THE UNCERTAINTY OF FOREIGN BLOCKED INCOME: TRYING TO RECONCILE THE 1994 § 482 REGULATIONS WITH PROCTER & GAMBLE

I. INTRODUCTION

Advances in technology, communications, and transportation have heralded the way toward a global economy in which U.S. corporations gain access to foreign markets through foreign subsidiaries. As U.S. companies extend their operations into foreign nations, special taxation problems arise for both corporations and the Internal Revenue Service (IRS). Corporations fear double taxation, and the IRS fears that corporations and their foreign subsidiaries will manipulate "transfer prices" to avoid paying U.S. income taxes.

1. See MANUEL PIRES, INTERNATIONAL JURIDICAL DOUBLE TAXATION OF INCOME 3-4 (1989) (noting that advances in technology, transportation and communications create international interdependence); see also Michael S. Knoll, Perchance to Dream: The Global Economy and the American Dream, 66 S. CAL. L. REV. 1599, 1603 (1993) (observing that the United States has become integrated into the global economy through trade, technology transfer and capital flows).


3. Double taxation occurs when two countries claim the authority to tax the same income. See James R. Mogle, Competent Authority Procedure, 23 GEO. WASH. J. INT'L L. & ECON. 725, 725 (1990).

4. Where two parts of a multinational corporation deal with one another in a business relationship they must determine a price to be paid for the goods, services, or property "transferred" between one another. The amount paid is the "transfer price." See Richard L. Kaplan, International Tax Enforcement and the Special Challenge of Transfer Pricing, 1990 U. ILL. L. REV. 299, 300-01 (1990). Corporations can utilize transfer pricing to shift income between their subsidiaries to minimize their aggregate taxes. Id. at 301.

5. Transfer pricing manipulation is an important concern of the IRS and in recent years has been targeted as a primary enforcement issue. Id. at 299.
Internal Revenue Code § 482 allows the IRS to counter transfer pricing manipulation by reallocating a corporation’s profits to reflect more accurately that company’s true income. IRS income reallocations under § 482, however, are open to question when a company’s transfer pricing decisions are dictated by foreign law.

The U.S. Court of Appeals for the Sixth Circuit addressed precisely this issue in Procter & Gamble Co. v. Commissioner, a case involving a U.S. corporation, Procter & Gamble (P&G), and its Spanish subsidiary, Procter & Gamble España, S.A. (España). In Procter & Gamble, Spanish law placed restrictions on transfer payments from España that ultimately resulted in a reduction in P&G’s U.S. income tax. The IRS insisted that § 482 of the Internal Revenue Code allowed reallocation of P&G’s profits to reflect more clearly the income that P&G indirectly received from España. This reallocation increased P&G’s U.S. income tax liability. P&G challenged the reallocation, contending that it was merely following the Spanish law and that it was not purposely trying to avoid U.S. income tax. Although P&G prevailed in its dispute with the IRS in Tax Court and in the Sixth Circuit Court of Appeals, in July of 1994 the IRS issued new regulations that will substantially alter this result in the future.

This Note proposes that the new treasury regulations regarding the treatment of foreign legal restrictions under § 482 should be modified to comport with the holding in Procter & Gamble. Part II provides a brief overview of § 482 as a background for the discussion. Part III examines the development of the law regarding legal restrictions and the payment of income taxes. Part IV analyzes the Tax Court and Sixth Circuit Court of Appeals’ decisions in Procter & Gamble. Part V evaluates how the new regulations would apply to the facts of Procter & Gamble, and recommends methods for avoiding future § 482 disputes over foreign blocked income. Finally, Part VI concludes that the optimal solution for resolving foreign blocked income disputes is avoiding the problem through tax treaties and

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6. All section references (unless otherwise indicated) are to the Internal Revenue Code of 1954.
8. Id.
9. Id. at 1257-58.
10. P&G argued that it faced a "legal restriction" on its income, and that it could not characterize the transactions the way the IRS suggested because it would require breaking the law in Spain. Id. at 1258-59.
advanced planning; in situations where the problem does arise, disputes should be resolved according to treasury regulations that follow the guidelines established in Procter & Gamble.

II. OVERVIEW OF § 482

Section 482 states that the IRS may reallocate the gross income, deductions, credits, and allowances of related taxpayers if it believes income is being misrepresented to reduce income taxes. The section is designed to prevent the artificial shifting of the true net income of controlled taxpayers by placing "a controlled taxpayer on a tax parity with an uncontrolled taxpayer." Specifically, § 482 seeks to ensure that the appropriate amount of tax is collected by guarding against any actions of a controlled taxpayer entity which may serve to distort income among the controlled group. If controlled or related entities structure their transactions such that their transfer price is the same as the price negotiated by entities dealing at arm's length, § 482 will not be applied. The more the transfer price
between related entities varies from the market price, the more likely a § 482 allocation becomes, because a parent corporation could potentially shift its income to a subsidiary by paying more than market price for the product in question.17

A "legal restriction to block income" is a law preventing a controlled tax paying entity from establishing transfer prices at the market rate, thus "blocking" the entity from reporting income as a company that was involved in an arm's length transaction would.18 Foreign legal restrictions block income when transactions similar to those at arm's length are prohibited by the laws of nations other than the United States.19 For example, a foreign legal restriction exists when a country sets a minimum price at which goods produced in that country can be transferred out of the country (e.g., 130% of the manufactured cost). Such a restriction is conceivable in a country which seeks to attract foreign investment but worries that foreign companies will take advantage of potentially low manufacturing costs (e.g., low capital and labor costs) without a significant contribution to the country's tax base. When the marginal tax rate in the foreign country is lower than the rate in the home country, these foreign legal restrictions can actually result in a tax benefit to a multinational firm.

III. THE LAW PRIOR TO PROCTER & GAMBLE

On several occasions federal courts have addressed challenges to IRS reallocations of income under § 482 where domestic laws restrict income transfers between companies and their subsidiaries. In Commissioner v. First Security Bank of Utah20 the U.S. Supreme

controlled transaction fall outside the arm's length range, the district director may make allocations that adjust the controlled taxpayer's result to any point within the arm's length range." Id. § 1.482-1(e)(3). The IRS, however, may make an allocation without establishing an arm's length range first, thereby shifting the burden to the taxpayer to prove that its transactions fall within an arm's length range. Id. § 1.482-1(e)(4).

17. If the subsidiary was located in a lower tax-rate jurisdiction than its parent, there would be a tax benefit to this shifting of income. This is a simplified example, but the principle is the same in more complex transactions. Some other common tax avoidance schemes include excessive charges for "work" done in "tax haven" jurisdictions and inflated costs for shipping and insurance. See Kaplan, supra note 4, at 300-01.

