

Northwestern Journal of International Law & Business

Volume 15

Issue 1 *Fall*

Fall 1994

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Wayne M. Gazur, The Forgotten Link: "Control" in Section 482, 15 Nw. J. Int'l L. & Bus. 1 (1994-1995)

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ARTICLES

The Forgotten Link: “Control” in Section 482

Wayne M. Gazur*

The foundation of international taxable income allocations between related parties is formed by the imposition of an arm's length standard. The presence of “control” over a person invokes this measure. The author examines the implications of control presented by continuing developments in the global business environment, including the rise of cooperative interfirm arrangements.

I. INTRODUCTION

With the increasing globalization of commercial activity,¹ competition among sovereigns for the international business tax base will

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¹ “Foreign direct investment from OECD [Organization for Economic Co-operation & Development] countries increased four fold in the 1980s and grew much more rapidly than domestic capital formation, GDP [Gross Domestic Product] or world trade.” ORGANIZATION FOR ECONOMIC CO-OPERATION & DEVELOPMENT, INTERNATIONAL DIRECT INVESTMENT: POLICIES AND TRENDS IN THE 1980s 11 (1990). For one of the many articles describing the globalization phenomenon, see Bill Saporito, *Where the Global Action Is*, FORTUNE, Special Issue Autumn/Winter 1993, at 63. The opening lines of the article demonstrate how “globalization” has become a cliché. “Globalization. Aren’t we sick of it? Haven’t we heard enough already. . . ?” *Id.*

surely increase,² placing more pressure on structural allocation mechanisms. For the United States and other members of the Organization for Economic Co-operation and Development (OECD),³ the principal income and expense allocation measure in establishing prices for transactions between different business units of related taxpayers is the imposition of an arm's length standard of valuation. That arm's length standard is the foundation on which section 482 of the Internal Revenue Code is based.⁴

There is already abundant literature wrestling with interpretations of the arm's length standard.⁵ This article instead addresses the

² For a discussion of international tax dispute resolution using treaty mechanisms and other measures, see Robert G. Clark, Comment, *Transfer Pricing, Section 482, and International Tax Conflict: Getting Harmonized Income Allocation Measures from Multinational Cacophony*, 42 AM. U. L. REV. 1155 (1993). The conflict is not limited to competing industrialized countries. The United Nations has been active in urging the adoption of uniform tax treaties, international tax agreements, and the enforcement of the arm's length standard of pricing intrafirm transfers, to aid the less-developed countries (LDCs) whose tax systems are seen as subject to extreme manipulation by the transfer pricing practices of large multinational enterprises. "Whatever the technicalities of taxation are, the public perception is that the MNCs [multinational corporations] are tax avoiders. This is an issue over which the governments of the industrialized as well as the LDCs readily agree. The United Nations, on behalf of the LDCs, urges the conclusion of either uniform bilateral tax treaties or an international tax agreement." Leslie E. Grayson, *The Means of Regulation of Multinational Corporations; The Developing Countries' Point of View*, in THE FUTURE OF THE UNITED STATES MULTINATIONAL CORPORATION 135, 140 (Lee D. Unterman & Christine W. Swent eds., 1975). The decision by the United States Supreme Court in *Barclay's Bank Int'l, Ltd. v. Franchise Tax Board*, 829 P.2d 279 (Cal. 1992), *aff'd sub nom., Barclay's Bank, PLC v. Franchise Tax Board of California*, 114 S. Ct. 2268 (1994), upholding California's controversial unitary tax scheme, could ultimately increase the tensions between trading partners. Although the passage of the "water's edge" bill, S.B. 671, by the California Senate at least temporarily halted British threats of retaliation and calmed the international waters, a voiced concern was that a ruling against Barclays could tempt California to return to a system of unitary taxation. See George Graham, *In a squeeze over tax: The impact of a transatlantic dispute*, FINANCIAL TIMES, May 14, 1993, at 16.

³ The arm's length standard was adopted by the Organization for Economic Co-operation & Development (OECD) in 1977. See ORGANIZATION FOR ECONOMIC CO-OPERATION & DEVELOPMENT, OECD COMM. ON FISCAL AFFAIRS, MODEL DOUBLE TAXATION CONVENTION ON INCOME AND ON CAPITAL, art. 9, at 30 (1977). The OECD was formed in 1960 to promote international economic relations. The organization currently has twenty-four members primarily drawn from the western industrialized countries, many of which have income tax treaties with the U.S. The United Nations adopted the same standard in 1982. See U.N. DEP'T OF INT'L ECONOMICS & SOCIAL AFFAIRS, U.N. MODEL DOUBLE TAXATION CONVENTION BETWEEN DEVELOPED AND DEVELOPING COUNTRIES, art. 9, at 27, U.N. Doc. ST/ESA/102, U.N. Sales No. E.80.XVI.3 (1980).

⁴ Internal Revenue Code section 482 does not contain the "arm's length" language. That language is supplied by the Treasury Regulations. E.g., "In determining the true taxable income of a controlled taxpayer, the standard to be applied in every case is that of a taxpayer dealing at arm's length with an uncontrolled taxpayer." Temp. Treas. Reg. § 1.482-1T(b)(1) (1993).

⁵ See, e.g., Stanley S. Surrey, *Reflections on the Allocation of Income and Expenses Among National Tax Jurisdictions*, 10 LAW & POL'Y IN INT'L BUS. 409 (1978); James P. Fuller, *The New Temporary and Proposed Section 482 Regulations: A Wolf in Sheep's Clothing?*, 6 TAX NOTES

largely overlooked role of control as a key to the application of section 482. It will be argued that avoiding the threshold for control found in section 482 could assume a position of growing importance in the international setting in response to several developments in the global business environment. First, American businesses are engaging in more international strategic alliances, such as joint ventures, which can involve a sharing of ownership and management. This is in contrast with the predominant wholly-owned subsidiary structure that effectively eliminates most control issues. Second, traditional concepts of control may be stretched by foreign investment activity in the United States (so-called "inbound" transactions) and foreign business practices that are not amenable to the existing principles of analysis.

This article will first discuss briefly the rise of the strategic business alliance as a supplement to, and in some cases supplanting, the controlled foreign subsidiary and the introduction to the United States of foreign business organizations such as the Japanese keiretsu. That discussion will be followed by an exposition of the existing law defining control for purposes of section 482. The paper will then conclude with an assessment of the prospects for modifying the control standard.

II. GLOBAL BUSINESS DEVELOPMENTS

A. The Rise of Alternatives to the Wholly-Owned Subsidiary

The predominant business structure for foreign direct investment by United States multinational enterprises⁶ has been and remains the wholly-owned subsidiary.⁷ Based on his research, one commentator

INT'L 525 (Mar. 1, 1993); Josh O. Ungerman, *The White Paper: The Stealth Bomber of the Section 482 Arsenal*, 42 SW. L.J. 1107 (1989); Richard L. Kaplan, *International Tax Enforcement and the Special Challenge of Transfer Pricing*, 1990 U. ILL. L. REV. 299; George N. Carlson et al., *Deja Vu All Over Again: The New Section 482 Regulations*, 93 TAX NOTES INT'L 21-11 (Feb. 2, 1993).

⁶ I use the term "multinational enterprise" simply to refer to a business enterprise (corporate, partnership, or otherwise) that does business in several countries. One can find much finer distinctions based on other factors like the domicile of the entity or its owners. For a general discussion of the debate over labels such as "international," "transnational," "global," "plurinational," or "supranational." See CYNTHIA DAY WALLACE, *LEGAL CONTROL OF THE MULTINATIONAL ENTERPRISE* 10-13 (1983).

⁷ Using information collected by the United Nations Commission on Transnational Corporations from data supplied by the Harvard Multinational Project, Professor Peter J. Buckley noted "the drift away from wholly-owned [sic] subsidiaries as means of technology transfer by multinational firms." Peter J. Buckley, *New Forms of International Industrial Co-operation*, in *THE ECONOMIC THEORY OF THE MULTINATIONAL ENTERPRISE* 39, 40 (Peter J. Buckley & Mark Casson eds., 1985). The information discloses that with respect to the affiliates of 180 United States based corporations in developing countries, the percentage of corporations operating as

has concluded that the wholly-owned subsidiary's predominance will not significantly decline in the foreseeable future.⁸ This view is given support by the observed preference of companies for the control offered by the wholly-owned subsidiary in the efficient, internalized exploitation of assets, particularly those involving high level technology.⁹

wholly-owned (over 95 percent) corporations was 58.4 percent, 44.5 percent, 37.4 percent, 46.2 percent and 43.7 percent for operations established before 1951, 1951-60, 1961-5, 1965-70, and 1971-5, respectively. *Id.* The same data indicates that co-owned (50:50) and minority-owned (5-50 percent) affiliates for the same years increased in importance, comprising 16.8 percent, 26.7 percent, 33.1 percent, 32.7 percent, and 38.5 percent, respectively of the new business operations. *Id.* The same data also demonstrates a much reduced reliance on the wholly-owned subsidiary by European-based corporations. The Harvard data was repeated by the Research and Policy Committee of the Committee for Economic Development in supporting the same conclusion. "Transnational enterprises have traditionally preferred to establish wholly owned subsidiaries, especially when operating in Third World countries. . . . [M]ost affiliates of U.S.-based companies are wholly owned. Although this predominance has persisted since the early 1950s, a clear trend toward an increasing proportion of minority-owned U.S. affiliates is discernible." RESEARCH AND POLICY COMMITTEE OF THE COMMITTEE FOR ECONOMIC DEVELOPMENT, TRANSNATIONAL CORPORATIONS AND DEVELOPING COUNTRIES: NEW POLICIES FOR A CHANGING WORLD ECONOMY 33 (1981). "Companies that favor wholly owned operations in the Third World offer a variety of reasons for their preference; the most important is the desire to maintain centralized management and decision making for the parent system. Other reasons include the desire to avoid the dilution of equity returns, ensuring greater security for technological know-how, and concern about pressure from domestic shareholders for quick returns in the form of dividends when the firm might prefer to reinvest local earnings." *Id.* at 35. Ford Motor Company reportedly followed a general one hundred percent ownership policy in its European activities "in order to give freedom of action in its market strategy." J.M. LIVINGSTONE, THE INTERNATIONALIZATION OF BUSINESS 77 (1989). Raw control of the foreign enterprise aside, a number of economists have theorized that the multinational enterprise has prospered through creating an internal market for certain inputs, like product information and research and development, which would be subject to leakage or high transaction costs if exploited through market transactions. The wholly-owned subsidiary serves this function well. "Production by subsidiaries is preferable to licensing or joint ventures since the latter two arrangements cannot benefit from the internal market of an MNE [multinational enterprise]. They would therefore dissipate the information monopoly of the MNE, unless foreign markets were segmented by effective international patent laws or other protective devices." ALAN M. RUGMAN, INSIDE THE MULTATIONALS 42 (1981). This short footnote cannot even adequately list the numerous competing theories of international production and business, labeled as Marxist, neo-classical, eclectic, and so forth. For a summary of the theories and an evaluation, see GRAZIA IETTO-GILLIES, INTERNATIONAL PRODUCTION (1992).

⁸ "[T]here is no reason to expect that there will be marked changes in ownership preferences on the part of U.S. manufacturing [multinational corporations] in the foreseeable future." Stephen F. Kobrin, *Trends in Ownership of U.S. Manufacturing Subsidiaries in Developing Countries: An Interindustry Analysis*, in COOPERATIVE STRATEGIES IN INTERNATIONAL BUSINESS 129, 140 (Farok J. Contractor & Peter Lorange eds., 1988).

⁹ "Technology, marketing, and global integration are at the core of most explanations of ownership preferences. . . . [T]o the extent that technology matures, for example, one would expect preferences for sole ownership to decline. . . . [T]he technological intensity and degree of global integration of many industries appear to be increasing, which should result in continued, or even increased, pressure for sole ownership." *Id.* "In many high technology industries, strategic flexibility and the desire to remove bureaucratic interference have favored majority control

Indeed, the propensity for joint ventures is uneven and varies from industry to industry corresponding, in part, to the presence of assets that "generate a return to unambiguous control."¹⁰

Although the wholly-owned subsidiary clearly remains important, other writers have suggested that it will be supplemented increasingly by interfirm cooperative alternatives such as joint ventures, minority ownership stakes, licensing, and subcontracting arrangements.¹¹ That prediction has been confirmed by recent reports that United States company activity in international joint ventures has increased significantly.¹²

There are a number of factors that have been offered to explain the apparent increase in cooperative activity. While there is a world-wide move toward free-trade zones and blocs, outsiders may still suffer penalties and handicaps. If these impediments that favor the "home teams" can be avoided by an alignment with a local company, the desirability of an affiliation is increased.¹³ "The attractions of

over 50:50 partnerships." Karen F. Hadlik, *R&D and International Joint Ventures*, in COOPERATIVE STRATEGIES IN INTERNATIONAL BUSINESS, *supra* note 8, at 187, 192.

¹⁰ Kobrin, *supra* note 8, at 135.

¹¹ See generally Buckley, *supra* note 7, at 39.

¹² Based on a number of sources, including United Nations data, one commentator has observed that "[t]ransnational joint ventures have been increasing, particularly in [less-developed countries] and Eastern Europe." IETTO-GILLIES, *supra* note 7, at 31. There also was "[a] general increase in [joint ventures] throughout the world . . . [and] a very considerable increase in [joint ventures] between partners from major developed countries between 1975 and 1986." *Id.* at 32. "In recent years there has been an explosion in the number of foreign operations structured as joint ventures. The growth has been driven almost exclusively by nontax factors." Bruce N. Davis & Steven R. Lainoff, *U.S. Taxation of Foreign Joint Ventures*, 46 TAX L. REV. 165, 167 (1991). "Lawyers say that while there are no hard numbers, there seem to be more joint ventures in the high-tech area and overseas." Claudia MacLachlan, *Joint Ventures Link Countries, Technologies; Blurring Boundaries*, NAT'L L.J., Sept. 12, 1994 at A1.

¹³ The investment laws of some host countries require participation by a domestic investor, and subsidiaries wholly-owned by foreign-based companies are not permitted. These restrictions are most often imposed by developing countries. See generally ROBERT BLACK ET AL., MULTINATIONALS IN CONTENTION: RESPONSES AT GOVERNMENTAL AND INTERNATIONAL LEVELS 48-51 (1978). For a more current summary of investment restrictions on joint ventures, see UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT, JOINT VENTURES AS A CHANNEL FOR THE TRANSFER OF TECHNOLOGY (1988). "[I]n some cases joint ventures . . . may represent the only option. For despite the efforts of the EC to create a level playing field for takeovers across the community, there remain considerable barriers to entry for companies wishing to make cross-border contested takeovers. Those barriers apply particularly to takeovers of quoted companies, and they divide continental Europe from Anglo-Saxon financial markets." Tim Handle, in Comm. of the European Communities, *Panorama of EC Industry '93* (Office for Official Publications of the European Communities, Luxembourg 1993), at 51. "For example, Western companies trying to do business in countries such as China or Vietnam find that joint ventures are the best way to navigate unfathomable political and economic cultures. In other countries, such as Mexico, joint ventures are the only legal way for foreign companies to enter certain markets." MacLachlan, *supra* note 12, at A1.

joint ventures for the multinational firms are time-unlimited access to the market and resources of the host country, possible political preferment and a measure of equity control.”¹⁴ The cooperative venture can offer new technology opportunities but require less capital commitment by either party because that burden is shared. In many cases the joint activity can use existing facilities or infrastructure of the participants. Speaking to joint ventures, plus contractual, non-equity alliances, Professor Dunning has observed that “[t]he nature and form of these coalitions vary but the most common reasons cited are those to do with the sharing of capital risks and R&D costs, the acquisition of complementary technology and skills, the need to capture economies of scale, and overcoming entry barriers to new markets.”¹⁵

Business planning structures adapt to the challenges of the business environment, and Professor Dunning has identified three key factors that have produced the rise of a “new-style multinational.” The first factor is the advance of technology and revolutionized production methods that have both internationalized production and expanded the functional boundaries of companies. The second factor is an acceptance, with some exceptions, of greater global economic interdependence by nations. The third factor is an increased focus on the most efficient means of production, which especially impacts the for-

¹⁴ See Buckley, *supra* note 7, at 45. However, Professor Buckley has questioned the significance of such barriers to a company with international experience. “How far do the barriers to entry to a foreign market decline as the international spread of the firm widens? Established multinational firms have gained worldwide dominance and have developed techniques to ‘learn in advance’ local conditions — products, processes, management style, marketing techniques are continually adapted to local markets. . . . It is now only the entry into unusually isolated markets . . . where heavy ‘costs of foreignness’ are still encountered. The advantage of locals in other instances can be discounted in advance by an experienced multinational firm.” Peter J. Buckley, *A Critical View of Theories of the Multinational Enterprise*, in *THE ECONOMIC THEORY OF THE MULTINATIONAL ENTERPRISE*, *supra* note 7, at 4. “Joint ventures are often related to involvement in [less-developed countries]; the local firm (usually a medium-sized one) will have the advantages of access to technology and managerial and marketing skills as well as to equity capital.” IETTO-GILLIES, *supra* note 7, at 31.

¹⁵ JOHN H. DUNNING, *EXPLAINING INTERNATIONAL PRODUCTION* 330 (1988). One writer has identified the following advantages of the joint venture: (1) risk spreading; (2) use of complementary resources; (3) reducing competition in the market; (4) ease of penetration into a market, particularly with a domestic partner; (5) easier repatriation of profits; (6) opening of further possibilities in that country; and (7) flexibility as to equity share and with regard to the effects of changes on the overall organization of the participant. See generally IETTO-GILLIES, *supra* note 7, at 31. There is not a shortage of lists of joint venture factors. “[T]he factors that encourage JVs have accelerated — and continue to accelerate. These factors include . . . 1. The enormous (and rising) cost of development projects, particularly risky ones. . . . 2. Unprecedented joint efforts by nation states, particularly in Europe. . . . 3. Access to technology. . . . 4. Access to markets. . . . 5. Access to critical mass.” PRICE WATERHOUSE, 19 INT’L TAX REV. 1 (Sept./Oct. 1993).

mation of cooperative ventures. That worldwide search for efficiency decreases emphasis on the single-product firm, and shifts attention to intermediate products, the production of which involves more collaborative work.¹⁶ The alliances or other cooperative networks may be less formally structured than traditional joint ventures, and can take the form of licensing or subcontracting agreements.¹⁷

A lot of overlapping terminology is used to designate various cooperative relationships. As discussed below, the term "joint venture" can refer to many types of arrangements, but generally the collaboration is of a longer duration.¹⁸ The term "strategic alliance" is generally used in a broader sense and can refer to joint ventures that involve the creation of a jointly owned entity, but also to cooperative arrangements like licensing, franchising, and co-production. Some writers have identified the latter arrangements as "contractual agreements" in which participants commit resources to a business activity, "but they do *not* share the ownership or profits of a venture."¹⁹ Another distinction is that in joint ventures, the participants have rights in the management of the enterprise.²⁰ Joint ventures may be further subdivided into equity and non-equity varieties, although the latter arrangement can strongly resemble a "contractual agreement" in the taxonomy discussed above. In the words of Professor Kolde, "[w]hen the partners' rights stem from their equity participation, the enterprise is classified as an equity joint venture; when one or more of the part-

¹⁶ "Most large firms today engage in a gamut of horizontal and vertical external relationships, ranging from [foreign direct investment] to the most informal and flexible subcontracting or service agreements." See DUNNING, *supra* note 15, at 332.

¹⁷ Professor Dunning has distinguished general purpose alliances (GPA) from so-called specific-purpose alliances (SPA). In the GPA, firms "merge their complete interests and/or set up a new company to jointly supply an external market with a particular product or range of products." Dunning, *supra* note 15, at 338. The SPA may be on an equity basis or strictly contractual in the sense that the "coalition is intended for a very specific purpose, the obligations of the parties are clearly defined and . . . it is for a limited period of time." Dunning, *supra* note 15, at 339.

¹⁸ In Professor Dunning's terms, the joint venture would more closely resemble the "general purpose alliance." See DUNNING, *supra* note 17. "A *joint venture* is a business enterprise in which two or more business entities from different countries participate on a permanent basis." ENDEL J. KOLDE, ENVIRONMENT OF INTERNATIONAL BUSINESS 242 (1982). In practice the longevity of joint ventures is relatively short, much less than permanent. See *infra* note 74.

¹⁹ Franklin R. Root, *Some Taxonomies of International Cooperative Arrangements*, in COOPERATIVE STRATEGIES IN INTERNATIONAL BUSINESS, 69, 71. Compare Unif. Partnership Act § 7 (4), 6 U.L.A. 39 (1969), "[t]he receipt by a person of a share of the profits of a business is prima facie evidence that he is a partner in the business;" Rev. Unif. Partnership Act § 202(c)(2), 6 U.L.A. 220 (Supp. 1993), "[t]he sharing of gross returns does not by itself establish a partnership, even if the persons sharing them have a joint or common right or interest in property from which the returns are derived."

²⁰ See Root, *supra* note 19, at 71.

ners have made no equity contribution, the enterprise is a non equity joint venture."²¹ It is not critical that we neatly resolve the confusion in labels. Both types of ventures, equity and non-equity, will have transfer pricing implications. As discussed in the last part of this paper, even strictly contractual alliances may also present transfer pricing issues.

Some notable corporate joint ventures have arisen through the acquisition of partial interests in established companies. Effective January 1, 1990, General Motors acquired a fifty percent interest in Saab Automobile A/B, while Saab-Scania retained the other fifty percent interest.²² The Walt Disney Company has used several forms of cooperative ventures in structuring its foreign investments. On the one hand, the Tokyo Disneyland is owned and operated by an unrelated company, the Oriental Land Co., Ltd., and the Walt Disney Company receives royalties for the use of the Disney theme.²³ On the other hand, Euro Disney S.C.A. is a publicly traded French company in which the Walt Disney Company holds a forty-nine percent ownership interest.²⁴ As discussed in the following materials, these less than

²¹ ENDEL J. KOLDE, *INTERNATIONAL BUSINESS ENTERPRISE* 192 (2d ed. 1973), quoted in WALLACE, *supra* note 6, at 16. The terminology does not present clear lines of differentiation among joint ventures, in the nature of a partnership, and long-term contracts between independent parties to cooperate in some, often discrete, endeavor. " 'Contract' joint ventures may be distinguished from 'equity' joint ventures. Contract joint ventures generally do not involve the formation of a separate corporate or partnership entity to which assets are contributed. While certain forms of contract joint venture may involve sharing of profits and amount to a general partnership, most commonly a contract joint venture is synonymous with a 'teaming arrangement' whereby two entities cooperate to carry out a particular venture either acting as co-prime contractors or pursuant to an agreement to subcontract." Stephen P.H. Johnson, *Negotiating and Drafting International Contract Joint Ventures*, in *NEGOTIATING AND STRUCTURING INTERNATIONAL COMMERCIAL TRANSACTIONS* 303 (Shelly P. Battram & David N. Goldsweig eds., 1991). The type of joint venture is important in other contexts, particularly in European Community competition law where a distinction is made between "concentrative" and "cooperative" joint ventures. See, e.g., Paul J. De Rosa, Comment, *Cooperative Joint Ventures in European Community Competition Law*, 41 *BUFF. L. REV.* 993 (1993); Alyssa A. Grikscheit, Note, *Are We Compatible?: Current European Community Law on the Compatibility of Joint Ventures with the Common Market and Possibilities for Future Development*, 92 *MICH. L. REV.* 968 (1994). Under Chinese law different consequences flow from structuring investments as "Equity Joint Ventures" or "Contractual Joint Ventures." See generally Gary J. Dernelle, Note, *Direct Foreign Investment and Contractual Relations in the People's Republic of China*, 6 *DEPAUL BUS. L.J.* 331 (1994).

