpayer for rental of the equipment in 1934, but did not allocate any amount from the affiliate. There was no evidence as to whether or not the Mississippi company had gross income for the taxable year. The Court of Appeals held for the taxpayer, stating that Section 45 did not authorize the Commissioner to set up income where none had before existed,[22] and that he was restricted to an apportionment or allocation of gross income only.

The Rule As Applied To Interest-Free Loans—Smith-Bridgeman

The leading case involving interest-free loans, *Smith-Bridgeman and Co.*,[23] involved the standard situation of a taxpayer loaning money to its parent corporation without interest, the loaned funds to be used to retire outstanding debentures. Smith-Bridgeman's parent corporation, Continental, had a small operating loss for the year in question, and the Commissioner attempted to allocate income to Smith-Bridgeman under Section 482 without a correlative adjustment to Continental's account. The Tax Court disallowed the allocation of a 4% interest charge by the Commissioner, holding that he was creating income where none had yet been realized, and cited *Tennessee-Arkansas Gravel Co.* with approval:

> The decisions involving Section 45 make it clear that its principal purpose is to prevent the manipulation of or improper shifting of

21. 112 F.2d 508 (6th Cir. 1940).

22. *Accord*, Epsun Lithographers v. O'Malley, 67 F.Supp. 181 (D.C. Neb. 1946) (dictum); Texsun Supply Corp., 17 T.C. 433 (1951) (no Section 482 allocation can be made when gross income has already been rebated to member co-operatives); E. C. Laster, 43 B.T.A. 159 (1940) *acquiesced in* 1954-1 Cum. Bull. 5; *modified on other issues*, 128 F.2d 4 (5th Cir. 1942).

23. 16 T.C. 287 (1951), *acquiesced in* 1951-1 Cum. Bull. 3.

> gross income and deductions between two or more organizations, trades, or businesses. Its application is predicated on the existence of income. The courts have consistently refused to interpret Section 45 as authorizing the creation of income out of a transaction where no income was realized by any of the commonly controlled businesses.[24]

Significant here is the fact that the parent corporation, Continental, did have gross income from a separate and unrelated transaction, despite an overall loss. Consequently, the Court's decision appears to be that not only must the borrowing corporation have gross income for the taxable year, but in addition, the gross income must be generated by the transaction giving rise to the Section 482 allocation.[25]

Also, imputing interest income to a lender where no provision for interest was made by the parties involved has been uniformly rejected by the Tax Court where the Commissioner has sought to use some theory other than Section 482.[26] Involved here is the principle that

24. *Id.* at 293.

25. In J. Simpson Dean, 35 T.C. 1083 (1961), the Commissioner attempted to impute income to the debtor on the theory of an economic benefit received from the use of an interest-free loan. In distinguishing the case of interest-free loans from rent-free use of property by a stockholder or officer, the Tax Court advanced the theory that interest-free loans do not result in income to the borrower because the interest, if paid, would have been fully deductible:

> In each of them (cases holding rent-free use of property results in realization of income), a benefit was conferred upon the officer or stockholder in circumstances such that had the stockholder or officer undertaken to procure the same benefit by an expenditure of money, such expenditures would not have been deductible by him. Here, on the other hand, had petitioners borrowed the funds in question on interest-bearing notes, their payment of interest would have been fully deductible by them under Section 163, I.R.C. 1954. Not only would they not be charged with the additional income in controversy herein, but they would have a deduction equal to that very amount. We think this circumstance differentiates the various cases relied upon by the Commissioner, and perhaps explains why he has apparently never taken this position in any prior case . . . . We have heretofore given full force to interest-free loans for tax purposes, holding that they result in no interest deduction for the borrower . . . nor interest income to the lender . . . . We think it to be equally true that an interest-free loan results in no taxable income to the borrower, and we hold that the Commissioner is not entitled to any increased deficiency based on this issue.

The Commissioner neither acquiesced nor nonacquiesced in this decision.