18. "Blocked income" can be defined as "income earned by a foreign taxpayer which is not subject to tax in U.S. because taxpayer is precluded from making conversion of foreign earned income into dollars." BLACK'S LAW DICTIONARY 172 (6th ed. 1990).


Court addressed income reallocation under § 482 in a situation where federal law prohibited the transfer of funds between a subsidiary and its parent corporation. Similarly, in *Salyersville National Bank v. United States*, the Sixth Circuit Court of Appeals addressed whether income reallocations under § 482 are appropriate when state law restricts income transfers. Because the rationale used by the courts in these cases provides a framework for analyzing the foreign legal restriction issue, a brief review of these decisions is helpful.

*First Security Bank* involved a dispute over income derived from transactions between two subsidiaries of First Security Corp., First Security Bank (the Bank) and Security Life, an insurance company. The Bank sold credit insurance policies to its customers through a third-party insurance company that in turn reinsured the policies with Security Life. Security Life received eighty-five percent of the reinsurance premiums, and reported this income for tax purposes. The Bank received no commissions or income for its sales efforts because federal law prohibited banks from receiving insurance income. These transactions led to significant tax savings for First Security Corporation, because at the time life insurance companies were subject to a lower overall tax rate than banks.

The IRS contended that the bank should have received a commission for selling the policies, thereby more accurately reflecting the true net income of the Bank and increasing First Security Corporation's tax liability. The Supreme Court disagreed, holding that the First Security Corporation

must have 'complete power' to shift income among its subsidiaries. It is only where this power exists, and has been exercised in such a way that the 'true taxable income' of a subsidiary has been understated, that the Commissioner is authorized to reallocate


23. *Id.* at 398. See Appendix I for a diagram of the transaction.
24. *Id.* at 399.
25. *Id.* at 398, 400-01.
26. *Id.* at 399.
27. *Id.* at 400.
under §482... The ‘complete power’ referred to in the regulations hardly includes the power to force a subsidiary to violate the law.\textsuperscript{28}

Since federal law prohibited the Bank from receiving insurance income, First Security Corporation did not have “complete control” over the income, and an allocation under § 482 was unwarranted.\textsuperscript{29} \textit{First Security Bank} stands for the principle that a § 482 allocation cannot be made when the taxpayer’s receipt of income is precluded by law.\textsuperscript{30}

In \textit{Salyersville National Bank v. United States},\textsuperscript{31} a case with similar facts,\textsuperscript{32} the Sixth Circuit Court of Appeals held that § 482 did not apply because the controlling entity did not have complete control over the income.\textsuperscript{33} The fact that state law restricted income transfers between the related taxpayers made an allocation under § 482 inappropriate.\textsuperscript{34} Section 482 does not apply where restrictions imposed by law, rather than by the actions of the controlling interest, distort income within a group: “Taxpayers are not required to arrange their affairs in such a way as to maximize the taxes owed the IRS. There is no question that taxpayers may structure their business affairs as they consider to be in their best interests.”\textsuperscript{35} At the same time, the IRS has legitimate concerns that companies may manipulate their operations or create sham transactions or corporate governance schemes to take advantage of legally restricted opportunities where § 482 allocations would otherwise be appropriate.

\textsuperscript{28} \textit{Id.} at 404-05. The regulations that the Court refers to state: “The interests controlling a group of controlled taxpayers are assumed to have complete power to cause each controlled taxpayer so to conduct its affairs that its transactions and accounting records truly reflect the taxable income from the property and business of each of the controlled taxpayers.” Treas. Reg. § 1.482-1(b)(1) (as amended in 1968).

\textsuperscript{29} \textit{First Security Bank}, 405 U.S. at 405.

\textsuperscript{30} \textit{Procter & Gamble Co. v. Commissioner}, 60 T.C.M. (CCH) 1463, 1466 (1990). Income that is precluded by law is also referred to as “blocked income,” because the receipt of the income is “blocked” by law.

\textsuperscript{31} \textit{Salyersville Nat’l Bank v. United States}, 613 F.2d 650 (6th Cir. 1980).

\textsuperscript{32} Like \textit{First Security Bank}, \textit{Salyersville National Bank} concerned a bank’s involvement in selling credit insurance. Customers in need of insurance were referred to the bank president who was also an insurance agent. \textit{Id.} at 650-51. The IRS assessed the bank an amount of money equal to the commissions that the bank could have received for insurance purchased by bank customers through the bank president. \textit{Id.} at 650.

\textsuperscript{33} \textit{Id.} at 655. The fact that the bank could have changed its operations to comply with state law to allow it to receive insurance commissions was held to be irrelevant. \textit{Id.}

\textsuperscript{34} \textit{Id.}

\textsuperscript{35} \textit{Id.} at 653.
These cases established the principle that "complete power" to control income is a prerequisite for utilizing § 482 to reallocate income among a corporation and its subsidiaries. The court in Procter & Gamble extended this analysis to a situation where foreign law, rather than state or federal law, prevented a company from exercising complete control over the income of its subsidiaries.36

IV. THE PROCTER & GAMBLE CASE

A. Tax Court

1. Facts. P&G is an American corporation engaged in the manufacturing and marketing of consumer and industrial products. P&G operates through domestic and foreign subsidiaries and affiliates. Procter & Gamble, A.G. (AG), a wholly-owned subsidiary of P&G located in Switzerland, was generally engaged in marketing and selling P&G's products where P&G did not have a marketing subsidiary or affiliate. AG and P&G had a licensing and service fee arrangement (also known as a "package fee agreement") under which AG could use P&G's patents, trademarks, research, and general business expertise. AG paid royalties to Procter & Gamble based principally on sales of P&G products by AG and its subsidiaries in other countries (such as Spain, Greece, and Austria). P&G and AG executed similar arrangements with their other directly-owned subsidiaries and affiliates in foreign countries.

In 1967, P&G made preparations to organize España, a wholly-owned subsidiary located in Spain. At that time, various laws, decrees, and orders regulated foreign investment in Spanish companies and limited the payments Spanish companies could make to foreign entities. Two such laws in particular were relevant to this case: (1) a foreign entity could not own more than fifty percent of a Spanish corporation without the prior approval of the Spanish Council of Ministers,37 and (2) a Spanish entity needed government approval before it could make payments to residents of foreign countries.38

In its request for authorization to organize España, P&G stated its intention to own 100% of España's capital stock either directly or indirectly through a wholly-owned subsidiary. P&G stated that it

36. Procter & Gamble, 961 F.2d at 1255.
38. Id.
wanted 100% ownership in order to give España immediate access to additional foreign investment, to allow P&G to bear the formidable risks associated with mass-produced consumer products, and to preserve the confidentiality of P&G's proprietary technology.\textsuperscript{39} The application listed España's schedule of royalty and technical assistance payments to P&G.