²² Investment Dealers' Digest Information Services, Inc., Mergers & Acquisitions Database, Dec. 15, 1989, available in LEXIS, Compny Library, Compny File.

²³ See 1992 Annual Report of The Walt Disney Company, pp. 19, 55 n.1, 57 n.6.

²⁴ *Id.* p. 56. The Walt Disney Company reportedly has an eight-year contractual obligation to manage the business and maintain an ownership interest of at least seventeen percent. *Id.* Euro Disney completed a public offering of convertible bonds in June 1991. If all of the holders

absolute ownership arrangements present significant issues with respect to control of the foreign business enterprises.

B. Foreign Inbound Investment

Until about 1990, much of the focus of the Internal Revenue Service (Service), and accordingly the developed case law, in the transfer pricing area involved the foreign operations of United States companies. However, concern in Congress about alleged under reporting of income by the United States subsidiaries of foreign-based companies shifted that focus somewhat to inbound investment by foreign-controlled companies, particularly those based in Japan.²⁵

The amount of foreign investment in the United States is significant and increasing by several accounts. For example, as of 1981, the estimated gross book value of property, plant, and equipment of United States enterprises in which one foreign owner had a direct or indirect voting interest of ten percent or more had grown to \$178 billion.²⁶ By 1990, the estimate had grown to \$550 billion.²⁷ As a related measure of foreign investment activity in the United States, Internal Revenue Code section 6038C requires that foreign-controlled compa-

of the bonds exercised the conversion option, the Walt Disney Company's ownership interest in Euro Disney would decrease to forty-two percent. *Id.*

²⁵ See generally *Tax Underpayments By U.S. Subsidiaries of Foreign Companies: Hearings Before the Subcomm. On Oversight of the Comm. On Ways and Means*, 101st Cong., 2d Sess. (1990); *Department of the Treasury's Report on Issues Related to the Compliance with U.S. Tax Laws by Foreign Firms Operating in the United States: Hearing before the Subcomm. on Oversight of the House Comm. on Ways and Means*, 102d Cong., 2d Sess. (1992) [hereinafter *Treasury Report*]. "In 1990, the focus shifted from the so-called outbound transactions to so-called inbound transactions involving foreign corporations and their U.S. subsidiaries." Statement of Alan J. Wilensky, Deputy Assistant Secretary for Tax Policy, U.S. Department of the Treasury. *Id.* at 56. The outbound transactions, however, are not ignored. "In the early 1980s, transfer pricing disputes largely involved transfers of tangibles between US parent firms and their foreign affiliates in low-tax jurisdictions. Now center stage has been taken by transfer pricing disputes over intangibles involving US parents and their foreign affiliates." GARY CLYDE HUFBAUER (WITH JOANNA M. VAN ROOIJ), *U.S. TAXATION OF INTERNATIONAL INCOME — BLUEPRINT FOR REFORM* 111 (1992). See generally Masahiro Max Yoshimura, Comment, *The "Tax War" Between the United States and Japan under Internal Revenue Code § 482: Is There a Solution?*, 12 *WIS. INT'L L.J.* 401 (1994).

²⁶ U.S. Bureau of Economic Analysis, *Survey of Current Business*, May 1992, and *Foreign Direct Investment in the United States, Operations of U.S. Affiliates of Foreign Companies, Preliminary 1990 Estimates*, reprinted in *STATISTICAL ABSTRACT OF THE UNITED STATES* 1993 (113th Ed.) No. 1335 at 799. The "United States" for this purpose excludes Puerto Rico and other territories.

²⁷ *Id.* It, however, has been observed that the rate of Japanese investment has been declining, perhaps reflecting, in part, a shift in emphasis to the emerging markets in the Pacific Rim and eastern Europe. See P. James Schumacher, Jr., Comment, *Legal Disincentives to Japanese Direct Investment in the United States*, 4 *IND. INT'L & COMP. L. REV.* 441 (1994).

nies file reports with the Internal Revenue Service. For this purpose, control is defined as ownership of at least twenty-five percent of the stock of the company.²⁸ As of 1989, approximately 45,000 companies operating in the United States fell into this category.²⁹

When foreign-based companies invest in the United States, they do so in the context of the United States business environment, but also with reference to unique aspects of their home country. "In some countries, e.g., in the US — the terms of the relationship may be formally codified in a legally binding contract; in others, notably, e.g. Japan, though no less binding, the ties may take the form of a moral commitment or a relationship based on forbearance, trust, reputation building and allegiance to group values."³⁰ A developing issue is whether established United States principles of determining the control over, or other relatedness, of business entities can be applied effectively to businesses based on other legal and cultural assumptions. A popular example is the Japanese horizontal keiretsu, in which control is wielded by a number of companies with aligned interests, each of which alone owns only a nominal stake in the company of focus. As discussed in this paper, the informal, but nevertheless cohesive, nature of the keiretsu does not easily fit into legally based control models generally found in international business transactions.

A recent report prepared by the United Nations Conference on Trade and Development found that small and medium sized firms, particularly those from Japan, are beginning to increase their share of foreign direct investment, although large corporations still dominate international investment.³¹ These smaller enterprises were defined as firms with fewer than five hundred employees in the home country. The data does not indicate the degree of family ownership of these

²⁸ For purposes of section 6038C reporting, a corporation is twenty-five percent foreign-owned if "at least 25 percent of — (A) the total voting power of all classes of stock of such corporation entitled to vote, or (B) the total value of all classes of stock of such corporation, is owned at any time during the taxable year by 1 foreign person." I.R.C. § 6038A(c)(1) (1988).

²⁹ According to Internal Revenue Service statistics, 71.7 percent of foreign-controlled corporations paid no Federal income tax, and the Service placed the absolute number of such non-paying corporations at 32,135, which produces an estimate of 44,818 foreign-controlled corporations in total. Responses of the Internal Revenue Service to Questions Q. 1.E. and Q. 1.F. posed in Letter of Honorable J.J. Pickle to Shirley D. Peterson, Commissioner of Internal Revenue (March 23, 1992), reprinted in *Treasury Report*, *supra* note 24, at 139. The 44,818 total computed above is roughly equivalent to the 46,000 amount for "foreign firms operating in the U.S." noted by Mr. Pickle in his opening statement before the Subcommittee on Oversight of the House Ways and Means Committee on April 9, 1992. *Treasury Report*, *supra* note 24, at 7.

³⁰ See DUNNING, *supra* note 15, at 337.

³¹ United Nations Conference on Trade and Development, Programme on Transnational Corporations, *Small and Medium-sized Transnational Corporations* (1993).

firms, but one might speculate that the degree of family ownership could be greater than that in larger corporations.³² Moreover, it has been suggested that a relative handful of families control even major corporations.³³ If a trend develops toward inbound or global investments by family groups, it may present new challenges to a system that is accustomed, at least in the international transfer pricing context, to dealing with the highly visible and disclosed arrangements of publicly held companies.³⁴ This article will now review the existing law defining "control" in the context of transfer pricing.

III. THE ROLE OF CONTROL IN TRANSFER PRICING

A. "Control" in the Internal Revenue Code

The pages of the Internal Revenue Code are replete with provisions linking certain consequences to prescribed degrees of ownership or control. In some cases the consequences of meeting such thresholds are favorable to the taxpayer.³⁵ In other cases the ownership or

³² In the debate of the North American Free Trade Agreement between Vice President Gore and H. Ross Perot, televised on the Cable News Network on November 9, 1993, Mr. Perot in referring to Mexico asserted that "[t]hirty-six families own over half the country." Larry King Live, Transcript No. 961 (CNN television broadcast, Nov. 9, 1993). He later repeated the charge. "President Salinas went to the 36 families who own over 54 percent of the gross domestic product and asked them for 25 million dollars a piece." *Id.*

³³ In the 1970s, one author charged that a single family, the Mellons, had "known controlling interests in at least four of the 500 largest nonfinancial corporations. . . . It seems as reasonable to assert that the Mellons are only instances of a less visible but prevalent situation among principal proprietary families. . . . [I]t should be understood that the same small proportion of stock in the hands of such a family in a specific corporation carries different implications and potential for control than when held by a single individual with no major resources and institutions to buttress his position. It is known that a great number of related individuals may participate in the ownership of a family bloc, utilizing a complex holding pattern to keep control concentrated, despite the diffusion of ownership." Maurice Zeitlin, *Corporate Ownership and Control: The Large Corporation and the Capitalist Class*, 79 Am. J. Soc. 1073, 1098-99 (1974).

³⁴ The reported transfer pricing cases form a "Who's Who" list of large multinational companies. *E.g.*, *Du Pont de Nemours & Co. v. United States*, 608 F. 2d 445 (Ct. Cls. 1979); *United States Steel Corp. v. Commissioner*, 617 F. 2d 942 (2d Cir. 1980); *Bausch & Lomb Inc. v. Commissioner*, 92 T.C. 525 (1989); *Eli Lilly & Co. v. Commissioner*, 856 F. 2d 855 (7th Cir. 1988); *G.D. Searle & Co. v. Commissioner*, 88 T.C. 252 (1987); *Sundstrand Corp. v. Commissioner*, 96 T.C. 226 (1991); *Procter & Gamble Co. v. Commissioner*, 95 T.C. 323 (1990).

There is at least one international transfer pricing case involving family owned corporations. *See Brittingham v. Commissioner*, 598 F. 2d 1375 (5th Cir. 1979), discussed at *infra* text accompanying notes 231-32. Also, in the controlled foreign corporation context, a separate but related issue, the focus of the case law was often on family owned corporations. *See infra* text accompanying notes 149-52 & 173-76. The Service has acknowledged that a problem exists in conducting family group audits. *See infra* text accompanying note 204.

³⁵ For tax deferred treatment of corporate formations, the transferors of property must "control" the transferee corporation. *See* I.R.C. §§ 351(a) (1988 & Supp. IV 1992) and 368(c) (1988). The tax deferred success of other corporate reorganizations in part turns on "control" of certain

control requirement serves a neutral function in determining which taxpayers will be subject to a particular treatment.³⁶ However, in many instances the ownership or control test is found in the context of an anti-abuse provision, and the result is less favorable to the affected taxpayer.³⁷

In the United States taxation of international transactions, questions of ownership or control generally arise in connection with out-

parties to the reorganization. *E.g.*, I.R.C. §§ 368(a)(1)(B)-(E) (1988). Several corporate liquidation provisions are tied to degrees of ownership. *E.g.*, I.R.C. §§ 332 (1988) and 337 (1988) (dealing with liquidation of controlled subsidiaries) and 338 (1988 & Supp. IV 1992) (dealing with corporate acquisitions for which taxable treatment is desired). The dividends received deduction generally increases in amount with the degree of corporate ownership. *See* I.R.C. § 243 (1988 & Supp. IV 1992). An ordinary loss (rather than a capital loss) is permitted for the worthlessness of "affiliated" subsidiary corporations. *See* I.R.C. § 165(g)(3) (1988). Certain related parties are permitted to transfer property, at least for income tax purposes, at below-market interest rates. *See* I.R.C. § 483(e) (1988). The privilege of filing a consolidated corporate income tax return is available only for members of an "affiliated group." *See* I.R.C. § 1504 (1988 & Supp. IV 1992). As discussed in the textual materials that follow, controlled foreign corporation status, although posing some drawbacks, provides some advantages with respect to the computation of the foreign tax credit. *See* I.R.C. § 904(d)(3) (1988).

³⁶ A number of sections allocate applicable tax credits, deductions, or other incentives among related taxpayers. *E.g.*, §§ 41(f)(1) (1988 & Supp. IV 1992) (aggregation of expenditures for research credit); 44(d)(2) (1988 & Supp. IV 1992) (apportionment of Disabled Access Credit among related taxpayers); 52 (1988 & Supp. IV 1992) (apportionment of targeted jobs credit); 179(d)(6) (1988) (apportionment of property subject to election to expense); 447(d)(2) (1988) (status as a family corporation for purpose of farming accounting methods); 474(d) (1988) (small business eligibility for simplified LIFO inventory method); and 613A(c)(8) (1988 & Supp. IV 1992) (apportionment of percentage depletion exemptions). Professor Coven has divided the affinity provisions into two principal categories, relationship provisions ("definitional adjuncts to specific substantive law provisions that require for their operation a defined relationship among two or more taxpayers") and attribution provisions ("used for the purpose of expanding the scope of the relationship provisions"). Glenn E. Coven, *The Affinity Provisions of the Internal Revenue Code: A Case Study in Nonsimplification*, 45 TENN. L. REV. 557, 561 (1978).

³⁷ The anti-abuse provisions in which affiliation is a factor are numerous. *E.g.*, I.R.C. §§ 267 (1988) (limiting deductions and losses with respect to transactions between related taxpayers); 269B(c)(3) (1988) (degree of relationship for finding that entities are "stapled"); 133(b)(2) (1988) (denying interest income exclusion for employee security acquisition loans between related persons); 163(j) (1988 & Supp. 1993-94 (CCH)) (deductibility limitations placed on interest paid to certain related persons); 269 (1988) (disallowance of deductions or credits in connection with the acquisition of control when primary purpose is evasion or avoidance of tax); 304 (1988) (special treatment of redemptions made by related corporations); 453(g) (1988) (immediate recognition of recapture income on installment sales of depreciable property between related persons); 453(e) (1988) (limitations on resales, by related persons, of property acquired from a related person in an installment sale); 707(b) (1988) (limitations on sales or exchanges of property between controlling partners and the partnership); 1031(f) (1988 & Supp. IV 1992) (limitations on subsequent related party dispositions of like-kind exchange property); 1235(d) (1988) (denying capital asset treatment to sales or exchanges of patents between related persons); 1239 (1988) (denying capital asset treatment for gains from the sale of depreciable property between related persons); and 1561 (1988) (allocating the surtax and minimum tax exemptions and other attributes among controlled corporations).

bound transactions in which United States persons are the interested participants. In that regard, potential status as a "controlled foreign corporation,"³⁸ with its accompanying benefits³⁹ and drawbacks,⁴⁰ dominates planning and discussions of this area.⁴¹ Ownership by

³⁸ Status as a controlled foreign corporation is determined under I.R.C. § 957(a), which provides that a foreign corporation is a "controlled foreign corporation" if more than 50 percent of: (a) the total combined voting power of all classes of stock of such corporation entitled to vote; or (b) the total value of the stock of such corporation, is owned by United States shareholders. For this purpose, attribution rules apply. See I.R.C. § 958 (1993). Also, a "United States shareholder" means a United States person who owns a threshold stake in the corporation of ten percent or more of the total combined voting power of all classes of stock entitled to vote. See I.R.C. § 951(b) (1988). The American Law Institute has proposed that the test be modified to include as a controlled foreign corporation, a foreign corporation if more than fifty percent of the voting power of its stock is owned by one or more United States persons, each of whom owns at least ten percent of the voting power of such stock, or forty-five percent of the voting power of such stock is so owned and it is not established to the satisfaction of the Commissioner that effective control of the corporation is exercised by (or only in conjunction with) other persons who are not United States persons and are independent of such persons. AMERICAN LAW INSTITUTE, FEDERAL INCOME TAX PROJECT, INTERNATIONAL ASPECTS OF UNITED STATES INCOME TAXATION 239 (1987).

³⁹ The primary benefit of controlled foreign corporation status is that dividends, interest, rents and royalties received by the United States parent from the foreign subsidiary are characterized, for purposes of the foreign tax credit "baskets," in accordance with the nature of the underlying income of the controlled foreign corporation. See I.R.C. § 904(d)(3) (1988). If the controlled foreign corporation is engaged in active business activities, otherwise passive dividends, interest, rents, and royalties paid by the corporation will be treated as general limitation income in the hands of the parent company. See I.R.C. § 904(d)(1)(I) (1988). For the purposes of many international income tax treaties, the amount of reduction in foreign taxes on the repatriation of dividends from a foreign subsidiary is linked to the degree of ownership by the parent company, albeit at a low threshold. In the 1981 Model Treaty, for example, the tax on dividends is reduced from 15 percent of the gross dividends to 5 percent of the gross dividends, where "the beneficial owner is a company which owns at least 10 percent of the voting stock of the company paying the dividends." U.S. Treasury, 1981 Model Treaty, Article 10, ¶ 2 (June 16, 1981), reprinted in sec. 211 Tax Treaties 10,573, 10,577 (1981).

⁴⁰ Controlled foreign corporation status is the key to application of several anti-abuse provisions. The central provision is I.R.C. § 951, which requires current inclusion of "Subpart F income" by United States shareholders of controlled foreign corporations, irrespective of whether earnings are in fact repatriated. Upon a sale of stock in a controlled foreign corporation, capital asset treatment is denied with respect to a portion of the gain tied to the earnings and profits of the corporation. See I.R.C. § 1248 (1988 & Supp. IV 1992). Controlled foreign corporation status and the current inclusion of Subpart F income would be most detrimental if the foreign corporation is domiciled in a tax haven, with no local tax payable, and the income in question would not constitute general limitation "I basket" income to the parent for purposes of its worldwide foreign tax credit limitation.

⁴¹ See, e.g., Donald R. Ravenscroft, *Foreign Exchange Rate Changes, the Indirect Credit for Foreign Tax of Controlled Foreign Corporations, and Revenue Ruling 74-230*, 30 TAX L. REV. 419 (1974-75); Roy Albert Povell & L. Frank Chopin, *Operating a Buy-Sell Controlled Foreign Corporation with a Fixed Place of Business in the United States*, 1 VA. TAX REV. 215 (1981); James H. W. Insley & Lottie Wolfe Cohen, *Stapled Stock and Decontrol of Foreign Corporations: Another Loophole Closing*, 62 TAXES 322 (1984); C. Richard Baker, *A New Look at Subpart F*, 54 TAXES 572 (1976).

United States persons is also a determinative factor in status as a "foreign investment company"⁴² or "foreign personal holding company."⁴³ All of these regimes serve a common function as limitations on the controversial principle of "deferral," which in this context refers to the general rule that exempts from United States taxation the earnings of foreign corporations until the earnings are repatriated to the United States shareholders.⁴⁴ Section 482 in the outbound context serves a kindred purpose in limiting transfer pricing abuses that could expand deferral opportunities.⁴⁵ These related provisions and their degree of overlap are important in exploring the reach of section 482 because they are an important, and potentially greater, factor influencing the structure of international business vehicles.⁴⁶

⁴² A foreign corporation in which at least fifty percent of: (a) the total combined voting power of all classes of stock entitled to vote; or (b) the total value of all classes of stock is held by United States persons will qualify as a "foreign investment company" if it is registered under the Investment Company Act of 1940 as either a management company or a unit investment trust, or is engaged in, or holds itself out as engaged in, investing, reinvesting, or trading in securities (as defined in the Investment Company Act of 1940), commodities, or any interest (including a futures or forward contract or option) in such securities or commodities. See I.R.C. § 1246(b) (1988). A portion of the gain from the disposition of foreign investment company stock is treated as ordinary income with reference to the corporation's earnings and profits. See I.R.C. § 1246(a) (1988 & Supp. IV 1992).

⁴³ Among other factors, more than fifty percent of: (a) the total combined voting power of all classes of stock entitled to vote; or (b) the total value of the stock of a "foreign personal holding company" must be held by not more than five individuals who are citizens or residents of the United States. See I.R.C. § 552(a) (1993). A consequence of such status is that each United States shareholder must include in income an amount computed as a hypothetical dividend of undistributed foreign personal holding company income. See I.R.C. § 551(b) (1993).

⁴⁴ See generally Joseph Isenbergh, *Perspectives on the Deferral of U.S. Taxation of the Earnings of Foreign Corporations*, 66 TAXES 1062 (1988). It has been proposed in Congress from time to time that the deferral privilege be eliminated or significantly curtailed. See generally BORIS I. BITTKER & JAMES S. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* ¶¶ 15.60[3] & [4] (6th ed. 1994). Total repeal aside, the inconsistencies in operation of the overlapping anti-abuse provisions have prompted the introduction of harmonizing legislation on several occasions. See, e.g., Tax Fairness and Economic Growth Act of 1992, H.R. 4287, Subtitle D. For a brief discussion of the operation of the proposed revisions and citations to other commentary, see BITTKER & EUSTICE, *supra*, at ¶¶ 15.40[3] & 15.46.

⁴⁵ The standard example is a situation in which the United States parent corporation understates the value of goods, technology, or other transfers to the foreign subsidiary, thereby increasing the income captured in the foreign subsidiary that enjoys deferral of United States income taxes. The example assumes that the operations of the subsidiary do not produce income, e.g., Subpart F income, that otherwise creates an exception to the general rule of deferral. It also assumes that for some reason, e.g., lax enforcement or "tax holiday" incentives, there is not an equally or greater tax burden created in the host country.

⁴⁶ See text accompanying *infra* notes 89-100. If parties are related for purposes of section 482, that opens them to application of I.R.C. § 1059A (1988), which requires that imports from a related party be valued at no less than their declared value for customs purposes.

B. An Overview of the Statute

The purpose of section 482 adjustments is to place transactions between related parties on the same basis as that between taxpayers operating at arm's length.

A transfer pricing problem may arise when . . . transactions . . . take place between entities that are commonly controlled. Much as an individual could write arbitrary contracts with himself, without affecting in any material way that individual's economic circumstances, commonly owned corporations could write contracts among themselves without necessarily implying anything about the economic conduct of those firms.⁴⁷

However, in applying section 482 to specific transactions, one must determine who or what is a "related party."

The persons subject to allocations of gross income, deductions, credits, or allowances under section 482 are "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."⁴⁸ When first introduced to the Code in 1921, the requirement was expressed as "two or more related trades or businesses (whether unincorporated or incorporated and whether organized in the United States or not) owned or controlled directly or indirectly by the same interests."⁴⁹ The term "affiliated" is not a general definition in the

⁴⁷ Charles H. Berry et al., *Arm's-Length Pricing: Some Economic Perspectives*, 54 TAX NOTES 731, 731 (1992).

⁴⁸ The complete section is terse by Internal Revenue Code standards. "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 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. In the case of any transfer (or license) of intangible property (within the meaning of section 936(h)(3)(B)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible." I.R.C. § 482 (1988).