26. *See* Brandtjen & Kluge, Inc., 34 T.C. 416 (1960), *acquiesced in* 1960-2 CUM. BULL. 4; Society Brand Clothes, Inc., 18 T.C. 304 (1952), *acquiesced in* 1952-2 CUM. BULL. 3; Combs Lumber Co., 41 B.T.A. 339 (1940), *acquiesced in* 1940-1 CUM. BULL. 2.

income is not attributable to an accrual basis taxpayer until the right to receive the income becomes fixed.[27]

From the foregoing discussion, it can be seen that there are four distinct propositions inherent in the rule against creation of income as regards interest-free loans.

(1) *Income may not be allocated to one member of a group under Section 482 without making a correlative adjustment to the income of the other group member.*[28]

This conclusion is in accordance with sound accounting principles and has been accepted by the Commissioner in TIR 838[29] and Revenue Ruling 67-79,[30] qualifying his acquiescences in *Smith-Bridgeman* and *Tennessee-Arkansas Gravel Co.*

(2) *Section 482 cannot be applied to allocate income in any transaction in which the parties themselves have made no charge.*[31]

The cases advancing this interpretation dealt mainly with the type of intracompany loan which ordinarily does not carry interest, such as loans by a company to its president or by shareholders to their company. No shifting of income motive is apparent in these cases, so a comparison with a Section 482 allocation is strained. The argument that no income can be attributed to an accrual basis lender until the right to receive the income is fixed is somewhat specious. If this principle were applied to cases which do involve a violation of Section 482, then the effect of the section would be nullified in any case in which the parties did not agree to an interest rate. Since the Commissioner can clearly impute income in certain cases, the question of when the right to receive income occurs is irrelevant.

However, there appears to be a much more obvious answer to this proposition. One of the stated purposes of Section 482 is to "prevent evasion and avoidance of taxes," and allowing evasion when based on an agreement between the parties would certainly frustrate this purpose. It is highly doubtful that the decisions of the cited cases can be extended this far.

(3) *No allocation can be made under Section 482 unless the con-*

27. Spring City Foundry Co. v. Commissioner, 292 U.S. 182 (1934).

28. Smith-Bridgeman, 16 T.C. 287 (1951), *acquiesced in* 1951-1 CUM. BULL. 3; Tennessee-Arkansas Gravel Co., 112 F.2d 508 (6th Cir. 1940).

29. TIR 838, August 2, 1966.

30. 1967 INT. REV. BULL. No. 11 at 7.

31. *See* Brandtjen & Kluge, Inc., 34 T.C. 416 (1960), *acquiesced in* 1960-2 CUM. BULL. 4; Society Brand Clothes, Inc., 18 T.C. 304 (1952) *acquiesced* in 1952-2 CUM. BULL. 3; Combs Lumber Co., 41 B.T.A. 339 (1940), *acquiesced in* 1940-1 CUM. BULL. 2.

trolled member receiving the loan realizes additional gross income generated from the transaction in question.[32]

On its face, a showing of specific gross income arising from the activities giving rise to the proposed allocation appears to better carry out the intent of the statute. However, neither the statute nor the regulations require that gross income be realized out of the transaction before an allocation can be made, despite the wording of the opinion in *Smith-Bridgeman.* Section 482 merely requires that a distortion of income result from the non-arm's length transaction.

In addition, there is the fact that money is fungible, and the source of the funds which generate the income is of little importance in this context. If the loan funds are used to pay expenses, the borrower corporation has benefitted economically since its working capital will not be reduced by these expense payments. Were the loaned funds used to pay salaries or buy inventory or machinery, they would then be at least partly responsible for gross income generated by the subsidiary's sales. Even if the specific funds were used to retire outstanding debt obligations (*Smith-Bridgeman*), it follows that gross income generated by the previously borrowed funds would thereafter be generated by the interest-free funds of the parent. Were the loan funds invested in research and development, they would free additional capital for use in other areas.