In January 1968, the Spanish government approved P&G's application for 100% ownership in España. However, the letter of approval expressly provided that España could not make any payments to P&G for royalties or technical assistance.\textsuperscript{40} España's Spanish counsel advised P&G that the limitation on royalty payments reflected normal practice and that a reversal of the decision was unlikely if P&G retained 100% ownership in España.\textsuperscript{41}

España was established indirectly through AG which owned 100% of the interest in España. España's deed of incorporation was registered in Madrid in May of 1968.

Over the next several years, P&G submitted several applications to increase its capital investment in España. In each of the letters granting approval, the Spanish government reaffirmed that España was prohibited from paying any licensing fees to its affiliates without approval.\textsuperscript{42} For the next few years P&G's Spanish counsel continued to informally pursue the possibility of España's paying royalties or technical assistance fees to AG. These attempts were not successful.\textsuperscript{43}

Even though España was unable to pay royalties to AG, AG paid royalties to P&G based in part on a percentage of España’s sales. This royalty payment to P&G resulted in a decrease in AG's income without any corresponding increase in AG's income from España's royalties.\textsuperscript{44} The Commissioner of the U.S. Internal Revenue Service determined that a royalty payment of two percent of España's sales should be allocated to AG under § 482 for 1978 and 1979 in order to more clearly reflect AG's income. As a result of this allocation, AG's income for these two years was increased by more

\textsuperscript{39} Id. at 326.

\textsuperscript{40} Id.

\textsuperscript{41} At the time España's was being organized, several of its competitors were also restricted from making royalty payments abroad. Id.

\textsuperscript{42} Id. at 327.

\textsuperscript{43} A few years after the tax period in question, the Spanish government liberalized its policies toward foreign investment. In 1986 P&G applied for the removal of the prohibition against España's royalty payments, and the application was approved in 1987. Id. at 330.

\textsuperscript{44} See Appendix II.
than three million dollars, and P&G received a notice of deficiency for the corresponding income tax. 45

2. Procter & Gamble's Position. P&G contended that the reallocation of España's income was improper under § 482. In doing so, P&G relied upon First Security Bank and Salyersville National Bank, 46 arguing that the Commissioner could reallocate royalties under § 482 only when the parent company exerted complete control over the subsidiary. 47 P&G asserted that the only question in deciding whether to apply First Security Bank and Salyersville National Bank was whether or not Spanish law would be recognized by a U.S. court as controlling the power of a Spanish corporation and legally determining the acts which it could and could not carry out. 48 A corporation exists as an entity because it is created by a government through a charter which defines and regulates the corporation's powers. 49 These principles extend to corporations created by

45. These allocations to AG had the effect of increasing Procter & Gamble's taxable income under § 951(a)(1)(A) (1988). Section 951 provides that U.S. shareholders of a controlled foreign corporation must include in their gross income their pro rata share of the controlled corporation's Subpart F income (which is defined in § 952(a)). I.R.C. §§ 951(a)(1)(A), 952(a) (1988). See Appendix III.

46. See supra part III.

47. Treas. Reg. § 1.482-1(b)(1) (as amended in 1968) sets forth the scope, purpose, and application of § 482 as follows:

(b) Scope and purpose. (1) The purpose of § 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 interests controlling a group of controlled taxpayers are assumed to have complete power to cause each controlled taxpayer so to conduct its affairs that its transactions and accounting records truly reflect the income from the property and business of each of the controlled taxpayers.


(3) The term "controlled" includes any kind of control, direct or indirect, whether legally enforceable, and however exercisable or exercised. It is the reality of the control which is decisive, not its form or the mode of its exercise. A presumption of control arises if income or deductions have been arbitrarily shifted.


49. "A corporation is an artificial being, invisible, intangible, and existing only in contemplation of law. Being the mere creature of law, it possesses only those properties which the charter of its creation confers upon it, either expressly, or as incidental to its very existence." Trustees of Dartmouth College v. Woodward, 17 U.S. (4 Wheat) 518, 636 (1819). The fact that the incorporating state has the power to regulate and control its corporations has been reapplied in more recent case law as well: "No principle of corporation law and practice is more firmly established that a State's authority to regulate domestic corporations, including the right to
foreign nations. P&G argued that España's actions were restricted by Spanish law to the same extent that the actions of First Security and Salyersville National Banks' were restricted by domestic banking law. Since Spanish law prohibited royalty payments from España to AG, P&G claimed that it had not improperly shifted income and § 482 did not apply.

3. The Commissioner's Position. The Commissioner argued that Spanish law did not prohibit the payment of royalties by España. He claimed that the prohibition was nothing more than an administrative decision which was subject to appellate review. Since España did not formally appeal the prohibition of royalty payments during the time in question, the Commissioner argued that España could not claim that Spanish "law" prohibited the payment of royalties from España to AG.

The Commissioner further stated that even if Spanish law did prohibit the payment of a royalty from España to AG, such foreign law did not affect the Commissioner's authority under § 482 to allocate royalties to AG. The IRS argued that the law of Spain should not be interpreted to diminish the authority granted the Commissioner by the Congress:

The United States ... contemplates taxation of its citizens on a worldwide basis with allowances, specifically permitted as a matter of legislative grace, made for taxes paid or incurred abroad. No provision contemplates a surrender of the authority to tax or to determine tax liability to a foreign government, let alone a foreign regulatory agency.

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51. "It must, in the absence of legislation equivalent to making it a corporation of the latter country, be taken, both by the government and those who deal with it, as a creature of the law of its own country, and subject to all the legislative control and direction that may be properly exercised over it at the place of its creation." Canada Southern R.R. v. Gebhard, 109 U.S. 1020, 1024 (1883).
52. Brief for Petitioner at 25, Procter & Gamble (No. 16521-84).
53. Id. at 332-33.
54. Id. at 333.
56. Id. at 23.
In accordance with this position, and in response to *First Security Bank*, the IRS issued a Revenue Ruling specifically denying a foreign government’s right to block income from a § 482 allocation.\(^{57}\)

4. **Tax Court’s Holding.** The Tax Court faced the question of whether income should be reallocated to correct shifting of income resulting from Spain’s prohibition of royalty payments from a Spanish subsidiary to its foreign parent.\(^{58}\) Relying on *First Security Bank* and *Salyersville National Bank*, the court held for P&G:

As we understand these cases [*First Security Bank* and *Salyersville National Bank*] § 482 simply does not apply where restrictions imposed by law, and not the actions of the controlling interest, serve to distort income among the controlled group.\(^ {59}\)