⁴⁹ Revenue Act of 1921, Pub. L. No. 98, § 240(d). The provision permitted the "Commissioner [to] consolidate the accounts of such related trades and businesses, in any proper case, for the purpose of making an accurate distribution or apportionment of gains, profits, income, deductions, or capital between or among such related trades or businesses." *Id.* The legislative history discloses the stated reasons for the new legislation. "Subsidiary corporations, particularly foreign subsidiaries, are sometimes employed to 'milk' the parent corporation, or otherwise improperly manipulate the financial accounts of the parent company." H.R. Rep. No. 350, 67 Cong., 1st Sess., 14 (1921). "This is necessary to prevent the arbitrary shifting of profits among related businesses, particularly in the case of subsidiary corporations organized as foreign trade corporations." S.Rep. No. 275, 67th Cong., 1st Sess., 20 (1921). In the Revenue Act of 1924 the provision was amended to also require that the Commissioner allow such consolidation at the

Code,⁵⁰ and it is not specially defined in the section. The term was added to the statute in the Revenue Act of 1928 when the provision was removed as a subsection in the consolidated return provisions and elevated to the status of a separate section 45.⁵¹ Presumably the language was included to reject, in general terms, a threshold percentage of common stock ownership as a requirement.⁵² On the other hand, the otherwise undefined "related" modifier was dropped in the 1928 amendments and that produced a statute closely resembling current section 482.⁵³ The focus today is accordingly on the phrase "owned or controlled directly or indirectly by the same interests."

request of the taxpayer. "[T]he Commissioner may and at the request of the taxpayer shall, if necessary, in order to make an accurate distribution or apportionment of gains, profits, income, deductions, . . . consolidate the accounts of such related trades or businesses." Revenue Act of 1924, Pub. L. No. 176, § 240(d).

⁵⁰ "Affiliated" is used throughout the Internal Revenue Code but is defined locally for the application of specific sections. *E.g.*, I.R.C. § 165(g)(3) (1988) (defining "affiliated corporation" for purposes of the treatment of worthless securities); I.R.C. § 1504 (a) (1988) (defining "affiliated group" for purposes of consolidated income tax returns).

⁵¹ Prior to 1928, the provision was a subsection in section 240 which generally dealt with the filing of consolidated tax returns. In 1928 the consolidated return provisions were redesignated as sections 141 and 142, and the precursor to section 482 was designated section 45. The early language, which was couched in terms of "consolidation," was changed to be an anti-avoidance tool, wielded solely by the Commissioner (apparently some taxpayers had asserted that the language permitted the filing of consolidated returns by a taxpayer, even when the corporations were not part of an affiliated group) and "related" was dropped as a modifier of "trades or businesses." The product of the 1928 amendments closely resembles today's statute. "In any case of two or more 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 Commissioner is authorized to distribute, apportion, or allocate gross income or deductions among such 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 trades or businesses." Revenue Act of 1928, P.L. 562, § 45.

⁵² "This reference, however, is evidently intended to make it clear that § 482 applies to related corporations whether or not affiliated in the technical sense of qualification to file consolidated returns." BITTKER & EUSTICE, *supra* note 44, ¶13.20[3][a].

⁵³ See *supra* note 51 for a unified discussion of the 1928 amendments. In the 1934 Act, the word "organizations" was joined with "trades, or businesses" in the statute. The purpose was "to remove any doubt as to the application of this section to all kinds of business activity." H.R. Rep. No. 704, 73d Cong., 2d Sess., 24 (1934). In 1943, the phrase "gross income or deductions" was deleted and "gross income, deductions, credits, or allowances" was inserted in its place. Pub. L. No. 235, 78th Cong., 2d Sess. The inclusion of this language was intended to create symmetry with new section 129, which dealt with acquisitions made to evade income or excess profits tax, the ancestor of current section 269. See generally H.R. Rep. No. 871, 78th Cong., 1st Sess., 71 (1943). In 1954, the current language, but for two modifications, was adopted. In 1977, the phrase "or his delegate" which had followed the word "Secretary" in the 1954 statute, was deleted. The final sentence dealing specifically with intangible property was added by section 1231(e)(1) of the Tax Reform Act of 1986, Pub. L. No. 99-514.

1. Ownership

“Owne[rship]” and “control” are expressed in the disjunctive so one could apparently apply each term in isolation. That approach does not work well with “ownership” alone because the statute does not prescribe a threshold ownership stake. That is, what constitutes two organizations “owned . . . by the same interests” if the common ownership is less than one hundred percent?⁵⁴

Although ownership and control will often accompany one another, one can easily envision structures in which ownership and control are separated. The separation could arise, for example, in a widely-held corporation with dispersed ownership in which no shareholder holds a controlling stake. In that event, management could essentially control the corporation without ownership.⁵⁵ Separation could also be produced through legal devices such as voting trusts or irrevocable proxies. Some entities, notably charitable organizations and mutual companies,⁵⁶ will have no owners. Although section 482 easily applies to the one hundred percent ownership situation, many business structures will involve multiple parties where less than one hundred percent of the entity is owned by the putative controlling party. In such cases, the determinative factor in application of section 482 will be the presence of “control.”

⁵⁴ There are a number of cases applying section 482 to one hundred percent owned and controlled entities. *E.g., Miles Conley Company, Inc. v. Commissioner*, 10 T.C. 754 (1948) (sole stockholder of corporation and sole proprietor of a business, both considered under common control). All of the transfer pricing cases cited at *supra* note 34 involved one hundred percent owned subsidiaries of a corporate parent.

⁵⁵ The seminal work is the treatise by ADOLF A. BERLE, JR. AND GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (1932). The authors divided control into five types: (1) control through almost complete ownership; (2) majority control; (3) control through a legal device without majority ownership; (4) minority control; and (5) management control. *Id.* at 70. Professors Berle and Means acknowledged that management control, which rests on the passivity of the shareholders, is not permanent. “Even here, however, there is always the possibility of revolt. A group outside the management may seek control. If the company has been seriously mismanaged, a protective committee of stockholders may combine a number of individual owners into a group that can successfully contend with the existing management and replace it by another that in turn can be ousted only by revolutionary action.” *Id.* at 88.

⁵⁶ For the application of section 482 to a tax exempt organization and a municipal district, see *infra* text accompanying notes 58-65. As discussed at *infra* text accompanying notes 89-100, some comparisons can be made between control for section 482 and that found in section 957 dealing with controlled foreign corporations. In that regard, the temporary regulations interpreting section 953 (dealing with captive insurance companies) treat as a controlled foreign corporation, a foreign mutual insurance company that “issues insurance policies that provide the policyholder with the right to vote for directors of the corporation, the right to a share of the assets upon liquidation in proportion to premiums paid, and the right to receive policyholder dividends in proportion to premiums paid.” 26 C.F.R. § 1.957-1T(c), example 9 (1994).

2. Control

For the purpose of section 482, actual control of the entity must be found and prescribed percentages of voting power are eschewed. The regulations, in defining "controlled," state that it "includes any kind of control, direct or indirect, whether legally enforceable, and however exercisable or exercised. It is the reality of the control that is decisive, not its form or the mode of its exercise."⁵⁷ The concept of control, as applied to specific situations, will be explored later in this paper. However, some general observations are appropriate at this point.

a. Control Without Ownership

As noted above⁵⁸ in many cases the controlling parties of an entity will not own controlling ownership stakes, but that is not an obstacle to application of section 482.⁵⁹ There are some examples of the extreme case, in which the controlling party does not own any interest in an entity.

In *Southern College of Optometry, Inc. v. Commissioner*,⁶⁰ the Tax Court found that an organization owned by no one could be linked with another based on common control. A husband and wife together owned all of the stock of the Southern College of Optometry, Inc., a for-profit corporation. They were also the president and secretary-treasurer, respectively, of that corporation and two tax-exempt corporations. The tax-exempt corporations did not have shareholders and were governed by trustees, of which the husband and wife were two of six. The husband received a salary as president of the corporation and as a teacher. Neither spouse, however, was paid any compen-

⁵⁷ Treas. Reg. § 1.482-1T(g)(4) (1993). As discussed at *infra* text accompanying notes 89-100, similar practical control tests are utilized in determining whether foreign corporations are "controlled" by United States persons. A practical control standard is also utilized in connection with the taxation of controlled entities of foreign governments. See Treas. Reg. § 1.892-5T(c)(2) (1988) ("Effective practical control may be achieved through a minority interest which is sufficiently large to achieve effective control, or through creditor, contractual or regulatory relationships which, together with ownership interests held by the foreign government, achieve effective control").

⁵⁸ See *supra* text accompanying notes 54-56.

⁵⁹ With respect to controlling persons, Professors Bittker and Eustice have concluded that there is no need for a finding of a pecuniary benefit from exercising a power subject to section 482 reallocation. "It does not appear to be necessary that the persons with control expect to gain a direct economic benefit from exercising their power; it is enough that control is exercised in a non-arm's length manner to distort the taxable income of the controlled enterprises." BITTKER & EUSTICE, *supra* note 44, ¶13.20[3][a].

⁶⁰ 6 T.C.M. (CCH) 354 (1947).

sation by the tax-exempt corporations, which paid salaries to other individuals who held the titles of directors or deans.

The tax-exempt corporations occupied space leased by the for-profit corporation from its shareholders. The tax-exempt corporations paid no rent to the taxpayer. The Service asserted that portions of the lease payments, insurance costs, and compensation of the husband as president were properly allocable to the tax-exempt corporations under an ancestor of section 482. The Tax Court agreed with the government. It found that the suggestions of the husband and wife were generally accepted by the other trustees. The apparent influence over the trustees, coupled with the control over daily activities provided by officer authority, were enough for a finding of control, supporting an allocation of expenses between the for-profit corporation and "its commonly-controlled exempt affiliates."⁶¹ It did not matter that the controlling parties did not own a pecuniary interest in the tax-exempt organizations; the statute does not require it.

There clearly was an improper income tax result produced by permitting the tax-exempt organizations to occupy space, rent free, leased by the for-profit corporation which in turn deducted all of the rent paid for the building. The nagging question from a practical standpoint is why the for-profit corporation's shareholders would permit this economic benefit to be bestowed on another entity in which they did not hold a pecuniary interest. They did earn a living from the synergy of the taxpayer's activities and those of the tax-exempt corporations, but why not be more greedy? Curiously, this issue was not raised.⁶²

The Tax Court again grappled with this question in *Foster v. Commissioner*,⁶³ which involved a partnership owned equally by a father

⁶¹ 6 T.C.M. (CCH) at 357.

⁶² The Tax Court could have responded as a matter of law that pecuniary benefit is irrelevant to the inquiry of whether there was a distortion of income. See *supra* note 59. If the issue had been approached on the facts, the Tax Court would have probably viewed any claim of crisp compartmentalism in the overall fact situation with some skepticism. An increase in rent or general and administrative expenses charged to, or paid directly by, the tax-exempt corporations, for example, would directly or indirectly increase the taxable income of the for-profit corporation, precisely the Service's goal. However, if the common control were so absolute, the total balance of wealth among the enterprises could be maintained, ignoring income tax costs, by reducing other related party expenditures of the tax-exempt entities, like salaries. This assumes that the proper amounts of the other expenditures are sufficiently pliable such that new section 482 issues are not produced. Perhaps the shareholders considered their control of all the entities to be so absolute that although they forfeited some additional wealth in the short term, they were confident that it could be recouped at some point in the future, the point in time being within their control.

⁶³ 80 T.C. 34 (1983).

and his three sons, a number of similarly owned "alphabet" real estate development corporations, and a California municipal district, the Estero Municipal Improvement District. The partnership was engaged in developing a large real estate project. The special improvement district was formed to help finance the project through its governmental borrowing authority. The district itself was also very active in constructing the project infrastructure. The partnership held certain parcels until most of the expenses had been incurred, and then transferred interests in the parcels to serially formed corporations. The maneuver was an attempt to capture the income from the sale of the property in the corporations that were taxed at a lower rate than the individual partners of the partnership.

The district was a quasi-governmental entity created by special California legislation and had no "owners." The district was governed by a board of three directors that was elected by the partnership through voting rights appurtenant to the land subject to the district.⁶⁴ The court first found that the partnership therefore controlled and dominated the special district for purposes of section 482. The court then attributed the development activities of the special district, which produced the increase in value of the land, to the controlling partnership, and consequently to the individual partners.⁶⁵

There are several cases that combine the courts' general skepticism about the absence of control in family-owned enterprises⁶⁶ with fact situations in which a party is held to be a controlling person in the absence of any ownership in the entity. In *Pauline W. Ach v. Commissioner*,⁶⁷ for example, the taxpayer transferred a profitable sole proprietorship to a net operating loss-laden corporation owned by her sons. The mother's business had been extremely profitable for years. Nevertheless, she sold the business for its net book value, receiving no stock in the corporation. The sons were not active in the day-to-day management of the corporation, but they did attend meetings of the board of directors and shareholders. The mother took no salary as manager, and approximately six years later, after the net operating

⁶⁴ Subsequent California legislation required that one of the three directors be designated by the County Board of Supervisors. See generally 80 T.C. at 61. However, the partnership still controlled the board because it could choose two of its three members. *Id.* at 165 n.79. In a year following the years in question, the board was to be expanded to five members, all of whom were to be residents of the community.

⁶⁵ The taxpayers did not argue in response that the corporations, instead of the partnership, controlled the special improvement district. This probably would have been futile because the partnership owned most of the land subject to the district. See generally 80 T.C. at 169-70.

⁶⁶ See *infra* text accompanying notes 211-35.

⁶⁷ 42 T.C. 114 (1964), *aff'd*, 358 F. 2d 342 (6th Cir. 1966), *cert. denied*, 385 U.S. 899 (1966).

losses had been utilized and some related party loans repaid, the sons returned the stock of the corporation to their mother for no consideration.

The Service asserted that the income of the business was not properly allocable to the corporation and instead included it in the taxpayer mother's income, because she controlled both the former sole proprietorship and the corporation.⁶⁸ The taxpayer argued that she lacked control, because she did not own any stock of the loss corporation. That argument was rejected by the courts because she enjoyed control through her positions as chairman of the board, president, and treasurer and as the individual responsible for directing the day-to-day business activities of the corporation.

If control for purposes of section 482 is easily separated from ownership of the entity, the opportunities for application of the statute multiply because it would seem to be easier to exercise control, even if temporary, through a number of means where actual ownership might be unattainable.

b. Temporary Control

Many forms of control are not permanent. Voting trusts, for example, are often limited in duration.⁶⁹ Control through the dynamics of corporate governance can be transient if produced, for example, through management control by dispersion of shareholder ownership⁷⁰ or minority control.⁷¹

If one accepts the premise that one need not derive pecuniary benefit from manipulations of income or expense subject to section

⁶⁸ Section 482 provides for allocations only among organizations or "trades or businesses" under common control. One might criticize this aspect of the opinion for recreating the sole proprietorship, which hadn't existed for several years, to be one of the two trades or businesses required for application of section 482. The allocation of income to Mrs. Ach, individually, is somewhat controversial if she were acting only as an investor, and was not herself engaged in a trade or business. This is the familiar issue raised by the decision in *Foglesong v. Commissioner*, 691 F.2d 848 (7th Cir. 1982). See generally BITTKER & EUSTICE, *supra* note 44, ¶13.20[2][a].

⁶⁹ A voting trust generally is valid for not more than 10 years, subject to extension by the parties. See MODEL BUSINESS CORP. ACT § 7.30 (1984).

⁷⁰ See *supra* note 55. For purposes of determining control in the context of the securities laws, one commentator noted that "[t]hose who exercise control by the sufferance of those with the power to control may also be controlling persons." A.A. Sommer, Jr., *Who's "In Control"?* - S.E.C., 21 BUS. LAW. 559, 564-65 (1966).

⁷¹ "So long as the affairs of the corporation run smoothly, minority control may be quietly maintained over a period of years. But in time of crisis, or where a conflict of interest between the control and the management arises, the issue may be drawn and a proxy fight to determine control may demonstrate how far dependent upon its appointed management the controlling group has become." BERLE & MEANS, *supra* note 55, at 81.

482,⁷² nor that the controlling party have ownership of the entity in question, the conclusion follows that even transitory control will invoke the section. This point is particularly significant in the context of ownership arrangements that involve a so-called "fade-out" structure in which the stake of one participant is scheduled to diminish at a certain point or points in the future. Such phase-out provisions may be a required condition of the host country government.⁷³ Apart from scheduled transitions like the fade-out, it is reasonably well documented that joint ventures, for example, are relatively unstable and most should not be expected to last for a significant period.⁷⁴ The control by one party may exist for a period that is shorter than the period over which certain otherwise related party transactions will take place. For example, a lease, promissory note, or license agreement may still be executory long after control is lost. Based on sparse case law, one commentator has concluded that the control relationship "should exist both at the time the contract or loan was entered into and at the time of the allocation."⁷⁵ This conflicts with the Ser-

⁷² See *supra* note 59.

⁷³ "The 'fade-out' formula is a scheme that provides for the progressive transfer of ownership and/or control of an established foreign enterprise into the hands of the host state or its nationals and, as such, is not only a technique of control over foreign operations, but is at the same time a technique of programmed disinvestment enforced by the host state." WALLACE, *supra* note 6, at 244. See generally Buckley, *supra* note 7, at 49. In *Alladin Indus. v. Comm'r*, 41 T.C.M. (CCH) 1515 (1981), the taxpayer's wholly-owned subsidiary, Pathfinder Resources, Inc., was one of two equal partners in a land development partnership that needed additional capital. As a part of the transaction, Alladin Industries guaranteed the partnership debt and Pathfinder Resources, Inc. agreed to advance funds required to make necessary interest payments. The existing 50:50 profit and loss ratios and capital account percentages were modified in favor of Pathfinder Resources, Inc., to be eighty percent and fifty-five percent, respectively, until the loan was repaid. Although the change was temporary and the partnership was returned to equal ownership upon the loan's repayment, the taxpayers conceded, and the Tax Court found, that the taxpayer and the partnership were controlled by the same interests. The court ignored the fact that management of the partnership continued to be shared, with equal votes held by each partner in management, including operations, and expenditures or investments in excess of \$1,000. The opinion is somewhat cryptic because it was a hearing on cross-motions for summary judgment. The litigants apparently settled the case at some point thereafter.

⁷⁴ In one study, the average life span of a venture was 3.5 years with a standard deviation of 5.8 years. "Of the ventures studied 42 percent lasted more than 4 years, 86 percent of them lasted less than 10 years, and 2.6 percent of them lasted 20 years or more. Of the ventures that were mutually assessed to be successful by their sponsors, 50 percent lasted at least 4 years." Kathryn Rudie Harrigan, *Strategic Alliances and Partner Asymmetries*, in COOPERATIVE STRATEGIES IN INTERNATIONAL BUSINESS, *supra* note 8, 205, 207.

⁷⁵ James P. Fuller, *Section 482 Revisited*, 31 TAX L. REV. 475, 485 (1976). The author based his conclusion on an equivocal footnote in *Cayuga Service, Inc. v. Commissioner*, 34 T.C.M. (CCH) 18, 24 n.2 (1975), and on the facts of *R.T. French Co. v. Commissioner*, 60 T.C. 836 (1973). In *R.T. French*, the Tax Court examined the payment of royalties paid by a wholly-owned United States company to a foreign corporation that was only fifty-one percent owned by the owners of the United States company at the time the long-term license was entered into, but

vice's view of the treatment of executory contracts in another related party context, i.e., gifts, in which the transfer is deemed to occur, and the gift tax aspects are resolved, as of the date the agreement is enforceable, rather than when payments are made.⁷⁶ Nevertheless, in the absence of a planned or scheduled future change of ownership, and in the presence of a contract that is not terminable by the party against whom a section 482 allocation would be asserted, the original arm's length dealings should be a strong factor in support of the agreement's terms, even after a change in control occurs.

c. Contingent Control

It is probably a misnomer to consider the holder of an option to purchase a controlling interest as having "contingent" control. The

that was wholly-owned at the time of the payments in question. The court looked at a number of factors and was, in part, persuaded by the practical suggestion that one would not structure an excessive payment to another entity in which one holds only a fifty-one percent stake. The agreement was amended during the sole ownership period, but the amendments did not significantly change the terms of the prior arm's length bargain. The legislative history accompanying the Tax Reform Act of 1986's enactment of the last sentence of section 482, dealing with the transfer or license of intangible property (see *supra* note 48), suggests that later revisions might be required for transfer pricing purposes to arrangements that were on an arm's length basis when originally negotiated. The "Blue Book" writers noted that "Congress did not intend . . . that the inquiry as to the appropriate compensation for the intangible be limited to the question of whether it was appropriate considering only the facts in existence at the time of the transfer. Congress intended that consideration also be given to the actual profit experience realized as a consequence of the transfer. Thus, Congress intended to require that the payments made for the intangible be adjusted over time to reflect changes in the income attributable to the intangible." Staff of the Joint Committee on Taxation, 99th Cong., *General Explanation of the Tax Reform Act of 1986* 1016 (Comm. Print May 11, 1987). The Service has provided several narrow safe harbors from such periodic reallocations in the applicable regulations. See, e.g., Treas. Reg. § 1.482-4T(e)(2) (1993). In *Mornes, Inc. v. Commissioner*, 43 T.C.M. (CCH) 317 (1982), a corporation paid an overstated price for inventory purchased from a related party. At the time of the purchase, the purchasing corporation was owned by two brothers. At the time of the Service's adjustment, denying a portion of the purchasing corporation's loss on worthless inventory, only one of the brothers owned the stock of the corporation. The Tax Court noted that there is no requirement that the same persons own the corporation both at the time of sale and at the time of the reallocation. See generally 43 T.C.M. at 333. However, that was a very cursory analysis because the court then proceeded to find on the facts that both brothers in fact still owned the corporation. See *infra* text accompanying notes 78-79. This is a different issue from the question being considered. The slight equivocation in *Mornes* notwithstanding, it is somewhat settled that identity of the particular shareholders, for example, is not required. The statutory phrase "same interests" does not mean the "same persons," and different persons can be linked over time by a common goal, design, or purpose. For a discussion of this point, see *Brittingham v. Commissioner*, 66 T.C. 373, 396-400 (1976).

⁷⁶ For example, in Rev. Rul. 69-347, 1969-1 C.B. 227, the Service addressed the timing of the gift in connection with payments made pursuant to an antenuptial agreement, ruling that the gift arose when "the taxpayer became legally obligated to perform according to the terms of the agreement." 1969-1 C.B. at 228.

option holder may already have influence over governance, and therefore a degree of control, because of the potential impact of the option's exercise.⁷⁷

The potential ownership by a creditor created through a pledge of shares as collateral for a loan can raise similar issues. *Mornes, Inc. v. Commissioner*,⁷⁸ presented some of those facts. An individual was found to be in control of the corporation even after he had sold his shares. Of course, the arrangement wasn't that simple. The terms of the stock sale provided that there would be no transfer of the stock until full payment was made. In addition, the seller retained the voting rights to the stock until it was conveyed. Because the selling shareholder had retained the shares and voting rights as collateral for the stock purchase obligation, the rights retained were enough to provide control because the purchaser did not own "all incidents of ownership"⁷⁹ in the stock.

