CHAPTER 15 - THE CORPORATION AS A SEPARATE ENTITY

Problem, page 507

15-1. Under the facts presented, it seems likely that Management Corp. will be treated as an agent of the partnership. Depending on the facts, Management Corp. should not have trouble satisfying the first four *National Carbide* tests (cited in *Bollinger)*. The fifth test, the obstacle in *Bollinger,* may not be an obstacle here if the shareholders of Management Corp. do not control the partnership. The fact that Management Corp. performs the agency function for other partnerships is helpful, as is the fact that reasonable compensation is paid.

Problem, page 516

15-2. This problem is based loosely on the fact pattern in *Exxon Corp. et al. v. Commissioner, 16* T.C.M. (CCH) 1707 (1993). That case addressed the issue of whether foreign legal restrictions justify a deviation from arm's length pricing. Stated differently, can a taxpayer rely on *First Security* in an international context? That issue was first addressed in *Procter & Gamble Co. v. Commissioner,* 961 F.2d 1255 (6th Cir. 1992). Procter and Gamble (hereinafter "P&G"), owned all of the stock of Procter and Gamble A.G. (hereinafter "AG") a Swiss corporation engaged in marketing P&G its products in countries where P&G did not have a marketing subsidiary. AG licensed and paid royalties to P&G for the use of P&G's patents, trademarks, tradenames, knowledge, and assistance. AG, in turn, sublicensed the patents, etc. to its subsidiaries throughout Europe and the Middle East. The income earned by AG from its sublicensing activities was taxable directly to P&G under subpart F. AG organized a Spanish subsidiary, Gamble España, S.A. (hereinafter "España") to manufacture and sell its consumer and industrial products in Spain. The tax court found that during the years in question, Spain prohibited the payment of royalties from España to AG.

Notwithstanding the Spanish law prohibition against royalty payments to a parent corporation, the Service determined that a royalty equal to 2 percent of España's net sales should be allocated to AG (and therefore be taxable to P&G). The Service reasoned that no taxpayer would give away the right to use property in an arm's length transaction. The only reason AG was willing to forego a royalty payment from España was because, as a parent corporation, AG would reap the benefit of España's use of the royalty property in the form of increased stock value. A nonshareholder licensor would not agree to license the use of its property unless it received royalty payments in exchange. Otherwise, the income produced by the transferred property would inure to the benefit of the licensee's shareholders. Indeed, Spanish law recognized this fact by permitting the payment of royalties to unrelated licensors. Accordingly, there can be little doubt that it was the relationship of AG to España that gave rise to the uncompensated use of P&G's property.

Although the relationship of AG to España made the transaction possible, it was the existence of Spanish law that made the royalty payment impossible. Relying on the Supreme Court holding in *Commissioner v. First Security Bank of Utah,* 405 U.S. 394 (1972) (income shifted from a bank to a captive insurance company could not be allocated under §482 because receipt of insurance income by the bank would have violated U.S. banking laws), the court in *Procter & Gamble* ruled that the Service could not allocate income between related corporations where the purported misallocation was caused by foreign law. As a result of the tax court's decision, AG did not have deemed royalty income from España that would be taxable to P&G as subpart F income.

Procter & Gamble was followed by the court in *Exxon.*

There is a danger in allowing foreign law to impede the application of §482. It is not difficult to imagine that some taxpayers actually may encourage (and be willing to pay for) foreign governments to prevent certain arm's length payments between related taxpayers in order to lower U.S. taxes. Moreover, just as the foreign tax credit mechanism does not allow a credit for foreign income taxes on what the United States considers to be U.S. source income, perhaps the United States should not allow foreign law to govern what is taxable in the United States when, under the arm's length principle of §482, the United States considers income to be subject to U.S. taxation.

Indeed, the Regulations now provide that a foreign legal restriction will be taken into account only to the extent that the restriction affects an uncontrolled corporation taxable under comparable conditions. Treas. Reg. §1.482-1(h)(2)(i). However, a taxpayer has a right to make a deferred income election to postpone taxation until payment of the item ceases to be prevented by the foreign legal restriction if the foreign restriction is widely imposed, the taxpayer has exhausted its remedies in seeking a waiver, the restriction has prevented payment in any form (rather than limiting a deduction), and the restriction has not been circumvented. *See id.* at (h)(2)(ii) and (h)(3). For example, the Service maintains that the payment of a dividend when royalties are blocked is a circumvention, a position rejected by the court in *Procter & Gamble.*

Problems, page 518

15-3. This problem focuses on an assignment of income over time - Rock Star is not splitting his income with another taxpayer but rather is splitting his income with himself over multiple taxable years. The intended effect of this scheme, like other income splitting schemes, is to reduce taxation by taking multiple advantage of the Code's progressive rates.

15-3a. Assume Deferral Corp. is capitalized adequately, the arrangement with Rock Star should be arm's length: Rock Star is exchanging a risky $1,000,000 per year for a certain $750,000. Is this transaction an impermissible circumnavigation of the pension provisions? The Supreme Court thought so in *United States v. Basye*, 410 U. S. 441 (1973), although the plan apparently would succeed if the annuity were unfunded. In *United States v. Drescher,* 179 F.2d 863 (2d Cir. 1950), it was held that a funded annuity is

currently taxable. Note that §§482, 269 and 269A cannot apply because Rock Star does not control Deferral Corp.

15-3b. In *Johnson v. Commissioner*, 78 T.C. 882 (1982), aff'd without opinion, 734 F.2d 20 (9th Cir.) it was held that the failure of the third party to sign directly with the corporation was fatal, with the court seemingly admitting the superficiality of its analysis. The court says that the issue turns on who - the individual or the corporation - really earned the income. Does that approach help in this case? Note that application of the assignment of income doctrine to this case demonstrates the corporate entity is not being ignored because the income is attributed to the employee and not the shareholders. When a corporation is not "viable," its income is passed through to the shareholders.