The court emphasized that P&G had legitimate business purposes for retaining 100% ownership of España.\(^ {60}\) There was no evidence that P&G exerted its control over its subsidiaries to manipulate or shift income among them.\(^ {61}\) The deflection of income in this case was a direct result of P&G’s valid business purposes and good faith compliance with Spanish law.\(^ {62}\) Therefore, an allocation under § 482 was inappropriate.\(^ {63}\)

The Tax Court held that, because the royalty prohibition was applied consistently, the administrative restrictions constituted Spanish “law” for purposes of § 482.\(^ {64}\) The court applied *U.S. Padding Corp. v. Commissioner*\(^ {65}\) which held that the term “laws of such country” included existing practice or policy of a foreign country in addition to

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57. “[W]hen the prohibition on the receipt of income is based not on the laws of the United States but rather on restrictions imposed by foreign governments, the decision in *First Security Bank of Utah* does not foreclose the Service from applying section 482 in order to clearly reflect income.” Rev. Rul. 82-45, 1982-1 C.B. 89.
59. *Id.* at 336.
60. *Id.* at 338; see *W. Braun Co. v. Commissioner*, 396 F.2d 264 (2d Cir. 1968) (holding that allocation under § 482 is appropriate only when there is no business purpose to the structure of the transaction); see also *V.T. Monette & Co. v. Commissioner*, 45 T.C. 15 (1965) (stating that income should not be allocated because businesses were not formed for principal purpose of obtaining a tax benefit), aff’d, 374 F.2d 116 (4th Cir. 1967).
62. *Id.* at 338.
63. *Id.*
64. *Id.* at 337.
explicit constitutional, statutory, or administrative provisions. Since the prohibition was "law," España was not required to formally seek an appeal, which might have wasted resources and strained P&G's working relationship with the Spanish government.

5. IRS Concerns. The IRS was concerned that the Tax Court's holding in Procter & Gamble would: (1) encourage collusion between U.S. multi-nationals and the foreign countries in which they operate, (2) allow the overreaching of foreign governments to displace the U.S. tax base, and (3) discourage the proper matching of expenses and revenue.

First, according to the IRS, the holding in Procter & Gamble provides the potential for collusion between U.S. corporations and foreign governments. Just as state and local governments in the United States make concessions to attract foreign investment, foreign countries could entice U.S. multi-national investment by passing legislation that would, in effect, give U.S. investors a tax benefit. Also, during the search for foreign subsidiary locations, corporations might demand that candidate countries implement laws designed to block the administration of U.S. tax law. Such foreign legal restrictions would provide an overall tax savings to U.S. companies whenever the marginal tax rate in the foreign country is lower than the rate in the U.S.

66. Id.
67. P&G asserted that it would have been futile for them to expend resources and pursue legal recourse. P&G wanted to maintain favorable relations with the Spanish government because it needed approval from local and national regulatory authorities to operate its businesses. The Tax Court agreed:

Also compelling in this regard is the testimony of [the Commissioner's] expert that while an appeal of the royalty prohibition could be possible, 'an appeal always puts you in a very difficult position vis-a-vis of the public administration and you could in the future be blackmailed by the official who has to approve afterwards all the dossiers in the exchange control authority.' Under these circumstances, there is no need 'to insist upon proof the acquisition of which requires such risk.' U.S. Padding Corp. v. Commissioner, 865 F.2d at 754.

Procter & Gamble Co., 95 T.C. at 337. P&G did, however, try through competent local counsel to "test the waters' from time to time by way of informal communications with influential Spanish officials." Id.


69. See discussion supra part II.
Second, the IRS maintains that the holding in *Procter & Gamble* would seriously erode the United States' tax base by allowing foreign laws to override § 482 allocations. According to the IRS, the discretion to allocate income under § 482 is derived from a Congressional mandate and cannot be limited or restricted by foreign law. Otherwise, foreign governments could, as discussed above, reduce the U.S. tax liability of a U.S. corporation. These concerns do not exist to the same degree (if at all) in *First Security Bank* or *Salyersville National Bank*: Congress would not change Federal law to restrict its own ability to raise revenue, and Congress could assert its authority under the Commerce Clause to trump any conflicting State regulatory law. The IRS has a legitimate concern that foreign laws could be used to overcome § 482 allocations under U.S. tax law.

A related concern is that foreign governments would impose foreign legal restrictions to block income to enlarge their own tax base at the expense of the U.S. Treasury. For example, a country with a tax rate exceeding the U.S. rate might restrict distributions of income to foreign parent companies despite the parent companies' objections. The foreign country would be overreaching its bounds by siphoning what would otherwise be U.S. tax revenue. Even without collusion, U.S. multinationals might be placed in a situation where foreign governments would restrict their transfer pricing as a method of raising taxes, and the IRS would need to effectuate a § 482 allocation to more clearly reflect the true income of the U.S. multinational.

Finally, the IRS is concerned that the *Procter & Gamble* courts' interpretation of § 482 would prevent the matching of income and expenses. The IRS requires symmetry of expenses and revenues: companies must reflect expenses in the time period in which the

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71. U.S. CONST. art I, § 8, cl. 3.
72. Rita McWilliams, *P&G Decision Represents Important IRS Defeat, Practitioners Say*, TAX MGMT. TRANSFER PRICING, May 13, 1992, at 18-19; see also Lee A. Sheppard, *The Procter & Gamble Case: Does Sec. 482 Require the Legal Ability to Receive Reallocated Income?*, 49 TAX NOTES 142, 145 (1990) (quoting H. David Rosenbloom, Treasury International Tax Counsel during the Carter administration) ("There are all sorts of reasons not to apply *First Security* to foreign law. You cannot have the same degree of confidence that the rule of law in the foreign jurisdiction has been adopted free of motivation to influence U.S. tax.").
73. In this example the U.S. multinational corporation would derive no tax benefit from collusion with the foreign country. In fact, the corporation would lower its overall tax liability by increasing its U.S. income through transfer pricing.
corresponding income is derived. Otherwise companies would get the benefit of deducting the expense while deferring taxation of the income. In *Procter & Gamble*, AG increased its expenses by paying a royalty based on España's sales. But AG did not receive (and therefore did not include in income) any royalty payments from España. This gave a tax benefit directly to AG and indirectly to P&G. Without the possibility of § 482 allocations, U.S. multinationals could take advantage of this asymmetry and defer (perhaps indefinitely) their tax liability for blocked income.

B. Sixth Circuit Court of Appeals

The Commissioner appealed the Tax Court's decision to the Sixth Circuit Court of Appeals. Because Tax Court decisions carry no presumption of correctness, the Sixth Circuit applied a de novo standard of review to legal conclusions made by the Tax Court. The Sixth Circuit affirmed the Tax Court's holding, stating that

>[t]he purpose of § 482 is to prevent artificial shifting of income between related taxpayers. Because Spanish law prohibited royalty payments, [P&G] could not exercise the control that § 482 contemplates, and allocation under § 482 is inappropriate.