In other sections of the Internal Revenue Code the effect given to convertible securities, at the pre-conversion stage, is inconsistent. For example, the regulations interpreting the one-class of stock requirement for S corporations use a reality test that looks to the probability

⁷⁷ At least one section 482 case included facts in which one of the parties held an option to acquire stock in one of the relevant entities. In *Rubin v. Commissioner*, 429 F.2d 650 (2d Cir. 1970), *rem'g*, 51 T.C. 251 (1968), the taxpayer, Rubin, was a seventy percent shareholder in Park International, Inc., and Rubin's two brothers each owned a fifteen percent stake. The corporation contracted to loan money and provide management services to another corporation, Dorman Mills, Inc. Rubin did not own any stock in Dorman Mills, Inc., but he did hold a four-year option to buy a controlling stake in the corporation, and, in the interim, held the right to vote the stock subject to the option. The Tax Court upheld a reallocation of income between Park International, Inc. and Rubin, individually. With respect to Park International, Inc., the decision supports the unsurprising conclusion that, in the absence of a corporate action requiring a super majority vote, seventy percent voting control is enough to create control. The allocation was not between Dorman Mills, Inc. and Rubin individually and that result would have given some guidance as to the control effect of the purchase option, the voting rights, and the management powers. In addition, at an early point in the relationship, in 1958, Rubin apparently exercised the option and actually purchased the stock of Dorman Mills, Inc.

⁷⁸ 43 T.C.M. (CCH) 329 (1982).

⁷⁹ 43 T.C.M. at 334. The same issue arises with respect to control for purposes of the securities laws. "Frequently creditors will be in this position [of a controlling person] as a consequence of the right to vote the pledged shares as a part of the transaction, or because upon default they have a right of foreclosure." Sommer, *supra* note 70, at 571. Compare Rev. Rul. 55-458, 1955-2 C.B. 579 (stock purchased but held in escrow can be counted in determining affiliation for the filing of a consolidated tax return; buyer had all rights to voting and dividends until a default). "It is the right of ownership . . . that controls rather than possibility that under certain circumstances nonexistent during such period, such right of ownership might be forfeited." 1955-2 C.B. at 579. See also *Miami National Bank v. Commissioner*, 67 T.C. 793 (1977) (stock sold to taxpayer but still held in a "subordinated securities account" of the seller qualified as stock owned by the taxpayer in creating an affiliated group).

that the option will be exercised.⁸⁰ On the other hand, stock with contingent voting rights is not treated as having voting rights for purposes of the redemption provisions “until the happening of the specified event.”⁸¹ Some analogies also might be made to the treatment of warrants and convertible debt instruments as “stock” or “securities” in the reorganization provisions where such instruments are usually denied the status of stock unless exercised.⁸²

None of the analogies to other Internal Revenue Code sections works particularly well, since the setting and objectives of those sections are dissimilar.⁸³ Two expressly “international” taxation provisions do equate options with stock ownership, without qualification. Section 958, which prescribes the stock ownership rules for the precise controlled foreign corporation provisions, incorporates the attribution rules of section 318, which in turn contain a rule that considers stock subject to a purchase option as owned by the holder of the option.⁸⁴ Section 554, which prescribes the stock ownership rules for the foreign personal holding company provisions, similarly treats stock subject to a purchase option as stock owned.⁸⁵ Moreover, subsection 554(b)

⁸⁰ “. . . [A] call option, warrant, or similar instrument (collectively, call option) issued by a corporation is treated as a second class of stock of the corporation if, taking into account all the facts and circumstances, the call option is substantially certain to be exercised (by the holder or a potential transferee) and has a strike price substantially below the fair market value of the underlying stock on the date that the call option is issued.” Treas. Reg. § 1.1361-1(l)(4)(iii)(A) (1992).

⁸¹ “Generally, for purposes of this section, stock that does not have voting rights until the happening of an event, such as a default in the payment of dividends on preferred stock, is not voting stock until the happening of the specified event.” Treas. Reg. § 1.302-3(a) (1955).

⁸² I will not repeat the involved analysis. See BITTKER & EUSTICE, *supra* note 44, ¶ 12.41[4].

⁸³ For example, section 302(c) (1988) (dealing with waivers of family attribution in connection with redemptions that completely terminate a shareholder’s interest in the corporation) strictly prohibits any interest other than as a creditor, because the redeeming shareholder is supposed to completely sever any equity relationship in the corporation, not just control. See generally Michael D. Rose, *The Prohibited Interest of Section 302(c)(2)(A)*, 36 TAX L. REV. 131 (1981).

⁸⁴ See I.R.C. § 318(a)(4) (1988).

⁸⁵ I.R.C. § 554(a)(3) (1988). In Rev. Rul. 82-150, 1982-2 C.B. 110, the Service ruled that an option to purchase stock should be considered as stock for purposes of the foreign personal holding company rules. Section 554(a)(3) would have readily treated the option as stock for purposes of constructive ownership in determining whether the corporation was a foreign personal holding company. However, this would not have extended to section 551(a), the income inclusion section of the foreign personal holding company provisions. Consequently, the Service ruled that under a substance over form analysis, the option holder owned the equivalent of stock for all purposes. The facts of the ruling are somewhat unique. The option holder paid 70,000x for an option to purchase all of the stock of the corporation for 30,000x. The assets of the corporation consisted of 100,000x. Because the option holder, as the beneficial owner of one hundred percent of the corporation’s stock, assumed the benefits and burdens of ownership of the shares, the Service ruled that it was as if the sale of the stock had in fact been completed.

treats convertible securities as stock. Both the controlled foreign corporation and foreign personal holding company provisions are aimed at abuses of the international taxation principle of "deferral."⁸⁶ Section 482 serves a similar function with regard to outbound transactions, but it also applies to inbound transactions, as well as domestic transactions, which raise other concerns. As exceptions to the rule of deferral, the key stock ownership provisions are expressed at length in the respective statutes; the section 482 control provision is not. It seems that the common thread of international taxation impact is not enough to weave the precise controlled foreign corporation and foreign personal holding company provisions together with the expansive section 482 provisions, in view of the different objectives and styles of statutory expression. The section 482 regulations' flexible search for the practical "reality" of control would suggest that the appropriate test should resemble that of the S corporation regulations, looking to the objective likelihood that the option will be exercised. In that regard, contingencies that are outside of the taxpayer's control,⁸⁷ other than the simple passage of time,⁸⁸ might be given less weight, and vice versa.

C. Cooperative Business Structures

1. *The Controlled Foreign Corporation Connection*

When United States companies do business abroad with foreign partners in a collaborative venture, the parties will generally have a number of dealings with the venture that have section 482 overtones for the United States participant. The United States company may sell or license goods or technology to the venture, and, on the other hand, may acquire other goods or technology from the venture. As

⁸⁶ See *supra* text accompanying notes 38-46.

⁸⁷ For example, the option to purchase another shareholder's interest upon death, dissolution, or some other independent event should not be considered control until the triggering event occurs. On the other hand, an option that can be initiated by the taxpayer, for example, a mutual buy-sell, could have the effect of control if there were no significant impediments to the exercise of the option. See *infra* text accompanying notes 169-84 (dealing with the courts' treatment of purchase options and deadlock breaking devices in the context of the controlled foreign corporation provisions).

⁸⁸ Control that is deferred in time, but still a certainty if the taxpayer wishes to elect it, has so much potential power that it could be treated as present control. Still, should the taxpayer be deemed to have so elected if there are significant obstacles to, or a price tag on, such exercise? The objective test of practical reality would mitigate the otherwise harsh rule produced by this test. Professor Coven seems to adopt such a test for the purpose of proposed changes to the option attribution rules, if one reads his footnote 295 as a significant exception to the rule expressed in the text of his article. See Coven, *supra* note 36, at 698-99.

noted in the first pages of this paper, it appears that the importance of joint ventures (whether corporate or partnership in nature) appears to be rising,⁸⁹ and the presence of unrelated parties in the foreign venture makes the potential section 482 control issues more interesting than those posed by the wholly-owned subsidiary that has been the dominant vehicle for foreign direct investment. This article uses the term "joint venture" broadly, in reference to a business enterprise in which there is shared ownership. Reflecting the laws of the host country,⁹⁰ and the ever present income tax structuring considerations,⁹¹ the "joint venture" could take the form of a partnership, a limited liability company, or a corporation. Joint ventures of a purely contractual nature, like co-production or joint marketing alliances, are discussed in the last part of this paper.

Section 482 issues are also raised by inbound investments by foreign persons in the United States, in dealings between the foreign company and its United States affiliate.⁹²

In the application of section 482 to these operations, an issue will be the degree of control created by the almost infinite number of variations in the legal and practical structure of the relationship between the parties. While there are several section 482 cases that give some direction as to the effect on control of certain ownership arrangements, additional direction can be found in several controlled foreign corporation cases interpreting the control requirement of section 957. Section 482 in its outbound applications serves to guard against abuses of the foreign income deferral principle. Status as a controlled foreign

⁸⁹ See *supra* text accompanying notes 6-24.

⁹⁰ See generally Richard E. Cherin & James J. Combs, *Foreign Joint Ventures: Basic Issues, Drafting, and Negotiation*, 38 BUS. LAW. 1033 (1983). The possibilities are even more numerous in civil law countries and would include the corporation, limited liability company, limited partnership, limited partnership with shares, general partnership, and contractual joint venture. See CHARLES H. GUSTAFSON & RICHARD CRAWFORD PUGH, *TAXATION OF INTERNATIONAL TRANSACTIONS* 1991-1993 742-44 (1991).

⁹¹ The principal issue is whether the foreign structure will be so-called "transparent," so that income, losses, and foreign tax credits flow directly to the United States corporate owner. Characterization as a partnership or branch for United States income tax purposes will provide this result, if it is desired. On the other hand, status as a foreign corporation will generally eliminate such immediate passthrough treatment, subject to Subpart F implications, but the deferral of United States income tax on the foreign profits, until repatriation, will be gained.

⁹² A foreign person doing business in the United States will also be concerned with compliance under I.R.C. § 6038 (1988 & Supp. IV 1992) (pertaining to the provision of certain information regarding corporations controlled by foreign persons). There is some relationship between control for purposes of section 482 and that invoking section 6038A. See David Tillinghast & Karen Haum, *Determining When a Foreign Person Is "Related" for Purposes of Sections 6038A and 482*, 4 TAX NOTES INT'L 39 (1992). Inbound transactions are a recent focus of the Service. See *supra* text accompanying notes 25-34.

corporation likewise can give rise to current recognition of income from so-called "Subpart F income" activities considered by Congress to be abusive. Control is a precondition to application of section 482 and application of the Subpart F provisions also turns upon "control" of the foreign corporation.⁹³

Section 957 is more narrowly drafted than section 482 with regard to control. At the time of the litigated cases, control under section 957 was achieved only if "more than 50 percent of the total combined voting power of all classes of stock entitled to vote is owned . . . by United States shareholders."⁹⁴ The Tax Reform Act of 1986 broadened control to include situations in which more than fifty percent of total combined voting power *or* more than fifty percent of total value of the stock in the corporation is owned.⁹⁵

The value prong appears to be largely irrelevant in drawing analogies for section 482 purposes because application of section 482 is control, rather than ownership, driven. The voting power test of section 957, however, is relevant to section 482, particularly because the regulations reflect an almost paranoid examination of all aspects of the voting power arrangement, much like the section 482 search for indirect control, in determining "if in reality voting power is retained."⁹⁶ A comparison of the control thresholds of sections 482 and 957 is also pertinent because the planning focus is probably on avoiding controlled foreign corporation status with its drawbacks,⁹⁷ or ac-

⁹³ The control test was fashioned to preclude the indefinite retention abroad of the Subpart F earnings. "[T]he power to compel distribution of that income strongly supports the equity of the tax; and the voting power of the shareholders seems most appropriately to measure this power." AMERICAN LAW INSTITUTE, *supra* note 38, at 233-34. The statute further reflects the underlying legislative assumptions about shareholder control over the retention of earnings of the foreign corporation. A shareholder is not counted in the control group, nor subjected to pre-emption income recognition, if a less than ten percent interest is held. See I.R.C. § 951(b) (1988).

⁹⁴ I.R.C. § 951(a) (West 1993).

⁹⁵ The American Law Institute recommended that the value test be eliminated because the "decontrol" problem appears to be a limited one. See *supra* note 38, at 238-39.

⁹⁶ "Any arrangement to shift formal voting power away from United States shareholders of a foreign corporation will not be given effect if in reality voting power is retained. The mere ownership of stock entitled to vote does not by itself mean that the shareholder owning such stock has the voting power of such stock for purposes of section 957." Treas. Reg. § 1.957-1(b)(2) (1988).

⁹⁷ For a brief discussion of the disadvantages of controlled foreign corporation status, see *supra* note 40. For a critique of the use of joint ventures to possibly avoid Subpart F income status see Colman J. Burke, *Can Subpart F Income Be Avoided Through the Use of a Partnership?*, 81 J. TAX'N 4 (1994).

tively seeking such status for its advantages,⁹⁸ and tax driven structuring would proceed in accordance with the selected goal. If avoidance of controlled foreign corporation status will also negate control for purposes of section 482, the section 482 control issue would be effectively mooted by the section 957 planning. On the other hand, if the interpretations of section 482 are more expansive, the issue must be dealt with even after the section 957 aspects are resolved. Furthermore, in some situations, achieving controlled foreign corporation status will be a desired goal of the United States investor.⁹⁹ Because a focus of section 957 is on value, it would seem possible that a United States corporation could hold more than fifty percent of the value of the foreign corporation, attaining controlled foreign corporation status, while avoiding control of the foreign corporation for section 482 purposes.

There are few cases interpreting the control test of section 957, and the area has been ably explored.¹⁰⁰ Consequently, that material will be recalled only to the degree necessary for making comparisons to section 482.

2. Equal Voting and Control

a. The Common Objective Exception

With the emphasis on percentages of voting shares, director and officer positions, and other indicia of control, a deadlocked venture should be controlled by no one. That was the conclusion of the Tax Court in *Lake Erie & Pittsburgh Railway Co. v. Commissioner*¹⁰¹ in-

⁹⁸ For a brief discussion of the advantages of controlled foreign corporation status, see *supra* note 39.

⁹⁹ In speaking to the structure of joint ventures in creating a controlled foreign corporation that will produce general limitation income for purposes of the foreign tax credit (see *supra* note 39 for a brief explanation of this point), one tax planning pamphlet observed: "Fifty-fifty incorporated joint ventures . . . can be transformed into 'controlled foreign corporations.' . . . In our experience, a foreign joint venturer often will agree to its co-venturer having a few shares of non-voting preferred stock to tip majority share-value ownership in its direction." PRICE WATERHOUSE, 19 INT'L TAX REV. 4, Vol. 19, No. 4, 3 (July/Aug. 1993). "The availability of look-through treatment for CFCs . . . often is so significant that the U.S. venturer will prefer CFC status even though it means relinquishing deferral for subpart F earnings of the venture . . . U.S. venturers sometimes will strain to achieve CFC status even if they do not have a greater than 50% interest in the economic earnings of the venture." Davis & Lainoff, *supra* note 12, at 217. The temporary regulations provide a supporting example. Controlled foreign corporation status was achieved when a shareholder acquired one additional share of stock from the other equal shareholder, which raised its stake in the value of the corporation to 501 shares out of 1,000 shares. See Treas. Reg. § 1.957-1T(c), Example 8 (1988).

¹⁰⁰ See generally Howard M. Liebman, *Taxation of Foreign Source Income: Implications of CCA, Inc.*, 17 HARV. J. INT'L LAW 335 (1976).

¹⁰¹ 5 T.C. 558 (1945).

volving the section 482 implications of the formation by two competitor corporations, with no overlapping shareholders, officers, or directors, of a third corporation, owned equally by them, which was to operate a railroad system. However, in 1972 the Court of Appeals for the Second Circuit reversed the Tax Court's decision in a case involving similar facts, *B. Forman Company v. Commissioner*.¹⁰²

In *B. Forman Company v. Commissioner*, B. Forman Co. and McCurdy & Co. owned competing retail department stores. The two corporations had no common shareholders, directors, or officers. To revitalize business at their stores' locations, the two corporations formed a third corporation, Midtown, McCurdy, which would develop a shopping center linking the two stores. The two competitors each owned fifty percent of the shares of the new shopping center corporation. Each of the two shareholders loaned money to the new corporation at rates of interest considered inadequate by the Service, which invoked section 482 to impute interest income to the two shareholders. The Second Circuit noted that the judicial trend was to determine actual control, "the realistic approach."¹⁰³ In the pursuit of "realism" the court applied a common goal analysis already seen in earlier family control cases.¹⁰⁴ The court concluded that with respect to the two shareholders of Midtown, McCurdy "[t]heir interests in the existence and career of Midtown and the interests of Midtown are identical."¹⁰⁵ At least with respect to this specific operational issue, the payment of interest on loans made in equal amounts, by equal shareholders, and by lenders with high levels of taxable income, the court was probably correct; there were no conflicting self-interests.

Early commentary on the *Forman* decision noted that "[t]he 1970s promise to be an era for significant judicial decisions involving section 482."¹⁰⁶ The Second Circuit's broad reading of control, however, was not aggressively pursued by the Service in its pronouncements. Some years before the decision was rendered, the Service indicated its non-acquiescence in the *Lake Erie & Pittsburgh Railway Co.* decision and issued its position statement in Revenue Ruling 65-

¹⁰² 453 F.2d 1144 (2d Cir. 1972), *cert denied*, 407 U.S. 934 (1972), *reh'g denied*, 409 U.S. 899 (1972).

¹⁰³ "The trend in the recent case law is to apply the realistic approach." 453 F.2d at 1153.

¹⁰⁴ See *infra* text accompanying notes 227-30. In connection with finding "controlling persons" in the securities laws, "acting in concert for a common purpose" can aggregate the interests of several persons. See, e.g., Sommer, *supra* note 70, at 578.

¹⁰⁵ 453 F.2d at 1153.

¹⁰⁶ Stephen A. Nauheim, *B. Forman & Co., Inc. — A Crucial Test of the Future of Section 482*, 26 TAX LAW 107, 107 (1972).

142.¹⁰⁷ The ruling stresses that section 482 should have applied when the two shareholders were “acting in concert, joined by a common interest, and by explicit agreements detailing the terms and conditions under which they were to deal with their joint subsidiary.”¹⁰⁸

In 1973 the Service had the opportunity to revisit the issue in a proposed revenue ruling addressing the applicability of section 482 to a corporation created to process and sell raw materials at cost to and for its shareholders. One shareholder was to own forty percent of the new corporation, and unrelated parties would hold the balance of the outstanding shares in the corporation. The proposed ruling was modified to include only a one hundred percent shareholder, eliminating the control issue. The General Counsel Memorandum explained that otherwise it was just too difficult to draft an appropriate ruling because “[w]ithout considerable additional facts, no ‘concert of action’ as described by the Second Circuit . . . can be developed.”¹⁰⁹

b. Equal Control in the International Setting

Even under the potentially broad rule applied by the Second Circuit, one would assume that it would not apply to most 50:50 international joint ventures.¹¹⁰ Taking, for example, payments by such a foreign-based joint venture to a United States parent company in exchange for the transfer of technology or other inputs of value,¹¹¹ a ready argument is that the United States parent would not un-

¹⁰⁷ Rev. Rul. 65-142, 1965-1 C.B. 222.

¹⁰⁸ *Id.* at 223. The explicit agreement could be provided by a joint venture agreement for the partnership of two corporations or by a shareholders’ agreement controlling a corporate joint venture.

¹⁰⁹ Gen. Couns. Mem. 35,375 (June 22, 1973). The proposed ruling was apparently never issued.

¹¹⁰ “Although Forman suggests that even a venturer that does not own a majority interest may be considered to control a joint venture if the co-venturers act in concert, this holding is clearly of limited scope. Where the Service is unable to show that both co-venturers are engaging in non-arm’s length dealings with the venture, it should not be able to argue that the co-venturers have acted in concert for purposes of § 482, and its ability to show common control will be impaired.” Davis & Lainoff, *supra* note 12, at 206. If both of the venturers were United States companies, otherwise unrelated, both of which were transferring technology or other inputs to the venture, and both of which desired deferral of the United States income tax on profits, both parties could have an incentive, and a common objective, to understate the price of the inputs to the venture.

¹¹¹ This argument assumes that the Service respects the structure of the transaction as being a license or other transfer to the joint venture by the United States parent, rather than a transfer by the United States parent, to the foreign subsidiary of the United States parent, and then in turn by the subsidiary to the joint venture. Some writers have noted that the latter structure could be required in view of other concerns. “Given JV constraints, it may be necessary to first license the technology to a wholly owned foreign subsidiary that would in turn license the technology to the foreign JV.” PRICE WATERHOUSE, *supra* note 15, at 5. See also Davis & Lainoff,

dercharge the joint venture in which it holds only a fifty percent stake; any potential United States tax savings would be offset by the economic loss of the undercharge bestowed on the other party.¹¹² This argument arguably suffers from an oversimplified, discrete,¹¹³ single transaction view of the parties' dealings. If there are other concessions made in the joint venture agreement, at the outset or in fulfilling the agreement, to compensate for a "sweetheart deal" on the technology payments, the argument loses much of its force when seen from an overall perspective.¹¹⁴ It would seem to be a murky factual question of directness and degree, but not an impossible task.¹¹⁵

supra note 12, at 200-01 (discussing license of intangibles to a controlled foreign corporation followed by a license to a foreign corporate venture to avoid I.R.C. § 367).

¹¹² The principal United States income tax benefit would be deferral of United States income taxes on the "profits" shifted to the foreign subsidiary through the undercharge. The argument that a United States company would not shift profits to even a company owned fifty-one percent by its parent interests, because forty-nine percent of the overcharge would spill over to outsiders, was accepted by the Tax Court in *R.T. French Co.* See *supra* note 75. "Furthermore, as a practical matter, in the absence of a corresponding non-arm's length transaction by the co-venturer, a court certainly would ask why a rational business person intentionally would shift profits to an entity in which a material unrelated party owned a substantial interest. . . . [W]hile the presence of a material unrelated co-venturer does not automatically preclude the Service from making a § 482 adjustment . . . , the presence of the co-venturer certainly raises the burden to a level that the government rarely will be able to meet." Davis & Lainoff, *supra* note 12, at 206.

¹¹³ A joint venture contemplates a course of dealings and is a so-called "relational contract," as contrasted with a discrete, single exchange found at the other end of a continuum. "A truly discrete exchange transaction would be entirely separate not only from all other present relations but from all past and future relations as well. In short, it could occur, if at all, only between total strangers, brought together by chance (not by any common social structure, since that link constitutes at least the rudiments of a relation outside the transaction). Moreover, each party would have to be completely sure of never again seeing or having anything else to do with the other." Ian R. Macneil, *Contracts: Adjustment of Long-Term Economic Relations Under Classical, Neoclassical, and Relational Contract Law*, 72 Nw. U. L. Rev. 854, 856 (1978).