(4) *A Section 482 allocation cannot be made unless some overall gross income has been realized by the controlled member within the taxable year.*[33]

This is the widest point of disagreement. The second example in the Proposed Regulations expressly repudiates this statement and even goes so far as to say that the allocation may be made if the subsidiary has an overall deficit for the year involved.[34]

This example does appear to be in conflict with the express language of the Code,[35] which states that the Commissioner may only allocate

32. Smith-Bridgeman and Co., 16 T.C. 287 (1951) *acquiesced in* 1951-1 CUM. BULL. 3.

33. Smith-Bridgeman and Co., *id.*; Tennessee-Arkansas Gravel Co., 112 F.2d 508 (6th Cir. 1940); J. Simpson Dean, 35 T.C. 1083 (1961).

34. Proposed Treas. Reg., § 1.482-1(d)(4), 31 Fed. Reg. 10394 (1966).

35. At least one writer feels that the concept of imputed income in situations where no income was realized may involve a serious constitutional question. The 16th Amendment provides for taxation of "gains, profits, and income from whatever source derived," and the definition of income has been uniformly restricted to a gain realized or a profit derived from capital, labor, or both. *See, e.g.,* Keasbey & Mattison Co. v. Rothensies, 133 F.2d 894 (5th Cir. 1943), *cert. denied,* 320 U.S. 739 (1943). Imputed income in such instances could be constitutionally sustained as an excise tax, but there

gross income, for it would appear that if there is no gross income, there is nothing to allocate. In addition, the reasoning appears to be somewhat inconsistent, as the IRS initially uses the concept of controlled corporations acting as a unit, and then splits the unit, attributing income to one part, when the unit as a whole realizes no income at all.

But regardless of whether or not the borrowing subsidiary has gross income in the taxable year, an interest-free loan still results in a shifting of an economic benefit, the use of the funds. The subsidiary may not realize income from the benefit immediately, but the benefit is still there, and will probably generate gross income for the subsidiary in the future. Much of the controversy surrounding Section 482 in this area has arisen because of undue emphasis on the effect of the allocation on the borrowing subsidiary. The section, as written, is aimed at frustrating tax evasion in the parent, not in the subsidiary. If the parent is allowed to loan funds interest-free to an insolvent foreign subsidiary, its net taxable income would be less than it would be had it loaned the funds at arm's length terms, which is the effect that Section 482 was specifically enacted to prevent.[36] In fact, loss corporations, as well as non-taxable foreign affiliates, present prime opportunities for the process of milking domestic entities, since in both cases profits can be shifted with the result of a lessor tax liability for the two entities as a whole.

Still, the act itself specifies that gross income, deductions, credits or allowances, only must be allocated. There is no question that if the domestic corporation borrows funds at interest and then loans the funds to the subsidiary without interest, the Commissioner could disallow the interest deduction to the parent,[37] reallocating it to the subsidiary. But if the parent is simply loaning from capital, there is no deduction to allocate. Perhaps the solution would be to defer allocation pending the earning of income by the subsidiary. However, there are obvious administrative difficulties inherent in this procedure, and in addition, the income may never be realized and the Treasury would sustain a permanent loss. Thus, this method could conceivably allow the domestic parent to accomplish its shifting of income and consequent tax advantage, and the intent of the act would be frustrated.

is some doubt as to whether this is the legislative purpose of Section 482. Jenks, *The Creation of Income Doctrine; A Comment on the Proposed Section 482 Regulations*, 43 TAXES 486 (1965).

36. "[t]axable income . . . is other than it would have been had the taxpayer in the conduct of his affairs been an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer." Proposed Treas. Reg., § 1.482-1(c), 31 Fed. Reg. 10394 (1966).

37. INT. REV. CODE OF 1954, sec. 482 specifically provides for allocation of deductions.

CONCLUSION

Several authorities have felt that the rule against creating income arose from cases in which the Commissioner merely made a procedural error.[38] Although a careful reading of the cases does not wholly substantiate this, there is certainly merit in the contention that it is time for the reasoning of these cases to be re-examined. Anytime a benefit is conferred, there is a resultant loss to the conferrer. In the case of a domestic parent corporation loaning funds interest-free to its foreign affiliate, the loss is a reduction in taxable net income due to lack of interest income which, at arm's length, would have been charged. If Section 482 is construed as not permitting allocation when the recipient realizes no gross income in the taxable year, the result is that the affiliate receives the benefit of increased funds with which to generate income in future years when it can no longer be made subject to a Section 482 allocation. The affiliate's future income generated by the loan will be taxed only at the lessor foreign rate, the parent's present taxable income is reduced by this amount, and the controlled entity as a whole realizes a tax benefit in proportion to the amount of the loan. The obvious result is a shifting of income, exactly the type of practice the statute was intended to prevent.