In other words, where governing law—and not the controlling party—causes a distortion of income, § 482 does not apply, and the Commissioner may not make an allocation.

In arguing its case, the Commissioner suggested that España could have paid a dividend to AG, which the IRS would have then treated as a royalty. The Sixth Circuit viewed this as a suggestion that P&G surreptitiously violate Spanish law by paying a royalty through a dividend: "We firmly disagree with the Commissioner's view that P&G should purposely evade Spanish law by making royalty payments under the guise of calling the payments something else."

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75. Id.
76. See *supra* note 46.
77. The Sixth Circuit Court of Appeals (the taxpayer's Court of Appeals) had jurisdiction pursuant to § 7482(a), (b) (1988).
78. *Procter & Gamble Co. v. Commissioner*, 961 F.2d 1255, 1258 (6th Cir. 1992) (citing *Smith v. Commissioner*, 937 F.2d 1089, 1096 (6th Cir. 1991)).
79. Id. at 1259.
80. During the time in question, dividends were permitted under Spanish law. Id. at 1259.
81. Id. at 1259.
The IRS had also argued that P&G could have deferred royalty payments under a “blocked income” regulation\(^\text{82}\) and then paid taxes once the payments became unrestricted. The court determined that the blocked income regulation dealt only with temporary prohibitions and that P&G had no reason to believe the prohibition would ever be lifted.\(^\text{83}\) The court further stated that P&G had no obligation to structure its subsidiaries in a way that would maximize its tax liabilities.\(^\text{84}\)

V. THE 1994 § 482 FOREIGN LEGAL RESTRICTION REGULATIONS

The 1968 and the 1992 regulations for § 482 did not have separate provisions for foreign legal restrictions. The issue was first addressed in the 1993 temporary regulations for § 482\(^\text{85}\) which were left substantially unchanged in the 1994 final regulations. Because foreign legal restrictions could lessen the IRS’s authority to raise otherwise appropriate revenue, the IRS has legitimate concerns regarding collusion, the overreaching of foreign governments, and the appropriate matching of revenues and expenses.

Under the 1994 regulations, foreign legal restrictions will be recognized by the IRS as precluding a § 482 allocation only if a series of four stringent conditions are met.\(^\text{86}\) These heightened require-

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\(^{82}\) Treas. Reg. § 1.482-1(d)(6) (as amended in 1968). Treas. Reg. § 1.482-1(d)(6) provides in pertinent part:

If payment or reimbursement for the sale, exchange, or use of property, the rendition of services, or the advance of other consideration among members of a group of controlled entities was prevented, or would have been prevented, at the time of the transaction because of currency or other restrictions imposed under the laws of any foreign country, any distributions, apportionments, or allocations which may be made under section 482 with respect to such transactions may be treated as deferrable income.

\(^{83}\) Procter & Gamble, 961 F.2d at 1260.

\(^{84}\) Id. at 1260 (citing Salyersville National Bank v. United States, 613 F.2d 650, 653 (6th Cir. 1980)).


\(^{86}\) In short, the regulation requires that:

1) the restriction is publicly promulgated and generally applicable to both controlled and uncontrolled taxpayers alike,

2) the taxpayer has exhausted all practicable legal remedies to obtain a waiver of the restriction,

3) there was a prevention of payment or receipt of an arm’s length amount with the meaning of §482, and

4) the taxpayer or related party must not have circumvented or otherwise violated the restriction.

ments effectively eliminate the applicability of foreign legal restrictions in most § 482 cases. Additionally, the controlled taxpayer must elect the deferred method of accounting with regard to the § 482 allocation on a written statement attached to its tax return before the IRS first contacts the taxpayer to examine the return for the taxable year in which the foreign restriction applies. This election statement must also identify the affected transactions, the parties to the transactions, and the applicable foreign legal restrictions that block the income. Alternatively, a foreign legal restriction will be respected with regard to § 482, and no allocation made, if the transaction was made as if at arm's length. These new regulations effectively reverse Procter & Gamble, and seem to be a further attempt by the IRS to limit the holding of First Security Bank.

A. The Four Requirements

The general rule under the new final regulations is that the Commissioner may make an allocation without regard to foreign legal restrictions, except when: the foreign regulation is generally applicable, the taxpayer has exhausted all practical remedies, an arm's length payment is expressly prevented by the regulation, and there is no taxpayer circumvention of the regulation. When all of these restrictive requirements are satisfied, the taxpayer may qualify for a deferral of the § 482 allocation until the restriction is removed. The new regulations also apply to both temporary and permanent foreign

87. Id. § 1.482-1(h)(2)(iii)(B).
88. Id.
89. Id. § 1.482-1(h)(2)(i). This regulation permits a controlled taxpayer to avoid making the deferral election with regard to the foreign legal restriction discussed above. This could "catch" the unwary taxpayer by surprise if she thought that her transactions were at arm's length. However, the IRS has subsequently ruled to the contrary.
90. The IRS has been concerned with the outcomes of § 482 case law generally and its unsuccessful defense of asserted allocations beyond the foreign legal restriction of blocked income issue. Westreco v. Commissioner, 64 T.C.M. (CCH) 849 (1992) (holding that a company could establish its own comparable transactions with isolated transactions with uncontrolled taxpayers); Sundstrand Co. v. Commissioner, 96 T.C. 226 (1991) (holding that a company could transfer intangibles to a controlled subsidiary, have the subsidiary make products incorporating the intangibles, and then purchase those products from the subsidiary and not be a "contract manufacturer"); Bausch & Lomb, Inc. v. Commissioner, 92 T.C. 525, 581 (1989), aff'd, 933 F.2d 1084 (2d Cir. 1991) (holding that a company did not have to allocate profit to subsidiaries involved in contract research and development).
legal restrictions.\textsuperscript{93} In comparison, the Sixth Circuit Court of Appeals in \textit{Procter & Gamble} stated that the previous regulations only applied to temporary foreign legal restrictions.\textsuperscript{94} While these requirements may seem facially reasonable and conceptually sound, when applied to a fact situation comparable to that in \textit{Procter & Gamble}, their inherent inadequacies become clear.