¹¹⁴ The other concessions would recoup the United States parent's "loss" on the transfer pricing of its inputs, but the recoupment, in the form of increased profits from the joint venture, would inure to the benefit of the foreign subsidiary and enjoy deferral of United States income taxation.

¹¹⁵ *Garbini Electric, Inc. v. Commissioner*, 43 T.C.M. (CCH) 919 (1982), is an example of compensating one owner indirectly, to induce that person to enter into an enterprise. One shareholder, Garbini, owned one hundred percent of Garbini Electric, Inc. Garbini wanted to retain Gamble as a key employee, but, among other problems, Gamble didn't have the capital for the purchase of a fifty percent interest in Garbini Electric, Inc. They consequently organized a new company, Garbini Management, Inc., in which Gamble owned fifty percent and Garbini and her daughter owned forty percent and ten percent, respectively, of the stock. Garbini Electric, Inc. paid a management fee to Garbini Management, Inc., which was paid out in salaries to Garbini and Gamble. Although the new company was not controlled by the sole shareholder of Garbini Electric, Inc., the Tax Court found that both corporations were controlled by the same interests because the shareholders of both shared the same "common design for the shifting of income." 43 T.C.M. at 926. This holding prevailed in spite of the argument that it was against the immediate interests of Garbini to shift income from a company one hundred percent owned by her to the benefit of a company only forty percent owned by her. At a later point, Garbini

One would assume that in most cases the United States parent company, on the other hand, would not, solely for United States income tax purposes, seek to overcharge the venture because deferral would be lost on the excess profits from the overcharge.¹¹⁶ Moreover, if one does not approach the problem from an overall bargaining perspective, the foreign joint venture partner would probably be much more vigilant in resisting overcharges to the joint venture.

The national partner . . . wants assurance that the prices charged by the [transnational corporation] are arms-length, competitive, and fair. . . . Provisions in the joint venture contract that the transnational corporation will base prices upon arms-length pricing, cost plus agreed margins, or competitive international prices can help to deal with this problem, but they do not guarantee a full resolution.¹¹⁷

Electric, Inc. was dissolved and Gamble purchased one-half of the assets and joined with Garbini in a partnership, with Garbini contributing the other one-half of the assets of the former Garbini Electric, Inc. The management fee was a way to provide Gamble with funds to buy one-half of Garbini Electric, Inc. In the findings of fact Gamble was characterized as the "backbone of the business" and if Gamble left Garbini Electric, Inc., it "had no business." 43 T.C.M. at 921. The practical reality was that if Gamble left, Garbini's overall fortunes would suffer more than the loss of sixty percent of the management fees paid to Gamble and her daughter. The Tax Court started down this reality track, but concluded the opinion with other reasons for Garbini's actions that are not as persuasive, including gaining an additional surtax exemption and solving certain problems with the retirement plans.

¹¹⁶ This assumes that the joint venture operates in a taxing jurisdiction with rates significantly below those of the United States. With many of the developed companies, notably those in western Europe, the overcharge, if deductible for purposes of the host country taxation, would result in a comparative tax savings through repatriation to the United States industrialized "tax haven." Japanese firms are routinely accused of overcharging their United States subsidiaries to lower any potential United States tax liability. At first glance, moving profits to Japan makes little sense since the nominal Japanese corporate tax rate is higher than its United States counterpart. "The 1988 effective rate is about 56.4 percent. For 1989, the combined effective rate can be 54.07 percent, and for 1990 and later, 51.39 percent." MARC M. LEVEY, *FOREIGN INVESTMENT IN THE UNITED STATES* 73 (1989, Supp. 1992). A number of explanations for the contradiction have been offered. "It is well-known that corporate taxes are sometimes negotiable in Japan. The corporations may not in practice pay any Japanese tax on those profits. Or the ministry of finance may have promised a big quid pro quo, such as special access to cheap capital in the warrant bond market." Clyde Prestowitz, Jr., quoted in Eamon Fingleton's *Japan: The Gaijin and Gyosei Shido — Ministry of Finance's Guidance Works Against Foreign Firms*, INSTITUTIONAL INVESTOR, at 71, Reuter Textline, Oct. 31, 1990. "The reason seems to be intense pressure, reinforced by the Japanese bonus system, for each division to show high before-tax profits, regardless of the tax consequence for the consolidated group." HUFBAUER & VAN ROOI, *supra* note 25, at 111 n.17. Another commentator rejects the argument that Japanese companies would pay higher Japanese taxes out of national loyalty, and downplays the roles of misunderstandings of the law and the argument that in fact Japanese companies do not pay taxes at the stated marginal rates. See Joseph H. Guttentag, *Transfer Pricing: U.S. and Japanese Views*, 94 TAX NOTES INT'L 25-14 at 20 (Feb. 7, 1994).

¹¹⁷ William A. Dymysa, *Successes and Failures of Joint Ventures in Developing Countries: Lessons from Experience*, in COOPERATIVE STRATEGIES IN INTERNATIONAL BUSINESS, *supra* note 8, 403, 413.

The section 957 case law referred to earlier has not produced an "in concert" doctrine to bind United States persons together. The need for such aggregation would rarely arise because section 957 enjoys statutory constructive ownership rules that would deal with many family situations, for example.¹¹⁸ Moreover, so long as a United States person holds at least a ten percent stake in the corporation, the stock ownership of all United States persons that meet that threshold is aggregated, irrespective of affiliation, in determining whether the requisite ownership by United States persons exists for purpose of controlled foreign corporation status.¹¹⁹ The case law's inquiry therefore generally focuses on whether a given United States person, or related group of United States persons, have in reality more than fifty percent of the voting power in the corporation vis-à-vis the other, foreign, shareholders.¹²⁰

3. *Other Voting and Management Arrangements — The Closely Held Setting*

The section 482 case law, as well as the section 957 case law, demonstrate a close scrutiny of the totality of entity governance arrangements in determining whether practical control of the entity is present.

a. Voting Agreements

The decision in *Charles Town, Inc. v. Commissioner*¹²¹ is illustrative of the recurrent theme that management control of an entity drives section 482, and the ownership stake may be negligible. Two brothers owned all of the stock of Fairmount Steel Corporation (Fairmount), which had significant net operating loss carryovers. The brothers formed a new corporation, Charles Town, Inc. (Charles Town) to acquire a West Virginia race track. A first cousin, and business associate, received ninety-eight percent of the stock in Charles Town, while each brother received one percent. The brothers became the president and secretary-treasurer and directors of Charles Town, while the cousin was a vice president and director. Fairmount agreed

¹¹⁸ See I.R.C. § 958 (1993).

¹¹⁹ See I.R.C. § 957(a) (1993) (a controlled foreign corporation exists where more than 50 percent of the total combined voting power or total value of stock is owned by "United States shareholders" on any day of the corporation's taxable year); I.R.C. § 951(b) (1993) (a "United States shareholder" means a United States person owning 10 percent or more of the total combined voting power of all classes of stock entitled to vote).

¹²⁰ See *infra* text accompanying notes 146-55 & 172-84.

¹²¹ 372 F. 2d 415 (4th Cir. 1966), *cert. denied*, 389 U.S. 841 (1967).

to advance funds to Charles Town to conduct racing at the track that Charles Town had leased from the owner. Charles Town operated the race track, retaining ten percent of the net profits, and paying the balance to Fairmount.

The court concluded that the brothers were in control of the "business" of Charles Town and approved a reallocation of profits from Fairmount to Charles Town.¹²² The small stock ownership position of the brothers in Charles Town was supplemented by a provision in the management agreement that a majority of the officers would make all decisions for the corporation so long as Charles Town was indebted to Fairmount. This voting agreement, which gave the brothers practical control of Charles Town, provided an easy path for a finding of control.

[The 98 percent shareholder] gave up the control he could have exercised as majority stockholder when he permitted Charles Town to contract that the [brothers] could not be removed from majority control of the Charles Town Board of Directors until the money advanced by Fairmount was returned. This was "the reality of control."¹²³

Voting agreements may assure incumbency of directors and officers as in *Charles Town, Inc.*, producing control.¹²⁴ In other cases the agreements can defeat control in creating a management structure where each shareholder is empowered through the requirement of unanimous agreement for corporate action. In *Bransford v. Commissioner*,¹²⁵ the Service argued that various groups controlled each of two entities, a partnership and a corporation. However, both entities required unanimous agreement for decisions, and the ownership interests between the two entities did not overlap to a degree that would establish common ownership. The court therefore rejected an application of section 482.¹²⁶

¹²² In an attempt to defeat application of section 482, the taxpayer unsuccessfully argued that the profit division agreement was a partnership.

¹²³ 372 F. 2d at 420.

¹²⁴ The controlled foreign corporation regulations assert that control can exist even if based on oral agreement. See Treas. Reg. § 1.957-1(c), Example 7 (1988). The section 482 regulations also reject any requirement of legal enforceability. " 'Controlled' includes any kind of control, direct or indirect, whether legally enforceable, and however exerciseable or exercised." Treas. Reg. § 1.482-1T(g)(4) (1993).

¹²⁵ 36 T.C.M. (CCH) 1262 (1977).

¹²⁶ Although each and every corporate action, for example, those in the ordinary course of business, probably did not require approval, the two active 16.66 percent shareholders, Messrs. Gree and Beal, acted at the sufferance of the other shareholders, who could seek to impose their authority at any time. This is distinguishable from the facts in *Charles Town, Inc.*, *supra* text accompanying notes 121-24, where the controlling persons exercised daily management control, backed by their assured director status. This result at first appears inconsistent with an example in the controlled foreign corporation regulations. In the example, a United States person owned

b. Fiduciary Duty

In *Bransford*, the court, in dealing with the motives of one shareholder, observed that "it is equally unlikely that he would have rendered himself vulnerable to claims by other . . . shareholders for violating his fiduciary obligation, as president of the corporation, to protect and preserve their interests."¹²⁷ The fiduciary obligation issue is raised only in passing. Nevertheless, it is an intriguing argument that state fiduciary law constraints may limit the putative controlling shareholder's power to deal with the corporation in a manner that would generate both a state law conflict of interest and an improper transaction invoking section 482. Fiduciary law issues have on other occasions been raised in connection with transfer pricing.¹²⁸ That set of facts would probably present itself in many cases in which there exists a truly unrelated minority shareholder group, and the income or expense allocations are to the economic detriment of the particular corporation in question, and to the benefit of another party, which is controlled by the majority shareholders, but in which the minority owners don't have an interest.

The issue could be posed in terms of whether section 482 applies only to situations in the control of persons with both the power and

a fifty-one percent interest in a foreign corporation, and seven other members owned the remaining forty-nine percent. The memorandum of association provided for only one manager, who would exercise the powers ordinarily exercised by a board of directors. The manager, however, was elected by unanimous agreement of all the members. The example concludes that "[s]ince [the U.S. person] owns 51 percent of the company, he will be deemed to own more than 50 percent of the total combined voting power of all classes of stock . . . , notwithstanding that he has power to elect a manager only with the agreement of the other members." Treas. Reg. § 1.957-1(c), Example 3 (1988). The key to reconciling this example with instances in which control is avoided by requiring unanimous agreement for all actions is the scope of the manager's powers. The United States person still controlled all other transactions, outside of the election of the manager, for which a vote of the members was required. *Compare* Rev. Rul. 69-126, 1969-1 C.B. 218 (voting power for consolidated tax return affiliation status is determined with reference to power to elect directors).

¹²⁷ 36 T.C.M. at 1271.

¹²⁸ The state law remedies for transfer pricing abuses were acknowledged, for example, in the 1984 "Blue Book" explanation of the I.R.C. § 269B stapled stock provisions. "Shareholders of stapled stock may have had no business reason to complain if their taxable entity undercharged their nontaxable entity for goods or services. If stock is not stapled, by contrast, the shareholders of a company can sue its management (in a shareholders' derivative suit) if the company undercharges another entity." Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984*, 455 (Dec. 31, 1984). Some state law decisions have expressed an arm's length standard. "The essence of the test is whether or not under all the circumstances the transaction carries the earmarks of an arm's length bargain." *Jones v. H.F. Ahmanson & Co.*, 460 P.2d 464, 471 (Cal. 1969) (quoting with approval language of the California Court of Appeal in an earlier decision in turn quoting from *Pepper v. Litton*, 308 U.S. 295, 306-07 (1939)).

the right to act in some manner, or to those with simply the power to act. There is authority in other taxation contexts, in particular the estate tax, requiring the presence of a legal right to act, finding an absence of meaningful power if the actor is subject to fiduciary obligations.¹²⁹ However, section 482 is so strongly couched in terms of "control" that power alone is probably adequate.¹³⁰ On that basis, fiduciary law constraints would not be a defense against a section 482 adjustment.

However, a related issue is raised by the decisions in *Comm'r v. First Sec. Bank of Utah*¹³¹ and *Procter & Gamble*¹³² of what constitutes the legal limitations on control affecting the payment of expenses or allocation of income.¹³³ In both of those cases, the

¹²⁹ In a notable international partnership classification case, fiduciary duty was a determinative issue. "Thus, although we agree with the government that [the related parties] are likely, as a practical matter, always to act in concert in their management of the distributorships, we cannot conclude as a matter of law that their interests will never diverge. Nor do we think that the tax consequences of a legitimate business transaction should turn on an unsupported assumption that certain parties to the transaction will act in breach of their fiduciary duties and, indeed, unlawfully." *MCA Inc. v. United States*, 685 F.2d 1099, 1104 (9th Cir. 1982). It is a well-established principle of federal estate taxation law that fiduciary constraints that are an external standard, which a court of equity could apply to compel compliance by the fiduciary, can overcome the existence of practical control over property. See, e.g., *Jennings v. Smith*, 161 F.2d 74 (2d Cir. 1947) (statutory antecedents of Internal Revenue Code §§ 2036 and 2038 not applicable to a settlor-trustee because discretion was limited by an ascertainable state law fiduciary standard). The power versus right distinction, which turned upon similar projected fiduciary constraints, was at the forefront in the much discussed estate taxation decision, *United States v. Byrum*, 408 U.S. 125 (1972).

¹³⁰ "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. § 1.482-1A(b)(1) (1993) (applicable to taxable years beginning on or before Apr. 21, 1993). The controlled foreign corporation regulations assert that an oral agreement to vote shares in one's favor can produce control and the section 482 regulations deny that legal enforceability is a requirement. See *supra* note 124.

¹³¹ 405 U.S. 394 (1972).

¹³² 961 F.2d 1255 (6th Cir. 1992).

¹³³ The Court's rationale in *First Security Bank of Utah*, *supra* note 131, was essentially that the taxpayer should not be taxed on income that had not yet been received, and that it was prohibited, by law, from receiving. That is to be contrasted with the tax treatment of the extension of that situation, the actual receipt of income, the receipt of which is illegal. The Court acknowledged that it was not dealing with the law addressing the latter situation, which generally holds that the recipient is taxed on the illegal gains, and the illegality is not a bar to taxation. See 405 U.S. at 405, n.19 and accompanying text. The *Procter & Gamble* decision, *supra* note 132, applied the principles of *First Security Bank of Utah* in an international context. Very simply, the Service asserted that Procter & Gamble's Spanish subsidiary had not paid sufficient royalties to a wholly-owned Swiss subsidiary of Procter & Gamble for certain intangibles which would in turn produce Subpart F income to the United States parent) and asserted a section 482 adjustment. However, Spanish law prohibited the payment of royalties in the amounts sought to be allocated by the Service. The Tax Court and the Sixth Circuit Court of Appeals held that income could

governing laws of an applicable sovereign, the United States and Spanish governments, respectively, forbade the payment of the increased amounts represented by the Service's allocation, and the courts rejected the Service's adjustment. In the hypothetical posed earlier, however, the controlling persons would be seeking to pay more than an appropriate price to, or undercharge, related persons, in violation of their fiduciary duties. The Service would probably seek to eliminate the overpayment as a deduction or allocate additional income for the amount of the undercharge. The goals of the Service would be roughly congruent with the fiduciary law requirements. The *Procter & Gamble* result does not therefore suggest that fiduciary legal constraints pre-empt the Service's application of section 482.¹³⁴

The fiduciary law aspects of improper pricing could be modified by the express agreement of the parties concerning transfer pricing procedure. In addition to the arm's length pricing and competitive pricing clauses mentioned above,¹³⁵ the agreement may specify that the joint venture can purchase inputs from the lowest-cost source available.¹³⁶ That, of course, can shift the controversy from price to suitability and quality, or be of little relevance to the transfer of unique technology.

Aside from the question of whether the "improper" payments violate duties owed to the affected entity, the imposition of the section 482 accuracy-related penalty¹³⁷ would potentially subject the corpora-

not be imputed to an amount, the payment of which was illegal under Spanish law. For some of the commentary on this case, see Marc M. Levy & James P. Clancy, *I.R.S. Seeks to Reverse Procter & Gamble With Proposed 482 Regulations*, 4 J. INT'L TAX'N 137 (1993). See also *Exxon Corporation v. Commissioner*, 66 T.C.M. (CCH) 1707 (1993), in which the Tax Court applied *Procter & Gamble* in the context of crude oil transfer pricing.

¹³⁴ This even assumes that the violation of fiduciary duties that give rise to a private action, in the absence of the violation of a public law like embezzlement, would be considered a governing law of a statute with the laws of the United States and Spain involved in *First Security Bank of Utah* and *Procter & Gamble*. In that regard, the Service in *Procter & Gamble* attempted unsuccessfully to distinguish that case from *First Security Bank of Utah* on the basis that the latter result extended only to U.S. federal law. See generally 961 F.2d at 1259.

¹³⁵ See *supra* text accompanying notes 116-17.

¹³⁶ Dymsha, *supra* note 117, at 413. The United States participant, on the other hand, will have a strong interest in quality, availability, and price if the joint venture agreement, usually at the insistence of the host country government, requires host country-supplied inputs. See generally L. Crawford Brickley, Comment, *Equity Joint Ventures in the People's Republic of China: The Promised Land is Not Yet in Sight for Foreign Investors*, 10 U. PA. J. INT'L BUS. L. 257, 281-86 (1988).

¹³⁷ The Internal Revenue Code imposes a twenty percent penalty for a "substantial valuation misstatement," and a forty percent penalty with respect to "gross valuation misstatements" concerning discrepancies in the claimed price for property, the use of property, or services or concerning a "transfer price adjustment" which is tied to the overall effect of multiple misstatements. See I.R.C. § 6662 (1988 & Supp. 1993-94 (CCH)).

tion's management to state law derivative actions. There is some precedent in connection with penalties assessed under the accumulated earnings tax.¹³⁸

c. Specific Control Issues

The materials that follow will focus on several types of control devices and their effect on the section 482 control issues. It must, of course, be emphasized that although the principles of analysis are of general application, the specifics of control arrangements can only be determined with reference to the type of entity and the prevailing law, generally Anglo-American or civil, which through obscure details can produce significant differences.¹³⁹ Moreover, if the relationship is a contractual joint venture, that is not construed as a partnership or other entity invoking the company laws of the host country or other pertinent jurisdiction, the control of the venture will be dictated by the terms of the contract.¹⁴⁰

(1) Day-to-Day Operations — The Joint Venture Manager

Matters can be complicated further by examining some of the internal workings of international joint ventures. In many cases, a manager of the joint venture will be designated. This individual, or company, manages the daily affairs of the joint venture on behalf of the owners. The manager may be chosen by, and be a former employee of, one of the joint venture partners.¹⁴¹ Nevertheless, one

¹³⁸ See, e.g., Note, *Derivative Actions Arising From Payment of Penalty Taxes Under Section 102*, 49 COLUM. L. REV. 394 (1949).

¹³⁹ For a brief but excellent discussion of the special aspects of civil law forms of business organization and their effects on control, see GUSTAFSON & PUGH, *supra* note 90, ch. 15. For a summary of the private and public company laws of European countries, see P. MEINHARDT, *COMPANY LAW IN EUROPE* (3rd ed. 1981).

¹⁴⁰ Reliance strictly on the contract requires attention to detail, because without entity law there will be no default governance provisions or procedures for termination and winding up. See generally Johnson, *supra* note 21, at 303. For a general discussion of common joint venture provisions see Michael E. Hooton, *Structuring and Negotiating International Joint Ventures*, 27 CREIGHTON L. REV. 1013 (1994).

¹⁴¹ The selection of the joint venture management can be confrontational. "Management development is a strategic responsibility of top management, so an inclination to demand staffing authorities on the venture in itself is not a surprise. At one extreme in this dilemma, one finds the partner who, after having stipulated a majority contribution in financing the venture's equity and loans, demands to select and appoint the management of the joint venture by itself. The other partner may then stipulate to put a controller in the venture." Willem T.M. Koot, *Underlying Dilemmas in the Management of International Joint Ventures*, in COOPERATIVE STRATEGIES IN INTERNATIONAL BUSINESS, *supra* note 8, 347, 360-61. "In 70 percent of the Mexican joint ventures, the joint venture's policies and procedures were a replication of one parent's. Since in each of those cases, the [joint venture general manager] had been appointed by the parent who

study found that the joint venture managers "tend to see their allegiance to the joint venture first and to the parents second."¹⁴²

Influence over the joint venture management team alone would not necessarily tip the scales in favor of a finding of control. In *Cayuga Service, Inc. v. Commissioner*¹⁴³ two parties each owned fifty percent of the stock of the corporation. The same parties held equal interests in other related enterprises to a degree that might have suggested a common design to shift income or expenses, but that was not the basis of the Tax Court's holding.¹⁴⁴ The Tax Court found that control existed because one fifty percent shareholder's "people" controlled the board of directors and held all the corporate offices but one. However, the other fifty percent shareholder was the president and handled the day-to-day management of the company. As far as the board meetings, each director had one vote and there was no agreement requiring unanimity, nor any agreement among the shareholders as to how to vote. Although the Tax Court did not discuss this issue, it would seem that the ultimate result can be justified only if, in view of the deadlock situation, the original slate of directors, which favored the one shareholder by a margin of two to one, became fixed as a practical matter.

The control wielded through the office of the manager can be made even more direct under the provisions of foreign law. In a French limited liability company, for example, it has been suggested that the organizational documents could designate a sole manager chosen by one of the parties, who could not be dismissed except for cause. Removal for cause in turn could be made more difficult by requiring a super majority vote that would provide the sponsoring party with a veto.¹⁴⁵ In that regard, in *Garlock, Inc. v. Commis-*

had established the policies and procedures, the [joint venture general manager] had a clear understanding of the joint venture's operating rules." Jean-Louis Schaan & Paul W. Beamish, *Joint Venture General Managers in LDCs*, in COOPERATIVE STRATEGIES IN INTERNATIONAL BUSINESS, *supra* note 8, 279, 289-90.