There is no doubt that, from an accounting standpoint, the income from the loan has not yet appeared on the books. But the Tax Court's dogmatic restriction to pre-existing income allows it to remain hidden in the balance sheet of the losing subsidiary until the spectre of Section 482 has been removed by the termination of the taxable year.

Perhaps legislative change would be the best solution, for it is obvious that the IRS intends to depart from prior case law in determinations under Section 482.[39] There is evidence that Congress had contemplated a revision of this Section in 1962, and found it unnecessary.[40] However,

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38. *See*, Smith-Bridgeman and Co., 16 T.C. 287 (1951), *acquiesced in* 1951-1 CUM. BULL. 3; Tennessee-Arkansas Gravel Co. v. Commissioner, 112 F.2d 508 (6th Cir. 1940); *see also*, Plumb and Knapp, *Reallocation of Income and Deductions under Section 482*, 41 TAXES 809 (1963); Hewitt, *Section 482—Reallocation of Income and Deductions between Related Persons—Up-to-date*, N.Y.U. 22ND INST. ON FED. TAX 381, 397-400 (1964).

39. "Regulatory activity has resulted from the desire of the Treasury to offer guidance in areas hitherto left to case by case action. The recent proposed Regulations under Section 482 respecting parent-subsidiary allocations is an example." Address by Stanley Surrey, Section of Taxation, American Bar Association Meeting, Montreal, Canada, Aug. 6, 1966, in 20 ABA Sect. Tax. Bull. 13, 20.

40. The text of H.R. 10659, as reported on March 12, 1962, contained a provision (Section 6) which would have amended Section 482 to provide for specific allocation

this raises the question of why this section was not changed by Congress in the 1954 Code in view of the fact that all prior decisions had been adverse to the Commissioner.[41]

Since the trend in IRS thinking is obviously directed toward assuming authority to create income under Section 482, it can be expected that the Proposed Regulations to Section 482 will be finalized substantially in their present form. Consequently, there is no doubt that the issue will appear before the Tax Court despite the ease with which cases of this type are settled.[42] Whether the Tax Court will reconsider its prior position cannot be foreseen, but it is hoped that the economic benefit argument will be embraced. If it is not, new legislation should be forthcoming to clear the issue, so that Congressional intent in establishing the act can be effectuated.

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rules. The new provision, however, was stricken by the Senate and never became law. The Conference Committee Report stated specifically that the objects of Section 6 could be accomplished by amendment to the regulations under Section 482.

41. The argument might be made that since legislative change was required to allow the Commissioner to impute interest income under Section 483, a legislative change is also necessary to enable him to impute interest under 482. However, comparison of the two sections indicates a marked difference and an analogy between them is not particularly helpful. Section 483 has to do with deferred payments on sales and exchanges of property where the parties have merely increased the total price rather than providing for interest. Under this section, the Commissioner may treat as interest "that part of payment . . . which bears the same ratio to the amount of such payment as the total 'unstated' interest under such contract bears to the total of the payments . . . which are due under such contract." INT. REV. CODE OF 1954, § 483(a).

As can be seen, Section 483 merely provides for part of a payment to be designated as interest, and, from an accounting standpoint, is quite different from Section 482, which imputes interest despite the fact that the debtor has paid nothing at all.

Conversely, it would be difficult to say that Section 483 gives the Commissioner legislative approval for imputing interest under Section 482.

42. One case which would have tested the new doctrine was Kimberly-Clark Corporation (Dkt. No. 6063-64), in which the Commissioner attempted to impute interest income to the corporation on interest-free loans to its foreign affiliates. However, the case was stipulated without litigation, and the issue was never determined.