The first requirement, that the restriction be public law and generally applicable, would allow reallocation by the Commissioner in most “blocked income” cases. Thus, because the legal restriction in \textit{Procter & Gamble} did not apply to controlled and uncontrolled taxpayers alike, P&G would not have met this first requirement. The Spanish law which restricted España’s payments was specifically designed for corporate subsidiaries with fifty percent or more foreign ownership. Blocked income situations generally arise when a foreign country prohibits related party payments.\textsuperscript{95} Accordingly, the Spanish law was meant to ensure that foreign multinational companies paid taxes in Spain; it was specifically directed at controlled or related taxpayers so that they would not take advantage of Spain’s relatively low costs through manipulative transfer pricing and licensing transactions.\textsuperscript{96} Furthermore, it is unlikely that a government would restrict and regulate the pricing abilities of unrelated or uncontrolled taxpayers because displacing the free market with price controls is bad business policy. Frequently, a country is attempting to prevent the shifting of income between related taxpayers, not trying to impact its national pricing policies broadly. In effect, this first requirement for a foreign legal restriction in the new regulations by itself overturns the principle set out in \textit{Procter & Gamble} and precludes most blocked income cases.

The second requirement forces the taxpayer to exhaust all “effective and practical remedies” prescribed by foreign law or practice for obtaining a waiver of the restriction.\textsuperscript{97} In \textit{Procter & Gamble}, the IRS argued that P&G had not formally sought approval

\textsuperscript{93} \textit{Id.} § 1.482-1(h)(2)(ii).
\textsuperscript{94} \textit{Procter & Gamble} Co. v. Commissioner, 961 F.2d 1255, 1260 (6th Cir. 1992).
\textsuperscript{95} Treas. Reg. § 1.482-1(h)(2)(ii)(A) (as amended in 1994).
\textsuperscript{96} Spain could argue that its law was meant to protect against foreign multinationals transferring monies out of the country through “sham” royalty payment schemes. The Spanish government’s prohibition against the payment of a royalty was implemented pursuant to its right to regulate business activities conducted within its borders. Richard Hammer, \textit{International Business Council Urges Provisions On Foreign Legal Restrictions Be Withdrawn}, \textit{93 TAX NOTES TODAY}, Aug. 11, 1993, available in LEXIS, Taxana Library, TNT File, at 93 TNT 167-28.
\textsuperscript{97} Treas. Reg. § 1.482-1(h)(2)(ii)(B) (as amended in 1994).
to pay royalties, and España had not appealed the imposition of the condition of nonpayment of royalties. Therefore, it seems that P&G would fail this second requirement as well. In *Procter & Gamble* the Tax Court held that the chance of obtaining a waiver of the prohibition should be weighed against the consequences of failure. However, the new regulations seem to require a higher standard in this second requirement. This appears unreasonable. Multinational companies like P&G are often accountable to the subjective influences of government regulations, and it would be awkward to engage in legal proceedings damaging to their long-term business interests. The regulations do allow a “safe harbor” provision which does not force companies to engage in legal actions with “negligible prospect of success if pursued,” but this standard gives little indication of how much a taxpayer must do to exhaust all remedies. Whatever the required standard is, it appears to be significantly higher than that which the Tax Court or the Sixth Circuit Court of Appeals outlined in *Procter & Gamble*.

Third, the restriction must expressly prevent the payment or receipt of the arm’s length amount that would otherwise be required under § 482. This actually represents a concession from the litigating position the IRS took in *Procter & Gamble*, where the IRS argued that *First Security Bank* (if applicable at all) only applied to restrictions on receipt and not to restrictions on payment. P&G would have met this third requirement, as the Spanish government explicitly told España that it could not make royalty or technical service payments.

98. See *supra* note 64 and accompanying text.

99. American Petroleum Institute, *API Comments on Transfer Pricing*, TAX NOTES INT’L, Aug. 2, 1993, available in LEXIS, Taxana Library, TNI File, at 93 TNI 147-12: “[T]his is a requirement that will be difficult to establish with developing nations where the effectiveness of various avenues of appeal is subject to question and a vigorous pursuit of an appeal may place the taxpayer’s business interests in the country at risk.”


The controlled taxpayer also must have exhausted all ‘effective and practical remedies’ afforded under foreign law or practice for obtaining a waiver of the restriction. It is not clear what this means: the Service argued in Procter & Gamble that P&G should have filed a formal appeal or application to have the royalty prohibition lifted. Does this mean that P&G should have commenced a legal proceeding against the Spanish government in the Spanish courts? The Service cannot really expect that, can it? What about the opinion of foreign counsel? The IRS felt that was not dispositive in Procter & Gamble. How is the ‘exhaustion of remedies’ requirement satisfied? Examples would be helpful.

Finally, the taxpayer must not have circumvented or have otherwise violated the foreign restriction. The IRS does not want a taxpayer manipulating its income through one method of transfer pricing, while claiming that a foreign legal restriction bars its application on another method of transfer pricing that has unfavorable U.S. tax consequences. For example, if a related party pays a dividend, the IRS may view this payment as a circumvention of a restriction on royalty payments. P&G would have passed this requirement as well, because it did not try to circumvent the Spanish law through other payments.

B. Impact of the New Regulations

The new regulations effectively overrule Procter & Gamble. Under these new tax regulations, P&G would have been denied the benefit of blocked income through a foreign legal restriction. The IRS would have been allowed to allocate royalty payments to increase P&G’s U.S. profits, thereby increasing the company’s tax liability. The IRS would then have subjected some of the company’s income to taxation in the United States as well as in Spain, since the company would still have had to abide by the laws in the foreign state in which it was operating.

The regulations do not address the main holdings of both the Tax Court and the Sixth Circuit Court of Appeals: that the taxpayer had no control over the income and therefore could not have been illegally shifting income. Section 482 should not apply where restrictions imposed by foreign law, and not the multinational itself, serve to distort income amongst a controlled taxpaying entity. The regulations also impose burdensome documentation requirements. For example, the taxpayer must attach a written statement to its tax return electing the deferred method of accounting for the blocked income, identifying the affected transactions, naming the parties to the

103. Id. § 1.482-1(h)(2)(ii)(D).
104. This fourth requirement is contrary to the position of the IRS in Procter & Gamble. See supra note 81 and accompanying text, describing the IRS suggestion that even though P&G did not pay a royalty, they could have paid a dividend.
105. Double taxation arises when a taxpayer has to pay tax on the same income twice, generally in different jurisdictions. Treaties between countries usually address this issue. “Problems can arise when both countries assert their taxing power over the same items of income on the same basis of taxation (such as source) inconsistently applied or when each follows different bases of taxation.” JOSEPH ISENBERGH, INTERNATIONAL TAXATION: U.S. TAXATION OF FOREIGN TAXPAYERS AND FOREIGN INCOME 432 (1990).
transactions, and specifying the applicable foreign legal restrictions that block the income.