¹⁴² Schaan & Beamish, *supra* note 141, at 290.

¹⁴³ 34 T.C.M. (CCH) 18 (1975).

¹⁴⁴ The Service allocated imputed interest income to the taxpayer for interest-free advances made to affiliated companies. The Tax Court followed the Second Circuit's opinion in *Forman v. Commissioner*, *supra* note 100, concerning the validity of imputing income, where none previously existed, to reflect the true taxable income of the taxpayers. 34 T.C.M. (CCH) at 26. However, the control issue was not decided on a *Forman*, in concert, basis. See generally 34 T.C.M. (CCH) at 25, n.3.

¹⁴⁵ See GUSTAFSON & PUGH, *supra* note 90, at 779. The Treasury regulations assert that relinquishing control over the selection of the manager, while retaining all other powers of a majority position, would not avoid controlled foreign corporation status. See *supra* note 126.

sioner,¹⁴⁶ dealing with controlled foreign corporation status, the articles of incorporation were amended to provide for director terms of one to five years. The United States shareholder's representatives held three of the five shareholder spots, which permitted them to control the board of directors for five years unless removed by majority vote of the shareholders. However, the voting structure was fifty—fifty deadlock, so barring the death of a director,¹⁴⁷ the United States shareholder could control for at least five years. The Tax Court found that the United States shareholder clearly held practical control of the corporation. "Barring arbitration, there was no means whereby the preferred shareholders could, if they had wished to do so, challenge that control."¹⁴⁸

As demonstrated by *Garlock, Inc.*, the controlled foreign corporation cases typically make a very close examination of the actual shareholder behavior, apart from stock ownership percentages. In *Kraus v. Commissioner*,¹⁴⁹ for example, the appellate court found it significant that the other shareholders "were carefully selected . . . so that no rocking of the corporate boat could be anticipated."¹⁵⁰ The shareholders were either relatives, close personal friends, or business associates. At only one meeting of the shareholders did any of the shareholders outside of the Kraus family appear in person. The compliant initial board of directors would continue in office until their successors were elected, but again, due to the deadlock voting position of the common and preferred shareholders, they could not be ousted without the acquiescence of the common shareholders.¹⁵¹ Although the preferred shareholders were represented at all meetings, they were very agreeable, leading the court to observe that "[t]he record is barren of any indication of dissent or disapproval of any preferred stockholder in person or by proxy at any meeting."¹⁵²

It was again a significant fact in *Koehring Co. v. United States*¹⁵³ that none of the outside shareholder directors participated in six out of ten board meetings. In addition, none of the outside directors, representing fifty-five percent of the voting stock, had signature authority

¹⁴⁶ 58 T.C. 423 (1972), *aff'd*, 489 F. 2d 197 (2d Cir. 1973), *cert. denied*, 417 U.S. 911 (1974).

¹⁴⁷ Panamanian law permitted a majority of the remaining members of the board to elect a successor. 58 T.C. at 431. That would give Garlock, Inc. only two out of four voting directors.

¹⁴⁸ 58 T.C. at 437. The shareholders' agreement expressly permitted arbitration. *See infra* text accompanying notes 180-82.

¹⁴⁹ 59 T.C. 681 (1973), *aff'd*, 490 F. 2d 898 (2d Cir. 1974).

¹⁵⁰ 490 F. 2d 898, 902 (2d Cir. 1974).

¹⁵¹ *See generally* 59 T.C. at 693.

¹⁵² 490 F. 2d at 903.

¹⁵³ 583 F. 2d 313 (7th Cir. 1978).

over checking accounts. On the other hand, in *CCA, Inc. v. Commissioner*,¹⁵⁴ in which the taxpayer prevailed, the Swiss corporate law permitted only individuals with "signature power" to act on behalf of the corporation. The members of the board of directors representing the outside shareholders were not excluded from this group and any two could act jointly on behalf of the corporation.¹⁵⁵

(2) Majority Equity Ownership

One would generally assume that a fifty-one to forty-nine percent ownership structure of a two-participant venture gives the majority participant working control of the entity, and control for purposes of section 482 would most likely be found under these circumstances.¹⁵⁶ This would seem to be the case although extraordinary decisions, like a sale of the business assets, require unanimous or a supermajority approval, unless the transaction in question was one of those extraordinary events.¹⁵⁷ This assumes the absence of aspects of local law or features in the organizational documents that empower the minority position, such as multiple classes of voting stock, cumulative voting, voting trusts, or shareholder agreements.¹⁵⁸

¹⁵⁴ 64 T.C. 137 (1975).

¹⁵⁵ See generally 64 T.C. at 145-46.

¹⁵⁶ The controlled foreign corporation regulations interpreting I.R.C. § 957, which requires "more than 50 percent of the total combined voting power of all classes of stock entitled to vote," state that this requirement is met in a situation where each share of stock has one vote for all purposes and the United States person in question owns 51 percent of the voting stock. See Treas. Reg. § 1.957-1(c), Example 1 (1988). In the redemption context, the Service has ruled that a decrease in interest from fifty-seven percent to fifty percent should be treated as a sale or exchange because of the loss of voting control, provided that only one other shareholder owns the remaining interest in the corporation. See Rev. Rul. 75-502, 1975-2 C.B. 111. Of course, if the other shares are widely dispersed, even a less than 50 percent stake could control the enterprise.

¹⁵⁷ In *South Texas Rice Warehouse Co. v. Commissioner*, the court rejected the argument that the otherwise controlling shareholders did not control the transaction in question because it required a supermajority approval. See *infra* text accompanying notes 227-30. In the redemption context, however, some courts have found that the loss of control over even extraordinary transactions can provide sale or exchange treatment for a redemption. See BITTKER & EUSTICE, *supra* note 44 ¶ 9.05[3][d]. See also *infra* note 168.

¹⁵⁸ "Cumulative voting and voting trusts are normally not recognized in civil law countries and a shareholders' agreement limiting the shareholders' freedom to vote may be void or unenforceable." GUSTAFSON & PUGH, *supra* note 90, at 776. For example, "[v]oting agreements are legally unenforceable" in the French public limited company, the *société anonyme*, or S.A. MEINHARDT, *supra* note 139, at F-9(ii). "Non-voting and multiple-voting shares are not permitted" in a French private limited company, the *société à responsabilité limitée*, or S.A.R.L. *Id.* at F-24(iii). On the other hand, in a Netherlands public limited company, Naamloze Vennootschap, or N.V., "[a]greements on voting between shareholders are permissible, unless they are contrary to good faith." *Id.* at NL-12(ii). See generally PH. John Kozyris, *Equal Joint-Venture Corporations in France: Problems of Control and Resolution of Deadlocks*, 17 AM. J. COMP. L. 503 (1969).

In the absence of special voting requirements, the holders of a majority of ownership interests are generally considered to be in control. In *Cannon v. Commissioner*,¹⁵⁹ the taxpayer was a limited partner holding a forty-five percent¹⁶⁰ interest in the partnership and a majority interest in a related corporation. Although the taxpayer was only a limited partner, the court found that she exerted "financial control" over each organization that supported a section 482 allocation. The other partners in the partnership held thirty percent, nine percent, eight percent, and eight percent interests. The court did not raise the issue of whether the other partners could combine forces to oppose the interests of the forty-five percent party. The court also did not note that the second largest interest, the thirty percent, was held by the general partner who would be a likely candidate for legal control of a limited partnership.¹⁶¹

In the context of Japanese investments, it has been observed that the fifty-one to forty-nine arrangement yields illusory benefits.

[U]ltimate control is normally not possible in the case of many important corporate decisions. Merger, liquidation, and other major decisions require a two-thirds vote of the shareholders. . . . [F]ifty-one percent control is often more nominal than real. Typically, a Japanese joint venture will be staffed by personnel provided by the Japanese partner, which means in essence that the Japanese partner will control day-to-day management decisions. A controlling United States partner often finds it difficult or impossible to reverse events put into motion through the incremental daily decisions of local management.¹⁶²

The ownership and control structures in application are understandably subject to almost infinite variation. One writer has compared the control aspects of three United States company joint ventures with foreign parties. In the NII-NKK joint venture a United States steel company sold fifty percent of National Steel to Nipon

¹⁵⁹ 59 T.C.M. (CCH) 164 (1990).

¹⁶⁰ One description of the interest by the court notes a "54%" interest. A later percentage in profits and proceeds of the partnership is "45%," and taken together with the other partners' interests that totals one hundred percent.

¹⁶¹ It is interesting that this argument is not made by taxpayers in light of the presumption of in concert action by otherwise minority shareholders followed by the Service in its rulings in the redemption area. See, e.g., Rev. Rul. 85-106, 1985-2 C.B. 116 (minority shareholder had not parted with control because it could participate in a "control group" by acting in concert with two other shareholders).

¹⁶² Rosser H. Brockman, *Foreign (Local) Law Issues*, 38 BUS. LAW. 1064, 1068 (1983). One observer has written that the United States desire for control can be damaging to the business. "When Americans and Europeans come to Japan, they all want 51 percent. . . . But good partnerships, like good marriages, don't work on the basis of ownership or control. It takes effort and commitment and enthusiasm from both sides if either is to realize the hoped-for benefits." KENICHI OHMAE, *THE BORDERLESS WORLD* 119 (1991).

Kokon. The partners have equal representation on the board of directors, but United States managers direct day-to-day operations.¹⁶³ AT&T Phillips Telecommunications, V.V. was also started as a fifty—fifty joint venture. AT&T has three votes, while Phillips has only two, on the board of directors, but managers are drawn from both companies.¹⁶⁴ The third venture, Beijing Jeep Corporation, Ltd., was created by American Motors Corporation and a company of the Chinese government. The United States company owned only thirty-one percent of the venture and its control, from a legal standpoint, is weak.¹⁶⁵

(3) *Veto Provisions*

Positions on the board of directors that are disproportionate in number to equity ownership, or the requirement of super majority approval of selected transactions, for example, can permit a less than equal owner to maintain at least deadlock with the other venturers.¹⁶⁶

Certainly, the United States company should seek at least a veto. This does not, however, mean that the share division must be fifty-fifty, because it is usually possible to manipulate voting requirements in the board and shareholder meetings to produce mutual vetoes, even though one of the partners may hold less than fifty percent of the voting shares.¹⁶⁷

If the veto is only for selected matters, the resulting power should exist only with respect to the transaction in question. That approach was, however, rejected in a noted family control situation.¹⁶⁸ If the

¹⁶³ Root, *supra* note 19, at 78.

¹⁶⁴ Root, *supra* note 19, at 78. Assuming that a majority vote of the directors is the rule, AT&T would probably be considered a controlling party.

¹⁶⁵ Root, *supra* note 19, at 78. One can find a number of additional anecdotes about joint venture arrangements, particularly with Japanese companies. For example, Hewlett-Packard's first joint venture in Japan began in 1963, with the United States company holding fifty-one percent of the joint venture with Yokogawa Electric. In 1983, "Yokogawa Electric gave Hewlett-Packard another 24 percent." OHMAE, *supra* note 162, at 119.

¹⁶⁶ Again the unique aspects of the host country law must be considered. With respect to an Italian public limited company, the *società per azioni*, or S.P.A., "[n]on-voting and multiple-voting shares are not permitted. However, the articles may provide that preference shareholders are entitled to vote at extraordinary and not at ordinary general meetings. Shares carrying restricted rights may not exceed 50 percent of the capital." MEINHARDT, *supra* note 139, at I-9(i).

¹⁶⁷ Brockman, *supra* note 162, at 1067-68. "As a minimum, the veto right should cover such matters as amendment of the corporation's [organizational documents], new investments, contracts with affiliated companies or shareholders, sale of a substantial portion of the joint venture company's assets, acquisitions or mergers, issuance of additional capital stock and borrowing by the corporation other than in the ordinary course of business." GUSTAFSON & PUGH, *supra* note 90, at 777.

¹⁶⁸ See *infra* text accompanying notes 227-30 discussing *South Texas Warehouse Co. v. Commissioner*. See also *supra* note 126 dealing with a requirement of unanimous voting for a sole manager of a foreign corporation. Nevertheless, by analogy to the law construing "voting

veto provisions create the effect of a fifty—fifty joint venture, then those control issues discussed above are raised. On the other hand, trying to address the deadlock situation raises the control questions discussed next.

(4) *Deadlock and Purchase Provisions*

The joint venture agreement may contain provisions that grant each venturer a right of first refusal, if another venturer seeks to transfer its interest in the enterprise.¹⁶⁹ In some situations, the agreement will contain a buy-sell arrangement that can be initiated in deadlock situations.¹⁷⁰ If the host country imposes investment restrictions on the venture's ownership, either provision can have less practical benefit to the United States participant.¹⁷¹

In the context of section 957, the absence of a deadlock breaking provision is apparently preferable if the deadlock breaking mechanism would favor one of the shareholders over the other.

United States shareholders . . . will be deemed to own the requisite . . . voting power . . . [i]f any person or persons elected or designated by such shareholders have the power to elect exactly one-half of the members of such governing body of such foreign corporation, either to cast a vote deciding an evenly divided vote of such body or, for the duration of any deadlock which may arise, to exercise the powers ordinarily exercised by such governing body.¹⁷²

power" for consolidated income tax return affiliation requirements, it should matter whether the transaction in question was one over which the party held veto or other power. In speaking to the consolidated return situation, Professors Bittker and Eustice wrote that "[t]he term 'voting power' has come to mean the power to elect the directors and to exclude the power to vote on such extraordinary events as mergers, sale of assets, and so forth." BITTKER & EUSTICE, *supra* note 44, ¶ 13.41[2][b].

¹⁶⁹ The articles of organization of a Netherlands private limited company, *Besloten Venootschap met beperkte aansprakelijkheid*, or B.V., for example, must generally contain a "blocking clause" which places restrictions on the transfers of shares, often subjecting the shares to the required consent of the company or purchase by existing shareholders. MEINHARDT, *supra* note 139, at NL-24(ii).

¹⁷⁰ "Not uncommonly encountered in joint venture agreements are breakup provisions which are of infinite variety. . . . The buyout may be according to a pre-established formula, by appraisal, by 'good faith negotiation,' or rarely a put/call option." Mark H. Berens, *Foreign Ventures — A Legal Anatomy*, 26 BUS. LAW. 1527, 1541 (1971). The extreme forms of these agreements, the put/call option, have been given various titles, including "Shotgun Buy-Sell," "Texas Buy-Sell," "Shootout" or "Russian Roulette." There are many variations on this theme, but generally one party initiates the process by offering to purchase the other party's interest at an offered price. The other party then has the option to sell at the offered price or to purchase the other party's interest at the same price. Even with extended notice and option periods, and perhaps extended payment terms, this type of arrangement can operate in favor of the wealthier party.

¹⁷¹ See generally Cherin & Combs, *supra* note 90, at 1038-39.

¹⁷² Treas. Reg. § 1.957-1(b)(1)(ii) (1988).

Differences in management can be resolved through a purchase of one party's interest. A very one-sided purchase arrangement could in substance resemble a "call" on the stock of the other shareholder, and call options were an important factor in *Kraus v. Commissioner*.¹⁷³ In *Kraus*, the United States persons held common stock that nominally represented fifty percent of the voting power in the corporation, and foreign persons held preferred stock that enjoyed fifty percent of the voting power. The preferred shares were subject to call by the corporation after not less than three months' notice and could be redeemed at par value plus unpaid dividends. The court noted that "[t]here was no arrangement for the breaking of a deadlock in voting, and in view of the call provisions, the redemption of any dissident stockholder's shares at par value provided an obvious solution to any problem."¹⁷⁴ The purchase option was not the only blemish. The preferred shareholders were relatives, close personal friends or business associates of the United States persons and were not active in shareholder affairs.¹⁷⁵ The preferred stock could be transferred only with the approval of the board of directors, and consent could be withheld for "important reasons,"¹⁷⁶ which helped insure that the cast of obedient shareholders would be maintained. The sale of the outside persons' shares was also neatly orchestrated by the United States persons when it was expedient. Based on this record, the court found that "real" voting power still rested with the United States persons.

In *Koehring Co. v. United States*¹⁷⁷ the taxpayer had structured the transaction in a manner that was probably assumed to be palatable fare for a reviewing court. The outside preferred shareholder held fifty-five percent voting power, rather than just deadlock power, and there were no "formal restrictions on transfer, call features, or charter provisions permitting [the preferred shareholder] to force redemption of its shares."¹⁷⁸ However, the appellate court did not disturb the lower court's conclusion on the evidence that the preferred shareholder had an "understanding" that it had the right to compel the re-

¹⁷³ 59 T.C. 681 (1973), *aff'd*, 490 F.2d 898 (2d Cir. 1974). Compare General Corp. Law of Delaware § 273, Del. Code Ann. Tit. 8, § 273 (1974) (procedure for judicial dissolution of joint venture corporations having only two fifty percent stockholders).

¹⁷⁴ 490 F.2d 898, 902 (2d Cir. 1974).

¹⁷⁵ See *supra* text accompanying notes 149-52.

¹⁷⁶ 490 F. 2d at 900.

¹⁷⁷ 583 F.2d 313 (7th Cir. 1978).

¹⁷⁸ 583 F. 2d at 318.

demption of its stock.¹⁷⁹ In *Kraus*, the presence of a call was fatal because it permitted the elimination of troublemakers. In *Koehring*, the presence of a put was equally fatal because it made it possible for the preferred shareholder to exit at will, and that, coupled with the lack of upside financial potential of traditional preferred stock, helped support the court's view of a shareholder with little interest in vigorous management of the company.

In *Garlock Inc. v. Commissioner*¹⁸⁰ the stock was transferable only with the prior written consent of the board of directors, and such consent could not be unreasonably withheld. The preferred shareholders had little long-term commitment to the corporation, because after one year they had the right to put the stock to the corporation on 120 days' prior notice. The voting rights were in a fifty—fifty deadlock configuration, but the agreements provided for the arbitration of shareholder disputes.¹⁸¹ The arbitration provision, which on its face would make control appear even-handed, was dismissed by the court.

[T]he picture of corporate sales, management and other decisions in the fast-moving international trade world of the mid-1960's being made through the process of arbitration under the rules of the International Chamber of Commerce is very nearly risible — the product, perhaps, of an imaginative tax lawyer's drafting contemplations, surely not a working solution to real business needs.¹⁸²

In *CCA, Inc. v. Commissioner*,¹⁸³ the taxpayer had declined to include the common Swiss corporate law provision that the chairman of the Board of Administrators had the authority to break tie votes of the administrators.¹⁸⁴ The taxpayer had scrupulously avoided the inclusion of any redemption power by the corporation or put rights on behalf of the shareholders, and there was no provision for resolving

¹⁷⁹ *Id.* at 318 n.7.

¹⁸⁰ See *supra* note 146.

¹⁸¹ See generally 489 F.2d at 199.

¹⁸² 489 F.2d at 202. The cumulative weight of the other factors probably moved the court to dismiss arbitration so summarily. Arbitration is a common remedy in international business agreements and is reportedly used frequently in joint venture agreements. "Arbitration clauses are the most commonly used contractual tools for providing alternative dispute resolution in joint ventures." Steven R. Salbu, *Parental Coordination and Conflict in International Joint Ventures: The Use of Contract to Address Legal, Linguistic, and Cultural Concerns*, 43 CASE W. RES. L. REV. 1221, 1228 (1993). But see Koziris, *supra* note 158, at 523-24 ("It is not surprising . . . that the use of arbitration to resolve business disputes in France has been rather rare. . . . [A]rbitration is better suited to rendering quasi-judicial decisions, rather than managerial ones. . . . [A]rbitration is cumbersome.").

¹⁸³ 64 T.C. 137 (1975).

¹⁸⁴ See generally *id.* at 144. This is reportedly typical and not limited to Swiss law. "One common solution is to give the chairman . . . the right to a so-called casting or extra vote in the case of tie." See Berens, *supra* note 170, at 1541.

deadlocks among shareholders. The transfer of stock by any shareholder did require the approval of the board of administrators, the membership of which was deadlocked at five members appointed by the common shareholders and five members appointed by the preferred shareholders. The court did not consider the transfer restrictions unreasonable. First, they applied to all shareholders, common and preferred, and did not single out the preferred stock held by the outside shareholders. Second, the provision was a carryover from the old articles of organization that had applied to the corporation when it had only common stock outstanding, and was not apparently added to deal with the new preferred shareholders. Third, it was reasonable to restrict transfers of stock in such a corporation, even if it helped to assure that at least fifty percent of the stock would remain in the hands of non-United States persons, so that controlled foreign corporation status would continue to be avoided.

D. Control Outside the Closely-Held Context

1. *Control Through Business Relationships*

The types of control-generating interests discussed above typically involve some type of equity involvement, or an interest, like an option, that could ripen into such a position. An emerging issue is whether control through economic power, without an ownership interest, can give rise to relatedness that would properly invoke application of section 482. One could offer a number of examples. Consider the position of an enterprise that does not itself have any unique qualities or expertise but that is the sole distributor of a unique good. Does the producer of the good "control" the distributor? Similarly, consider an enterprise that relies on unique licensed technology or a supply of a scarce commodity. Again, consider an enterprise that is a borrower from, or the beneficiary of guarantees given by, one principal lender. There is little guidance in this area, but this topic is discussed in the last part of this paper.¹⁸⁵

2. *Control of the Publicly Held Corporation*

In following the well-traveled path blazed by Berle and Means,¹⁸⁶ it is not surprising that publicly held corporations can be controlled by a less than majority shareholder (or shareholder group) or, on the other hand, by management. In the first general case, a less than ma-

¹⁸⁵ See *infra* text accompanying notes 236-89.

¹⁸⁶ See Berle & Means, *supra* note 55.

jority shareholder could control because the other shares are so dispersed that no other party can mount a challenge, except in very extraordinary circumstances.¹⁸⁷ An otherwise minority shareholding group could also control through "legal devices" such as pyramid ownership structures, non-voting stock or stock with superior voting power, or a voting trust.¹⁸⁸ The Berle and Means treatise is probably most famous for the second case, that it is a predictable result of the rise of the publicly held corporation that control of the entity will be separated from the owners (the shareholders) and wielded by the managers. So-called "management control" exists where no ownership bloc is large enough to constitute owner control of the entity, such that management remains imbedded and in control until a crisis occurs that moves the shareholders to action.¹⁸⁹

Although there is little case law applying section 482 to publicly held corporations beyond dealings with their subsidiaries, it would seem that control would be found in the presence of legal devices. The same result should follow from minority control. In an international context, Disney's ownership of EuroDisney raises this issue. While Disney owns only a forty-nine percent share in the French company, the remaining fifty-one percent is publicly held, such that Disney surely controls the subsidiary for section 482 purposes.¹⁹⁰

Management control is more provocative because it would suggest that interlocking control by professional managers, without significant ownership stakes, could subject the controlled entities to section 482. Because of the state law fiduciary duty conflicts, it is difficult to envision such overlapping management without ownership that overlaps to a corresponding degree.¹⁹¹ However, such structures could arise, particularly in dealing with ownership structures that do not necessarily follow the traditional themes of those encountered in the United States.

¹⁸⁷ Berle and Means describe this phenomenon as "working control." Bearle & Means, *supra* note 55, at 80.

¹⁸⁸ Bearle & Means, *supra* note 55, at 72-80.

¹⁸⁹ Bearle & Means, *supra* note 55, at 84-90. The work of Berle and Means has been criticized, in part, because it does not acknowledge the power of takeovers and unfriendly acquisitions in which control ultimately rests with the shareholders. See, e.g., George J. Stigler & Claire Friedland, *The Literature of Economics: The Case of Berle and Means*, 26 J.L. & ECON. 237, 247-48 (1983). It has also been argued that the degree of ownership by the directors and management is larger than that suggested by Berle and Means. See, e.g., Harold Demsetz, *The Structure of Ownership and the Theory of the Firm*, 26 J.L. & ECON. 375, 387-90 (1983).

¹⁹⁰ See *supra* text accompanying notes 23-24.

¹⁹¹ Of course, one could find such situations if one searches. In *Southern College of Optometry*, *supra* note 60, there existed overlapping management without overlapping ownership.

3. *The Keiretsu Structure*

The "keiretsu" is an informal Japanese business structure that has attracted recent attention, particularly in the context of trade and anti-trust enforcement.¹⁹² The keiretsu groups are generally divided into horizontal keiretsu and vertical keiretsu.¹⁹³

a. Horizontal Keiretsu

Essentially, the horizontal keiretsu involves an interlocking group of companies, often with a bank at the center. "Only the six largest city banks . . . and the leading long-term credit bank . . . are commonly referred to as the centers of their own industrial groups. In English, they are simply the Big Six The Big Six are the strongest and most representative horizontal keiretsu."¹⁹⁴ Each member of the group has some practical business relationship with the others, for example, as a lender, supplier, or customer. The relationship provided by regular business dealings can be strengthened by reciprocal stock ownership, but in many cases the ownership stake of one company in another will be less than five percent. Representatives at different levels of the group may meet very informally, over lunch in many cases, but the consensus is said to be as binding as that provided by formal written resolution. Additional "glue" for the arrangement is provided by the collectivist nature of Japanese culture and transcends legal documentation. One early account described the relationship of the then forty-three member Mitsubishi group:

There is no parent corporation. In addition to national pride and a common cultural heritage for group cooperation, what links the companies together is an array of cross-shareholdings and intercorporate trading. Since the profits of one are partly linked to the profits of another, there is an inducement to give business to one another and to participate in continuing contractor/sub contractor, and other cooperative projects. These activities are coordinated by the *Kinyo-kai* or Friday Conference.¹⁹⁵

If the keiretsu acts as such a disciplined unit, the implications for transfer pricing abuse are obvious. The foreign members of the keiretsu could overcharge the United States affiliates of keiretsu

¹⁹² See, e.g., Julie A. Shepard, *Using United States Antitrust Laws Against the Keiretsu as a Wedge into the Japanese Market*, 6 TRANSNAT'L LAW. 345 (1993); Jonathan E. Johnson III, *Keiretsu: Their Effect on Business and How American Government and Business Can Confront Them*, 1992 B.Y.U. L. REV. 1155 (1992); KENICHI MIYASHITA & DAVID W. RUSSELL, *KEIRETSU — INSIDE THE HIDDEN JAPANESE CONGLOMERATES* (1994).

¹⁹³ See generally MIYASHITA & RUSSELL, *supra* note 192, at 8-12.

¹⁹⁴ MIYASHITA & RUSSELL, *supra* note 192, at 9.

¹⁹⁵ ROBERT EMMETT TINDALL, *MULTINATIONAL ENTERPRISES* 79 (1975).

members, thereby reducing income subject to United States taxation. The overcharge could be adjusted in the myriad of transactions between the members of the keiretsu outside the taxing jurisdiction of the United States. Lest all purchases from foreign companies be scrutinized, one could envision, in more advanced stages of United States based production, similar pricing abuses among the United States affiliates of the keiretsu members.¹⁹⁶

The Service has reported that with respect to a keiretsu, "a court would uphold a broad interpretation of Treas. Reg. § 1.482-1, and that in an appropriate case the IRS may assert that a minority shareholder is in control."¹⁹⁷ If the Service wished to aggregate the minority interests of the keiretsu members, the common objective required by *Forman*¹⁹⁸ would be more difficult to establish under the subtle facts of the keiretsu, which are based on the expectation of mutual benefit that cannot be reduced to a legally binding expectancy. If the common objective requirement is instead a test for establishing why otherwise independent companies would act in concert, then the inquiry might be refocused to why such companies would act together. The standard must be more than simply acting together for one another's mutual benefit. Presumably that would apply to most joint venturers who have joined together for a project with the expectation of profit, and *Forman* arguably isn't that broad. On the other hand, the keiretsu seems to create a tighter relationship than simply goodwill, or the expectation of reciprocal favors, created through continuous dealings or repeated patronage. There are very modest interlocking ownership interests, but taken alone they are not sufficient to create the power usually identified with control.

The complex mixture of factors legal, practical, historical, and cultural that create the keiretsu are not contemplated by the largely legalistic views of control. As discussed in the material that follows, the courts, in applying section 482 to family groups, have tended to assume, in more recent cases, that members of a family act in concert, beyond legal ties. In that regard, members of the family may be presumed to generally act in one another's best interests, not at arm's length, for reasons that they are "family."¹⁹⁹ There may be a general expectation of family support, that favors will be returned at some

¹⁹⁶ For example, one affiliate might otherwise have unutilized United States operating losses, while another is very profitable.

¹⁹⁷ INTERNAL REVENUE SERVICE, REPORT ON THE APPLICATION AND ADMINISTRATION OF SECTION 482, 19 (1992) [hereinafter "IRS 482 REPORT"].

¹⁹⁸ See *supra* text accompanying notes 101-09.

¹⁹⁹ I will resist the obvious analogy that could be made to organized crime "families."

time, and in some form, but neither the immediacy nor the legal enforceability²⁰⁰ is crucial. Those ties could be weakened if certain "family" members perceive that, overall, they receive less from the relationship than they give. In commenting on the keiretsu relationship, one writer observed:

The officers of these firms do, in fact, place the interest of their own company over that of the Group. They are willing to cooperate only insofar as such collaboration will be beneficial to their own firm. But it usually is. . . .²⁰¹

In that regard, it has been observed that the major benefit of horizontal keiretsu is not monopolistic profit sharing, but rather stable profitability and security. Much of the stability stems from the reciprocal aid provided by the keiretsu described as an "implicit mutual insurance scheme."²⁰²

It is uncomfortable to speak in terms of "family" in connection with large corporations or other business entities. The family tie transcends the dealings of the marketplace, and involves a great deal of altruistic behavior that is probably lacking in the keiretsu.²⁰³ Although an analogy to family is probably overstated, some comparisons might be made. The portion of the Service's report on section 482 dealing with the keiretsu opened with language suggesting some similarities in the international audit difficulties encountered in family control and keiretsu control situations.

²⁰⁰ In the controlled foreign corporation regulations, legal enforceability of voting agreements is not a requirement. See *supra* note 124. The controlled foreign corporation case law also focuses on the practical setting of the parties, e.g., as family members, friends, or business associates. See *supra* text accompanying notes 146-54 & 172-84.

²⁰¹ TINDALL, *supra* note 195, at 46.

²⁰² MIYASHITA & RUSSELL, *supra* note 192, at 197.

²⁰³ The role of altruism in the family has been the source of significant scholarly inquiry. See generally GARY S. BECKER, A TREATISE ON THE FAMILY (1991). Some of the family dynamics turn upon a hierarchical structure, in which the altruist, typically a parent, makes gifts to other family members, and the expectation of those gifts helps keep members "in line."

The Rotten Kid Theorem can explain why a parent delays some contributions until later stages of his lifetime; he wants to provide his children with a long-run incentive to consider the interests of the whole family. Indeed, he might retain some contributions until after he dies so that he can have the last word. He would not usually delay all contributions to the end, partly because he must establish good faith with his children.

Id. at 293. It seems that the horizontal keiretsu is not an easy analogy. First, unlike humans, business corporations have perpetual existence, and there is no compelling incentive to distribute largesse to others altruistically. Second, Professor Becker's theory would seem to rest on the presence of a hierarchical altruist, sprinkling wealth to lower levels. The keiretsu does not generally have a parent company structure, and all of the members are more akin to sibling companies, which would seem to suggest a looser, more autonomous relationship among the members of the group.

International examination personnel are confronting a number of situations in which a family group or consortium of corporate taxpayers conducts an integrated economic enterprise coordinated through minority stock ownership. The issue these operations present is whether a shareholder can control a corporation for purposes of section 482 despite the absence of majority ownership. One example is the Japanese concept known as keiretsu. . .²⁰⁴

b. Vertical Keiretsu

As the terminology suggests, a vertical keiretsu is an arrangement resembling parent-subsidary chains, or pyramids, of entities as opposed to brother-sister relationships. The vertical keiretsu is reportedly more common in manufacturing industries where numerous suppliers are required.²⁰⁵ While the first several tiers of subsidiaries may be owned in whole or in part by the parent company, and may bear the parent's name, there are no ownership ties to the lower level members. The bond of the lower level members to the upper tiers is through an exclusive production relationship with those layers above them. "The Japanese tradition of loyalty within a hierarchy has made it very difficult, until quite recently, for subcontractors or free-lance operators to work for more than one organization."²⁰⁶ It has been estimated, for example, that when all the small "mom-and-pop" firms are included, there are around six thousand companies in the NEC keiretsu.²⁰⁷

The first layers of the vertical keiretsu that are affiliated with the parent company through ownership are amenable to traditional analysis. However, the lower tiers, whose only link is a course of exclusive dealings, present more difficult issues. It is reported that the expenses, production methods and investment policies, and overall profitability of the lower tier subcontractors are monitored by the keiretsu with excruciating detail. The subcontractors are periodically required to slash their prices and must deliver products on tight "just-in-time" schedules. Options were limited in the past because if a supplier wished to "defect" from the keiretsu, competing keiretsu would not deal with the defector.²⁰⁸ However, due to economic pressures that ruined many subcontractors, the vertical keiretsu, particularly in man-

²⁰⁴ IRS 482 REPORT, *supra* note 197, at 19.

²⁰⁵ MIYASHITA & RUSSELL, *supra* note 192, at 12.

²⁰⁶ MIYASHITA & RUSSELL, *supra* note 192, at 12.

²⁰⁷ MIYASHITA & RUSSELL, *supra* note 192, at 12-13.

²⁰⁸ MIYASHITA & RUSSELL, *supra* note 192, at 159 (restrictions on outside work); 166-68; 174-75 (parent review of supplier operations).

ufacturing, is reportedly in decline, and subcontractors are more likely to do business with several parties.²⁰⁹

The Japanese vertical keiretsu subcontractor relationship is not without its United States counterparts. Some domestic manufacturers maintain long-term contractual relationships with suppliers. The issue of whether such economic control over a person is within the realm of section 482 "control" is addressed in the last part of this article.

E. "Control" in Family Arrangements

In several contexts, the Internal Revenue Code inflexibly aggregates interests owned by "family" members, irrespective of the cooperativeness of given individuals.²¹⁰ Such attribution rules are not incorporated in section 482. In reading the cases in this area one must distinguish situations in which individuals act in concert for their own self-interests, and happen to also be related to one another, from those in which it is presumed that individuals acquiesce in the decisions of others, due to family dynamics.

1. *Spouses and Children*

The courts do not generally admit that immediate family members, particularly spouses, will be presumed to act in concert due solely to the family relationship. However, one commentator has offered that "[a]s a starting point, in the absence of strong facts to the contrary, whenever the attribution rules of section 318 would impute control, there will be control for section 482 purposes."²¹¹

a. Some Exceptions

Some taxpayers, particularly in older cases, avoided summary application of section 482 to family-owned enterprises. In *Rolland Motor Co., Inc. v. Commissioner*,²¹² the Tax Court addressed the relationship between the owners of a corporation and a sole proprietorship. Mr. Rolland owned 32.24 percent of the stock of the corporation, and his wife owned the remainder. He was also the president

²⁰⁹ MIYASHITA & RUSSELL, *supra* note 192, at 201-02.

²¹⁰ *E.g.*, I.R.C. §§ 318(a), 267(c)(4), 7872(f)(7).

²¹¹ Nauheim, *supra* note 106, at 109. On the other hand, since section 482 turns on the "reality" of control, control might be defeated by established family hostility, which otherwise would have little effect on section 318 attribution. For the case law dealing with "bad blood" and section 318, see BITTKER & EUSTICE, *supra* note 44, ¶ 9.02 [2], n.48. In referring to many of the same authorities cited by Professors Bittker and Eustice, one commentator concluded that family hostility should deflect a finding of section 482 control. See Fuller, *supra* note 75, at 483 n.44.

²¹² 22 T.C.M. (CCH) 143 (1953).

and treasurer of the corporation. The Tax Court refused to allocate to the corporation all of the net income earned by the sole proprietorship that was owned one hundred percent by Mr. Rolland. The result, however, apparently did not turn on the absence of control, and instead was the Tax Court's rejection of the Service's complete allocation of the taxable income of the sole proprietorship. The court believed that the statute permitted only a more considered allocation of items of gross income and deductions, and the wholesale allocation of all net income, without further analysis, was an abuse of discretion.

In *John L. Denning & Company, Inc. v. Commissioner*,²¹³ the Court of Appeals for the Tenth Circuit recognized that spouses and children can operate businesses outside of the control of the other spouse. The husband owned the majority of shares of the taxpayer corporation, and his wife, son, daughter and twenty other individuals owned minority interests. The wife, son, and daughter formed a partnership that engaged in a similar and very successful business. The court refused to treat the family as a unitary control group by linking the corporation and partnership together. The taxpayer enjoyed very good facts. Mrs. Denning was thoroughly experienced in the business and entered the new venture against her husband's advice. Mr. Denning contributed no funds to the partnership, and it established its own credit with independent banks. The partnership ultimately purchased its own warehouse, but in sharing office space and some employees in common with the taxpayer, the parties circumspectly allocated among themselves the overhead expenses, rent, and wages.

The decision first addressed the question of whether the separate business was a sham arrangement, and then the alternative argument that section 45, the statutory antecedent of section 482, applied. In the section 45 discussion the court observed that "[t]he holder of the majority of the stock in the corporation owned no interest in the partnership. The partners owned only a minority interest in the corporation. The earnings of the two entities were entirely separate and distinct."²¹⁴ However, in the discussion of the sham argument, on which the taxpayer prevailed, the court observed, apparently reflecting their view of family relationships, that Mr. Denning did control both entities. "No doubt, John L. Denning exercised a domination over both the corporation and the partnership, but his domination of the partnership was because of the family relation and not because of

²¹³ 180 F. 2d 288 (10th Cir. 1950).

²¹⁴ *Id.* at 291.

the ownership of any interest therein.”²¹⁵ This observation did not bode well for the future vitality of the court’s decision, which was fixated on the legal ownership percentages rather than on the practical realities of control.

Again in *A.G. Nelson Paper Company, Inc. v. Commissioner*,²¹⁶ the Tax Court found that there was no common ownership or control between one corporation, owned 50 percent by the husband, 16 2/3 percent by his wife, and 33 1/3 percent by Mr. Leland Marshall, and another corporation owned 2/3 by the wife and 1/3 by Mr. Marshall’s wife. The corporation owned by the wives was therefore held exactly in the same proportions as the two households’ ownership of stock in the taxpayer. The decision is even more extreme because in *Rolland Motor Co.* and *John L. Denning & Co.*, the principal inquiry was whether the related entities were to be respected as separate taxpayers, and except for some shared expenses, there were few dealings among the entities. In *A.G. Nelson Paper Company, Inc.*, however, the second corporation was formed by the wives to own a building that was leased to the taxpayer, directly raising arm’s length rental concerns. The new corporation, Plainridge Corporation, leased the building from its owner, so capital requirements were limited to the cost of certain improvements. Those were funded by the wives from their own funds, except for a small short-term loan from the taxpayer. On the other hand, the officers of Plainridge were Mr. Nelson as president, Mrs. Nelson as vice-president, and Mr. Marshall as secretary treasurer.

b. Control in Summary Fashion

There are several decisions, generally of more recent vintage, that treat the immediate family as a unit without much discussion. One commentator has discounted the current vitality of the earlier taxpayer-favorable decisions, including *John L. Denning & Co.* and *A.G. Nelson Paper Co.*, noting that “[m]ore recent decisions . . . have looked to the reality of control rather than technical legal ownership.”²¹⁷ In *Central Bank of the South v. United States*,²¹⁸ for example, section 482 was applied to a lease of equipment by a husband to a

²¹⁵ *Id.* at 290. This was an unfortunate comment in light of the strong facts suggesting that Mrs. Denning was truly independent in her new business venture.

²¹⁶ 13 T.C.M. (CCH) 44 (1944).

²¹⁷ Fuller, *supra* note 75, at 481. In referring to the outdated law in this area, the author cited *A.G. Nelson Paper Co.* and *John L. Denning Co.* discussed in *supra* text accompanying notes 213-16. *Id.* at 481 n.35. The controlled foreign corporation cases discussed earlier also provide an analogy, because they look to the activism and self-interest of the outside shareholders and

partnership owned one-half by his wife and one-fourth each by their children.²¹⁹ The court did not discuss the basis of control because it was conceded in the district court and appellate court proceedings.²²⁰

In *Davis v. Commissioner*²²¹ a physician established an x-ray services corporation and a physical therapy services corporation and gifted ninety percent of the stock to his minor children, retaining ten percent for himself. The dividends from the stock were deposited in savings accounts for the children, and none were used to satisfy support obligations of the father. Inasmuch as the children were minors, and the parents were divorced, guardians were appointed, but the identities of the guardians were not reported. The father served as the president of both corporations. In a footnote, the Tax Court tersely concluded without discussion that "we find reality of control obvious."²²²

In *Bluefeld Caterer, Inc. v. Commissioner*²²³ the Tax Court found another clear section 482 control case. Two corporations were in question. In the first corporation, two brothers and their wives each owned fifty percent of the stock. In the other corporation, the two brothers each owned fifty percent. The two brothers served as directors of both corporations, with one or two other individuals, and as the president, vice president, secretary, and treasurer of each. One might argue that although the husbands controlled the second corporation, it is not clear that was the case with the first. On the face of it, if the shares were split one-fourth each, they were in a deadlock position with their wives.²²⁴ On the other hand, one could focus on the common day-to-day control, as evidenced by the overlapping director

assume control by the other shareholders in the face of passivity. See *supra* text accompanying notes 146-55 & 172-84.

²¹⁸ 646 F. Supp. 639 (N.D. Ala. 1986), *rev'd*, 834 F. 2d 990 (11th Cir. 1987).

²¹⁹ Neither the lower nor appellate court indicated if the children were emancipated adults. It appears that the daughter, Jane Cain, was married to Larry Cain, referred to as the son-in-law of the parents.

²²⁰ "It is not contested that the parties to the subject lease were 'controlled parties.'" 646 F. Supp. at 641 (N.D. Ala. 1986). "Appellees concede that the parties to this equipment lease are controlled parties." 834 F. 2d at 992.

²²¹ 64 T.C. 1034 (1975).

²²² *Id.* at 1045 n.4.

²²³ 28 T.C.M. (CCH) 315 (1969).

²²⁴ It appears from the court's description that the stock was held jointly by each married couple. In that event, one would need to refer to the bylaws or governing corporate law to determine their relative rights to vote the stock. Under the Delaware corporation law, for example, among joint tenants, "if only one votes, his act binds all. . . . If more than one vote, the act of the majority so voting binds all. . . . If more than one vote, but the vote is evenly split on any particular matter, each faction may vote the securities in question proportionally." General Corp. Law of Delaware § 217(b), Del. Code Ann. Tit. 8, § 217(b) (1974). One would have expected some discussion of this by the Tax Court.

and officer positions.²²⁵ The Tax Court did not engage in extended analysis and considered the two corporations to have sufficient ties to one another to constitute entities under common control. There are other decisions that are equally summary in their analysis of this issue.²²⁶

An approach, perhaps one followed but not articulated clearly by the courts, would be an application of the common objective principles discussed in the following paragraphs.

c. Control Through Common Objective

Other decisions reach the same result as those discussed immediately above, but base them on the family members acting in concert, for a common goal, apart from family loyalties.²²⁷ This principle of the driving common design produced a chain of three controlled entities in *South Texas Rice Warehouse Co. v. Commissioner*,²²⁸ which extended beyond a simple aggregation of family interests in each entity. The members of four families held identical shareholdings in two corporations. Those shareholders formed a new partnership to engage in the rice drying business, excluding, however, two brothers who together owned thirty-five percent of each of the corporations. The taxpayers argued that the corporations and the partnership were not under the control of the same interests because the partners owned only sixty-five percent of each corporation, and the transaction in question, a lease, required the affirmative vote of shareholders holding at least eighty percent of the voting power of the corporations. The Tax Court found that control in fact was exercised. Although the excluded individuals owned no interests in the partnership, the two

²²⁵ In the absence of shareholder voting agreements or other modifications of corporate governance, such positions could be considered transitory if not founded on ultimate shareholder control. However, permanence of control appears not to be a requirement. See *supra* text accompanying notes 69-76. In the controlled foreign corporation regulations and case law, the legal enforceability of control is not required. See *supra* note 124.

²²⁶ See, e.g., *Engineering Sales, Inc. v. United States*, 510 F.2d 565 (5th Cir. 1975) (corporation 100 percent owned by parents and corporation 99.6 percent owned by children conceded by taxpayers to be under common control); *Friedlander Corp. v. Commissioner*, 25 T.C. 70 (1955) (aggregated the varying interests of husband, wife, and children to find overall control).

²²⁷ There are, of course, a number of cases that ignore transactions by family members when requisite facts are present to support attacks couched in terms of sham or mere agency. See, e.g., *Plantation Patterns, Inc. v. Commissioner*, 462 F.2d 712 (5th Cir. 1972) (husband treated as constructive owner of wife's stock because "surrounding circumstances clearly demonstrate[d] that [the husband] completely controlled the shares held by [the wife].") 462 F.2d at 722. Compare, *Cole v. Helbrun*, 4 F. Supp. 230 (W.D. Ky. 1933) (son's purchases of stock on the advice of father not treated as purchase by father for purposes of wash sale provisions).

²²⁸ 43 T.C. 540 (1965).

corporations, which provided rice for processing by the partnership, and the partnership were an interdependent business operation that required the cooperation of all parties. The identities of the particular shareholders might have changed, but the overall control of the family enterprise did not change, although the court did in passing place some weight on the blood ties of the participants.