However, the new regulations do effectively address the IRS concern of collusion between U.S. multinationals and foreign governments, the overreaching of foreign governments to displace the IRS tax base, and the matching of expense and revenue. No collusion will be allowed by virtue of the "generally applicable" test, which would also address the overreaching issue. The objective of matching income with expense is addressed by forcing companies to defer the income that might otherwise be allocated under § 482. Since the income must eventually be realized in the United States, the IRS has chosen to treat foreign legal restrictions for blocked income as temporary measures at best. Consequently, U.S. companies eventually face double taxation, paying taxes to both the foreign country in which they are doing business and to the United States. Because the regulations are so aggressive in addressing the IRS concerns, they present a dilemma for taxpayers: whether to comply with the previously decided precedents such as Procter & Gamble and First Security Bank, or the new final regulations.

The Court in Procter & Gamble relied upon the long-standing judicial interpretation of § 482, including First Security Bank and Salyersville National Bank, to decide that no statutory authority exists under § 482. The IRS only has the authority to issue regulations pursuant to the Internal Revenue Code. Consequently it is unclear whether the IRS can promulgate a regulation which would seem to undermine a Supreme Court opinion finding no statutory authority exists under § 482. Although lacking a clear mandate

106. Treas. Reg. § 1.482-1(h)(2)(ii)(A) (1994). The generally applicable test requires that the foreign legal restriction applies to uncontrolled taxpayers, creating a "price control" for all taxpayers, not just related and controlled ones. See supra notes 95-96 and accompanying text. The regulations also state that the foreign legal restriction may not be "part of a commercial transaction between the taxpayer and the foreign sovereign." Treas. Reg. § 1.482-1(h)(2)(ii)(A) (1994).


108. "[T]he Secretary shall prescribe all needful rules and regulations for the enforcement of this title, including all rules and regulations as may be necessary by reason of any alteration of law in relation to internal revenue." I.R.C. § 7805(a) (1988).

from Congress to amend or revise § 482, the IRS has, nevertheless, effectively overruled *Procter & Gamble* through new regulations.

Because the new regulations depart from the settled principles of existing case law, they are likely to have little effect on reducing the volume of litigation in the area of foreign legal restrictions. The new regulations may even create more litigation as taxpayers seek to apply the principles set out in *Procter & Gamble* that conflict with the new regulations. Thus, as opposed to clarifying this important and growing area of tax law, the IRS has potentially created even more confusion.

C. Recommendations

The harsh effects of the current form of § 482 should be remedied to ensure certainty and fairness for taxpayers operating internationally. Several independent alternatives could solve this problem: clarification of § 482 by judicial interpretation or legislative action; utilization by taxpayers of treaties between the United States and foreign jurisdictions allowing for competent authority proceedings; or administrative changes by the IRS in its interpretation of § 482. Any of these measures, either alone or in combination, would represent an improvement over the current IRS position as represented in the new § 482 regulations.

1. **Legislative and Judicial Action.** The foreign legal restriction of blocked income demands legislative or judicial attention. As international business dealings become more prevalent, taxpayers need to be able to predict how U.S. tax law will be applied to their international transactions. To solve this problem, Congress should amend § 482 so that it is in accord with *Procter & Gamble*.

Alternatively, judicial action could solve the problem. The IRS may attempt to force the Supreme Court to review the issue by encouraging conflicting results between the Sixth Circuit and other courts of appeals. If the Supreme Court does address the issue, the Court should follow its own precedent in *First Security Bank* and

110. American Petroleum Institute, supra note 99.
uphold *Procter & Gamble*. The *Procter & Gamble* holding is more desirable than the current regulations, which are not only too restrictive, but also impose difficult tax planning issues for U.S. multinational taxpayers and create the possibility of double taxation.

2. **International Agreements.** As an alternative to direct judicial or legislative measures, international agreements may alleviate some of the problems associated with the present configuration of § 482. Situations similar to that in *Procter & Gamble* could be dealt with through a mutual understanding between the U.S. and foreign governments.\textsuperscript{112} The United States has tax treaties with many countries,\textsuperscript{113} and one of the common goals of these treaties is the prevention of double taxation.\textsuperscript{114} To the extent such treaties exist and contain provisions for competent authority proceedings, they can, through such proceedings, provide effective relief from double taxation.

The U.S. Treasury Department's Model Tax Treaty contains such a "competent authority" proceedings provision:

Where a person considers that the actions of one or both of the Contracting States result or will result for him in taxation not in accordance with the provision of this Convention, he may, irrespective of the remedies provided by the domestic law of those States, present his case to the competent authority of the Contracting State of which he is a resident or national.\textsuperscript{115}

The IRS has issued a Revenue Procedure\textsuperscript{116} which outlines how taxpayers may obtain competent authority consideration when the United States or a foreign treaty country proposes, or makes, an

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\textsuperscript{112} See, e.g., McWilliams, *supra* note 72, at 19.


\textsuperscript{114} "Under the rubric 'double taxation,' most treaties contain a set of rules coordination on the national tax systems of the treaty countries." \textsc{Joseph Isenbergh}, \textit{International Taxation: U.S. Taxation of Foreign Taxpayers and Foreign Income} 432 (1990).


\textsuperscript{116} Rev. Proc. 82-29, 1982-1 C.B. 481.
allocation of income. The Revenue Procedure requires the taxpayer to submit a written request for competent authority consideration. If the request is granted, the Associate Commissioner for Operations will act as the U.S. competent authority in resolving the issue with the foreign jurisdiction.

The taxpayer seeking competent authority proceedings, like Procter & Gamble, is often "caught in the middle" with its home country on one side and the foreign country on the other. Instead of forcing the taxpayer to seek legal relief in one or both countries, the competent authorities of the treaty governments should seek mutual agreement on who should garner the tax revenue in question.

117. Id. at 482-83. According to Rev. Proc. 82-29, 1982-1 C.B. 481, 482, the taxpayer’s written request for competent authority consideration should include:

(a) a reference to the specific income tax treaty provisions under which the request is being made;
(b) the name, address, and taxpayer identification numbers of the United States taxpayer and all related persons involved in the proposed allocation and the tax years affected;
(c) the office where the United States taxpayer and the related person or persons filed federal income tax returns for the years in question;
(d) a statement whether the Federal income tax returns of the United States taxpayer for the years in question were examined, or are in the process of being examined;
(e) a description of the control and business relationship between the United States taxpayer and the related person or persons;
(f) a statement of the status of the tax liability of the related person in the treaty country for the year or years of the proposed adjustment;
(g) actions requested of, proposed, or taken by the competent authority of the treaty country, a description of the pertinent transactions and the issues, and the amount of any correlative adjustment that would have to be made to the income or deductions of the United States taxpayer if the United States competent authority were to accept the position of the treaty country;
(h) copies of pertinent foreign income tax returns (with English translations), schedules (in United States dollars) showing the allocation proposed by the treaty country and computation of the resulting foreign tax;
(i) copies of pertinent correspondence from the treaty country, briefs, protests and other relevant material (all with English translation);
(j) copies of Foreign Tax Credit Computation (Forms 1118) that were filed with the tax return for each ear under consideration;
(k) copies of powers of attorney on file with respect to the United States taxpayer; and
(l) on a separate document, a statement that the United States taxpayer consents to the disclosure to the competent authority of the treaty country (with the name of the country specifically stated) and the competent authority’s staff of any or all of the items of information set forth or enclosed in the request for United States competent authority consideration. This statement must be dated and signed by a person having authority to sign the United States taxpayer’s federal income tax return and is required to facilitate the administrative handling of the request by the United States competent authority for purposes of the recordkeeping requirements of section 6103(p) of the Code. Failure to provide such a statement will not prevent the United States competent authority from disclosing information under the terms of a tax treaty.

118. Id. at 481.

119. A taxpayer can also prevent transfer pricing allocations by establishing an “advance pricing agreement” with its own competent authority. See Rev. Proc. 91-22, 1991-1 C.B. 526. An advance pricing agreement establishes the methodology and principles that will be applied
3. Administrative Changes. Absent the responses on the part of other organs of government outlined above, the IRS could modify the 1994 § 482 regulations to follow First Security Bank and Procter & Gamble. Such a modification would still allow the IRS to address its concerns about collusion, overreaching, and unmatched expenses and revenues. Specifically, the IRS should revise the first and second requirements of its current foreign legal restriction regulations and leave the third and fourth requirements unchanged.

The first requirement, that the restriction be publicly promulgated and generally applicable to both controlled and uncontrolled taxpayers, should be amended to apply only to controlled taxpayers. Because a foreign legal restriction is rarely applicable to both controlled and uncontrolled taxpayers, this requirement exposes taxpayers like Procter & Gamble (who exhibit no control over the income) to double taxation. By ensuring that the foreign legal restriction is publicly promulgated and generally applicable to controlled taxpayers, the IRS still addresses its concerns.

The IRS should also modify the second requirement, which requires the taxpayer to exhaust all practicable legal remedies to obtain a waiver of the restriction. This requirement should be changed to balance the chance of the foreign legal restriction being waived against the consequences of failure, as the Tax Court elucidated in Procter & Gamble.

to the taxpayer's transfer pricing transactions. The advance pricing agreement serves as a tool for seeking mutual agreement between taxing authorities prior to double taxation issues arising, and for more clearly delineating what the outcome of disagreement will be with regard to uncertain and unclear transactions. See generally Robert G. Clark, Transfer Pricing, Section 482, and International Tax Conflict: Getting Harmonized Income Allocation Measures from Multinational Cacophony, 42 Am. U. L. Rev. 1155, 1203 (1993) (discussing solutions to problems of double taxation).

120. See Hammer, supra note 96; Perlman, supra note 109; American Petroleum Institute, supra note 99; Fuller & Aud, supra note 101.

121. See supra part IV.A.5 for an explanation of the IRS's concerns of collusion between U.S. multi-nationals and the foreign countries in which the multi-nationals operate, the overreaching of foreign governments to displace the IRS tax base, and the proper matching of expense and revenue.

122. The four requirements are delineated in Treas. Reg. §1.482-1(h)(2)(ii)(A)-(D) (as amended in 1994). See supra part V.A for a list of the four requirements and an explanation of how they conflict with Procter & Gamble.
VI. CONCLUSION

Because the uncertainty raised by the new regulations creates prospective tax risks, the new § 482 regulations present difficult planning issues for taxpayers operating in countries where there are currency restrictions, limits on the compensation for goods or services, or other foreign legal restrictions. The cautious taxpayer should interpret the new regulations as effectively overruling Procter & Gamble, denying a taxpayer in P&G's position recognition of the foreign legal restriction to blocked income. In most cases, this will expose the taxpayer to the risk of double taxation, forcing the taxpayer to seek relief through competent authority proceedings. The more aggressive taxpayer, by comparison, would continue to rely on the Procter & Gamble holding, arguing that the IRS overstepped its authority by issuing new regulations which contradict the legal precedent regarding § 482.

Despite the legitimate concerns of the IRS, the policy benefits of following Procter & Gamble (e.g., a consistent application of U.S. tax laws to similarly situated taxpayers, and a simple and predictable test for taxpayers to use in making their decisions) clearly outweigh the costs associated with failing to do so. The IRS should therefore treat foreign legal restrictions to blocked income as it does any other potential tax avoidance issue by considering the facts and circumstances of each individual case to determine whether manipulation has occurred. Ideally, competent authority proceedings and mutual agreement between tax authorities would eliminate the need for cases like Procter & Gamble in the future. Alternatively, the IRS should modify the new foreign legal restriction regulations in order to adhere to the precedent set by Procter & Gamble.

James A. Davlin, V

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123. Levey & Clancy, supra note 111, at 140.
APPENDIX I: DIAGRAM OF FIRST SECURITY BANK ARRANGEMENT\textsuperscript{125}

\textbf{First Security Corporation}

\textbf{Security Life}
\textit{(lower tax rate than Bank)}

\textbf{First Security Bank}

\textbf{Unrelated Insurance Company}

\textit{reinsured policies with}

\textit{marketed polices for}

APPENDIX II: DIAGRAM OF TRANSACTIONS AND CORPORATE STRUCTURE IN THE PROCTER & GAMBLE CASE

100% Ownership

Procter & Gamble
U.S. Corporation, Parent

Royalty paid by P&G A.G. to P&G based in part on sales of P&G Espana, License and Fee Agreement

Procter & Gamble, A.G.
Swiss Corporation, Subsidiary

Royalty payments blocked by Spanish law from P&G Espana

Procter & Gamble Espana
Spanish Corporation, Subsidiary

APPENDIX III: DIAGRAM OF ADJUSTMENTS AND CORPORATE STRUCTURE IN THE PROCTOR & GAMBLE CASE

1. **Step 1 of IRS Adjustment:**
   - Even though royalty payments are prohibited by Spanish Law, adjustment is for 2% of P&G España's sales to be paid to P&G A.G.

2. **Step 2 of IRS Adjustment:**
   - As a result of royalty income from P&G España, P&G's subpart F income increases.

Diagram:

- **Procter & Gamble U.S. Corporation, Parent**
  - 100% Ownership
  - Step 2 of IRS Adjustment: As a result of royalty income from P&G España, P&G's subpart F income increases

- **Procter & Gamble A.G. Swiss Corporation, Subsidiary**
  - 100% Ownership
  - Step 1 of IRS Adjustment: Even though royalty payments are prohibited by Spanish Law, adjustment is for 2% of P&G España's sales to be paid to P&G A.G.

- **Procter & Gamble España Spanish Corporation, Subsidiary**