[T]hat common control . . . exists is shown not only by the relationship of father and child with respect to the stockholders . . . who permitted their family interest in the partnership to be taken over by their children but also by the fact that the entire operations of [the partnership] were dependent on the overall family interests in various business entities. . . . The facts here show that [the two brothers] merely permitted their children to take their respective portions of the drying, cleaning, and warehousing operations of the entire related businesses, but that in so doing they in no way changed the actualities of the overall control of the various family enterprises.²²⁹

The result in *South Texas Rice Warehouse Co.* is an example of a common objective producing a unified family control group. It is also noteworthy because it demonstrates that the judicial doctrine operates beyond merely aggregating family interests held in each entity, and section 482 control cannot be avoided by simply scrambling ownership interests such that overlapping interests do not exist across putative controlled entities.²³⁰ The business synergy argument demonstrated in the case could be used in analyzing keiretsu relations, but in the latter context the facts will probably not be so clear or confined.

2. Siblings and Other Family Members

The decision in *Robert M. Brittingham v. Commissioner*²³¹ presents a fact situation of family businesses operated by two brothers with international taxation overtones. One brother, Juan, together

²²⁹ 43 T.C. at 562.

²³⁰ The doctrine that identical owners are not required had been followed by the Tax Court on several earlier occasions, most notably in *Grenada Industries, Inc. v. Commissioner*, 17 T.C. 231 (1951).

²³¹ 66 T.C. 373 (1976), *aff'd*, 598 F.2d 1375 (5th Cir. 1979). A companion case involved the corporation that was the subject of *Brittingham*. After the district court found ownership or control by the same interests, the case was reversed and remanded by the same appellate panel of judges, citing at length from the pro-taxpayer result in *Brittingham*. See *Dallas Ceramic Company v. United States*, 74-2 USTC ¶ 9830 (N.D. Tex. 1974), *rev'd & rem'd*, 598 F.2d 1382 (5th Cir. 1979). An interesting fact in these cases was that the taxpayers claimed a different price for customs valuation that was lower than the invoice price between the corporations. That did not affect the transfer pricing tax issue. Under a provision enacted after the years in question, if it is established that imported goods are transferred among related parties (as defined in section 482) the costs of goods in the hands of the purchaser can not exceed the customs value. See I.R.C. § 1059A (1988).

with his wife, mother, and several nominal shareholders owned a Mexican corporation, Ceramica Regiomontana, S.A., that produced ceramic tiles. Juan, his wife, and three daughters owned thirty-seven percent of Dallas Ceramic Corporation, a Texas corporation also involved in the ceramics business. Juan's brother Robert and his two sons also owned thirty-seven percent of the stock of the latter corporation, and the balance of the stock was owned by uncles, an aunt, and cousins of Juan and Robert. The Tax Court declined to apply section 482 to sales of tile between the two corporations, because the stake of Juan and his immediate family in Dallas Ceramic Corporation was not enough alone to permit exercise of control over the business policies of the corporation. The court also rejected the government's argument that there was a common design to shift income that would enlarge the potential control group to include Juan, Robert, and their mother (whose shares were controlled by Juan under a power of attorney). The court was satisfied that, any sibling affection notwithstanding, the ownership stakes by each brother were sufficiently disparate to create conflicting self-interests in the dealings between the two corporations.

To believe that Robert would be a part of a plan to divert \$1.5 million from a corporation in which he and his children owned a 37-percent interest to a corporation in which his immediate family had no interest strains all credulity. . . . Their fraternal relationship alone is not sufficient to infer that there existed any plan to shift income between them.²³²

In this decision, the brothers had clearly adverse interests. It is distinguishable from cases where family members have a common design. It is also distinguishable from those cases involving members of the immediate family where individual family members are presumed to lack conflicting interests and are considered as dominated by other members, particularly those with day-to-day management control of the enterprise.

3. *Related Trusts and Estates*

There are several decisions in which the courts included stock owned by estates or trusts for the benefit of family members.²³³ In

²³² 66 T.C. at 398-99.

²³³ One inquiry should be whether the trustee is an independent trustee, or a family member or similarly situated person subject to influence. This, of course, raises the issue of the role of fiduciary obligations in negating control for section 482 purposes. *See supra* text accompanying notes 127-38. There was no discussion of this point nor the pertinent facts, like the trustee's obligations, in one case presenting this issue. That is not surprising because section 482 was found inapplicable under the facts and circumstances of the parties' dealings. *See Diefenthal v. United States*, 367 F. Supp. 506 (E.D. La. 1973) (stock held by testamentary trusts under grandfa-

Sunshine Department Stores, Inc. v. Commissioner,²³⁴ for example, the court had little trouble aggregating the interests in several entities owned by an estate with those owned by the fiduciaries and beneficiaries.²³⁵

IV. CHANGING THE STANDARDS OF CONTROL

The statutory requirements of “ownership” or “control” play a role in establishing the boundaries of the economic enterprise. Conceptually, they serve to delineate where the enterprise under common control ends and the market’s pricing mechanism begins. That general issue, of course, has been the topic of this article. The refined question is whether the prevailing concepts of control are appropriate.

A. Some Alternatives

The existing statute defining control in section 482 is obviously, and probably intentionally, vague. Some commentators have noted the flexibility that offers the government in applying a section aimed at tax evasion.²³⁶ In the interest of coherence, one might seek to coordinate the control provisions of section 482 with those of other kindred sections, for example, section 957.²³⁷ Although section 957,

ther’s will for the benefit of grandsons, but for which the father was trustee, considered to be a control stake held by the father, but section 482 ultimately found inapplicable on other grounds). *Compare* Rev. Rul. 79-353, 1979-2 C.B. 325, for estate taxation purposes attributes the powers of an otherwise independent trustee to a person who has the right to remove and replace the trustee without cause. *But see Estate of Helen S. Wall v. Commissioner*, 101 T.C. No. 21 (1993) (declining to apply Revenue Ruling 79-353).

²³⁴ 42 T.C.M. (CCH) 1379 (1981).

²³⁵ *See also Cadillac Textiles Inc. v. Commissioner*, 34 T.C.M. (CCH) 295 (1975) (interests held by their children and grandchildren through trusts were aggregated with the interests held by two brothers in finding common control); *Compare* Rev. Rul. 81-233, 1981-2 C.B. 83 (for purposes of section 302(c), custodianship under Uniform Gifts to Minors Act was a tainted interest); Rev. Rul. 71-426, 1971-2 C.B. 173 (trustee of voting trust held tainted interest for purposes of section 302(c)). The analogy, however, to section 302(c) is not strong because of the different objectives of the sections. *See supra* note 83.

²³⁶ “Section 482 is not weighted down with mechanical percentage tests as are other Code sections, such as sections 542, 552 and 957, and thus can be applied much more flexibly.” Fuller, *supra* note 75, at 483. “Section 482 is left intentionally vague in order to allow flexibility of administration.” William T. Plumb, Jr. & Robert H. Kapp, *Reallocation of Income and Deductions Under Section 482*, 41 TAXES 809, 811 (1963).

²³⁷ *See, e.g., Coven, supra* note 36; Fred M. Ringel et al., *Attribution of Stock Ownership in the Internal Revenue Code*, 72 HARV. L. REV. 209 (1958); Thomas J. Reilly, *An Approach to the Simplification and Standardization of the Concepts ‘The Family,’ ‘Related Parties,’ ‘Control,’ and ‘Attribution of Ownership,’* 15 TAX L. REV. 253 (1960). “It is believed that the usual conception of control as well as uniformity would be served if the definition under section 304(c) was applied uniformly throughout the Code in determining control.” *Id.* at 269. “‘Control’ should also have a uniform concept, with a stock ownership of 50 percent constituting control,” *Id.* at 276

determining controlled foreign corporation status, is a critical factor in the structuring of outbound transactions by United States persons, it does not affect the inbound transactions that are one of the emerging areas of interest in section 482. In that regard, a more lenient standard for outbound, as opposed to inbound, transactions would undoubtedly be unacceptable to the international trading partners of the United States²³⁸ In addition, although section 482 definitely has an international role, one cannot overlook its continuing role in purely domestic transactions. One could still argue that to facilitate outbound transactions, if that should be a goal,²³⁹ the standard must be at least as clear as that in section 957. Perhaps, but this area is apparently more sensitive to controlled foreign corporation and foreign tax credit planning anyway.²⁴⁰ Moreover, if it is a reality of international taxation diplomacy that transfer pricing standards cannot discriminate between inbound and outbound transactions, a more taxpayer-friendly standard may be less appealing as a domestic political matter if it comes with the price of also aiding foreign taxpayers. Recent history would not suggest that significant liberalization of transfer pricing restrictions is a legislative interest.²⁴¹

Putting aside the issue of whether the overall balance of the section should be tilted in a given direction, the language of the provision might be improved. "Control" is used in numerous contexts outside of the tax law, notably in securities regulation,²⁴² lender liability²⁴³

(however, the author does not deal with section 482 so that conclusion was probably not intended so broadly).

²³⁸ Aside from the international diplomacy issues, the inbound investments could be through United States corporate subsidiaries. A different standard based on the foreign ownership would also violate the non-discrimination terms of many treaties. See, e.g., U.S. Treasury, 1981 Model Treaty, Article 24, ¶ 5 (June 16, 1981), *reprinted in* sec. 211 Tax Treaties (CCH) 10573, 10,583 (1981).

²³⁹ It is beyond the scope of this article to enter, or even attempt to adequately describe, the political and economic policy debate over appropriate United States government responses to foreign investment by United States persons abroad, on the one hand, and United States investment by foreign persons, on the other. The United States system overall aims to be neutral, but the exceptions and competing cross-currents render that generalization meaningless. For a treatise exploring this subject see HUFBAUER & VAN ROOIJ, *supra* note 25.

²⁴⁰ See *supra* text accompanying notes 92-100.

²⁴¹ The Revenue Reconciliation Act of 1993, Pub. L. No. 103-66, 107 Stat. 416 (codified in scattered sections of 26 U.S.C.), contained several provisions which further tightened the taxation rules for both inbound and outbound transactions. The act reduced the threshold amounts necessary for treatment of a transfer pricing adjustment as a substantial valuation misstatement under I.R.C. § 6662. The legislation also introduced a new I.R.C. § 956A which eliminates deferral on certain earnings of a controlled foreign corporation when invested in "excessive passive assets."

²⁴² See generally Sommer, *supra* note 70; Joseph W. Bartlett & Philip S. Lapatin, *The Status of a Creditor as a "Controlling Person,"* 28 MERCER L. REV. 639 (1977).

and a host of otherwise unrelated federal statutes.²⁴⁴ Because section 482 permits the Service to ignore the separate identity of corporate entities, one might also draw from state law and taxation themes that seek that result for other purposes, like piercing the corporate veil.²⁴⁵ In that regard, one finds approaches such as the unitary business, integrated enterprise, and enterprise doctrines.²⁴⁶ These alternative approaches can be dispatched for the most part, because they are drawn from contexts that are dissimilar in purpose, they use set formulae for finding “relatedness” that may be too easily avoided in the context of section 482 and its purposes,²⁴⁷ or they are as equally vague and pliable as the existing standard. This is not to say that there are no useful expressions of control standards among the many formulations. The American Law Institute Corporate Governance Project, for example, offers a definition of control.

[Control is] the power, directly or indirectly, either alone or pursuant to an arrangement or understanding with one or more other persons, to exercise a controlling influence over the management or policies of a business organization, through the ownership of or power to vote equity

²⁴³ See generally Jeffrey John Hass, *Insights Into Lender Liability: An Argument for Treating Controlling Creditors as Controlling Shareholders*, 135 U. PA. L. REV. 1321 (1987).

²⁴⁴ Control is a factor in applying a number of federal laws, including the Securities Act of 1933, Securities Exchange Act of 1934, Interstate Commerce Act, Federal Power Act, Federal Communications Act of 1934, Bank Holding Company Act of 1956, Public Utility Holding Company Act of 1935, Investment Company Act of 1940, Transportation Act of 1940, and Age Discrimination in Employment Act. See generally Phillip I. Blumberg, *The Corporate Entity in an Era of Multinational Corporations*, 15 DEL. J. CORP. L. 283, 325-45 (1990).

²⁴⁵ In considering whether to pierce the corporate veil and hold a parent corporation liable, the courts have in many cases required more than a finding of control. Other factors such as domination and the “excessive” exercise of control are required. See generally PHILLIP I. BLUMBERG, *THE LAW OF CORPORATE GROUPS* §§ 6.02, 10.02, 19.02 & 20.02 (1987). “Lifting” the corporate veil is a consideration in international law. For example, courts have been faced with determining the nationality of corporations in time of war in the application of “trading with the enemy” legislation. See generally IGNAZ SEIDL-HOHENVELDERN, *CORPORATIONS IN AND UNDER INTERNATIONAL LAW* 8-9 (1987). “Control” over documents has been an issue in the international production of documents for purposes of discovery. See WALLACE, *supra* note 6, at 154-69.

²⁴⁶ Blumberg, *supra* note 244, at 345-75.

²⁴⁷ Professor Blumberg did not suggest changing the pliable language of section 482 as interpreted in the regulations, “[a]voiding reliance on any precise mathematical test that could serve as a blueprint for evasion.” Blumberg, *supra* note 244, at 334. The unitary business doctrine of course is the basis for a formulary apportionment of state and international business taxable income. Rather than refining “control” for purposes of section 482, it would seek to avoid the immediate problem altogether. See generally Stanley I. Langbein, *The Unitary Method and the Myth of Arm’s Length*, 30 TAX NOTES 625 (Feb. 17, 1986); GEOFFREY JOHN HARLEY, *INTERNATIONAL DIVISION OF THE INCOME TAX BASE OF MULTINATIONAL ENTERPRISE* (1981).

interests, through one or more intermediary persons, by contract, or otherwise.²⁴⁸

That definition sounds something like the section 482 regulations, except that it expressly limits influence to that obtained through the power to vote, excluding influence through economic means, such as control over a unique asset. In that regard, the revenue laws for the United Kingdom, for example, in similar fashion limit control to that conferred by share ownership, the articles of association, or other document.²⁴⁹

Even if the current standard is to be retained, interpretations of that standard will continue to evolve in response to new taxpayer developments, including those in the global business environment. As demonstrated by the preceding material, the judicial trend has been a more expansive interpretation of the control requirement. Although the courts have not been reluctant to finely examine the almost infinite variations in the ownership related control structures of enterprises, little precedent exists concerning control through practical or economic means. The latter issue is addressed in the materials below.

B. Control and the Boundaries of the Firm

Multinational enterprises in part engage in transactions with their affiliates because it is more efficient for them than resorting to market transactions.²⁵⁰ Professor Coase proposed that individuals create "firms" because some costs of using the price mechanism can be

²⁴⁸ THE AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE § 1.08(a) (Proposed Final Draft Mar. 31, 1992). Under this definition control can spring only through the ownership of or power to vote equity interests. For this purpose an equity interest includes an interest that is convertible into such an interest. *Id.* § 1.20. A person is not in control solely because of status as a director or principal manager. *Id.* § 1.08(c). Control is expressed in terms of influencing management or policies of the corporation, and transfer pricing decisions would be included under the management role. The American Law Institute proposal has other facets. A person who owns or has the power to vote more than twenty-five percent of the equity interests is presumed to be in control unless some other person owns or has the power to vote a greater percentage of equity interests. *Id.* § 1.08(b). An in concert concept is used in section 1.09, which defines a "control group" as a group of persons who act in concert to exercise a controlling influence pursuant to an arrangement or understanding with each other. This requirement of an understanding is narrower than the standard applied by the court in *Forman*, *supra* note 102. Compare California General Corporation Law § 160(a), Cal. Corp. Code § 160(a) West 1990) ("... '[C]ontrol' means the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a corporation").

²⁴⁹ Paul D. Hunston & Michael W. Turner, *International Taxation and the Great Transfer Pricing Debate: The Position Adopted on the Other Side of the Atlantic*, 24 LOY. L.A. L. REV. 691, 694-96 (1991).

²⁵⁰ See *supra* text accompanying notes 6-10.

thereby avoided.²⁵¹ For him the boundaries of the firm are defined by whether the entrepreneur has the power to direct the activities of the party in question, but "it is not possible to draw a hard and fast line which determines whether there is a firm or not."²⁵² Professor Coase later suggests that the direction factor resembles the degree of direction that, as a matter of law, produces the relationship of master and servant, employer and employee.²⁵³

This analysis at first does not seem particularly relevant in comparing the boundaries of the "firm" to the parties' relatedness for section 482 purposes. However, in building on the work of the economists Cowling and Sugden,²⁵⁴ one writer has suggested that the concept of the firm be expanded to include operations controlled by the enterprise but outside the boundaries of the legal firm.

For example, through sub-contracting the principal can exercise a considerable amount of control over the sub-contractor. Sub-contracting is one of the various ways in which a large corporation can become involved in the coordination of production and can exercise some control over another "firm" without the existence of equity participation. . . . As the network of joint ventures, alliances, licensing agreements and sub-contracting arrangements widens, the need to consider the corporation in terms of control over assets and production rather than in terms of ownership also grows.²⁵⁵

²⁵¹ "[T]he operation of a market costs something and, . . . by forming an organization and allowing some authority . . . to direct the resources, certain marketing costs are saved." R.H. Coase, *The Nature of the Firm*, reprinted in *THE FIRM THE MARKET AND THE LAW* 33, 40 (1988).

²⁵² *Id.* at 40 n.21. Professor Coase uses the example of a contract with a supplier where the service to be provided is expressed in general terms, with details to be supplied at a later date. The contract states only the limits of what the supplier is expected to do, and the details of what the supplier is expected to do are not stated in the contract but are to be decided by the purchaser. "When the direction of resources (within the limits of the contract) becomes dependent on the buyer in this way, that relationship which I term a 'firm' may be obtained." *Id.* at 40.

²⁵³ See generally Coase, *supra* note 251, at 53-55. Years later Professor Coase admitted that the employer-employee example was a weakness of his 1937 article, because the firm will have control over other factors of production, like property, as well as labor. See generally R.H. Coase, *The Nature of the Firm: Influence*, reprinted in *THE NATURE OF THE FIRM* 61, 64-65 (Oliver E. Williamson & Sidney G. Winter eds., 1991).

²⁵⁴ See Keith Cowling & Roger Sugden, *Market Exchange and the Concept of a Transnational Corporation: Analysing the Nature of the Firm*, 9 *BRIT. REV. OF ECON. ISSUES* 57 (1987) (key to the existence of the "firm" is that production is coordinated and controlled from one center of strategic decision making, although some of the relationships might involve market exchanges through, for example, subcontracting).

²⁵⁵ IETTO-GILLIES, *supra* note 7, at 13. "Many long-term contractual relationships (such as franchising) blur the line between the market and the firm. It may be more useful to merely examine the economic rationale for different types of particular contractual relationships in particular situations, and consider the firm as a particular kind or set of interrelated contracts." Benjamin Klein et al., *Vertical Integration, Appropriable Rents, and the Competitive Contracting Process*, 21 *J.L. & ECON.* 297, 326 (1978).

Control exercised through contractual arrangements, short of equity ownership, has been noted by a number of other writers²⁵⁶ and such non-equity relationships are found in many international business arrangements that are growing in popularity.²⁵⁷

In a notable controlled foreign corporation decision, *Estate of Weiskopf v. Commissioner*,²⁵⁸ the Tax Court included in its list of control factors the shareholders' power to terminate supplies of a proprietary technical good. "Since Ininco had no contract with Limited assuring it of any supply beyond current orders, the use of Ininco as an exporting business could have been halted at any time by a firm over which [the shareholders in question] had control."²⁵⁹ This was only one factor in the context of corporations in which the United States party already held a fifty percent equity stake; it should not be confused with an arm's length relationship. Still, the United States party in *Estate of Weiskopf* undeniably held influence over the enterprise beyond its equity stake. This aspect, the compulsion and influence, is considered below.

C. Examining Freedom of Action

Essentially, section 482 is a valuation provision, which seeks to place a fair market valuation on transactions considered as outside the market mechanism because they are between controlled or related actors. In a wealth transfer taxation context, "fair market value" is defined as "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts."²⁶⁰ The degree of "compulsion" is key to the definition. One might argue that a person is not "compelled" to enter into a disadvantageous transaction; there is the alternative of simply foregoing

²⁵⁶ In addressing the special case of the international hotel industry, one commentator has noted that a very high degree of control can be exerted over the local hotel operation through the management contract, which can have an initial term of fifteen to twenty years. *De jure* control is not necessary in part because there is little intra-group trade that needs to be coordinated and the objectives of the multinational are generally shared by the host country licensee. See DUNNING, *supra* note 15, at 260-61.

²⁵⁷ See *supra* text accompanying notes 11-21.

²⁵⁸ 64 T.C. 78 (1975), *aff'd*, 538 F.2d 317 (2d Cir. 1976).

²⁵⁹ *Id.* at 95.

²⁶⁰ Treas. Reg. § 20.2031-1(b) (1993). The regulations dealing with foreign ownership of real estate add "unrelated" to essentially the same definition of fair market value. "Gross value is the price at which the property would change hands between an unrelated buyer and willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of all relevant facts." Treas. Reg. § 1.897-1(o)(2)(ii) (1988).

the opportunity. On the other hand, that view treats business relationships as static, or consisting of only a single negotiated transaction in which the decision is a simple "up or down." It is not unrealistic to assume that the dynamics of business relationships can shift once the parties are committed so that a degree of compulsion is introduced. In that manner, one might expand the concept of control for purposes of 482 to include situations where one of the parties cannot freely bargain, even if temporarily, in the absence of traditional forms of equity-based control.²⁶¹

A recurring theme in discussions of Professor Coase's work is the long-term contract's role in limiting opportunistic behavior by parties to a contract produced by so-called "asset specificity." Asset specificity would arise where "a firm, in order to supply another firm, has to make investments which have little value to it except in its role as supplier to that purchaser."²⁶² The hold-up potential is obvious; once the supplier has made the investments,²⁶³ the purchaser has a bargaining advantage. The converse situation can arise, on the other hand, if the purchaser relies solely on one supplier for a good that cannot be readily obtained elsewhere.²⁶⁴ Professor Coase suggests that long-term contracts can be utilized to limit hold-up tactics, and in that re-

²⁶¹ In classifying international cooperative arrangements one writer has referred to so-called "interfirm cooperative arrangements" as referring to any form of long-term cooperation between firms. He includes within this term long-term supply contracts, a distributor agreement, as well as a manufacturing joint venture. Root, *supra* note 19, at 69. The writer suggested that additional control over the cooperative arrangement can be obtained through ownership, by creating an equity joint venture or by increasing one's equity share, or through enhanced bargaining power, by making the arrangement more dependent on the availability of the firm's proprietary resources such as technology or market entry so that it would be "costly or impossible for other partners to replace." *Id.* at 76. The Treasury Regulations themselves at least suggest that transactions that are arm's length on the surface give rise to "[a] presumption of control . . . if income or deductions have been arbitrarily shifted." Treas. Reg. § 1.482-T(g)(4) (1993).

²⁶² Coase, *supra* note 253, at 69.

²⁶³ The investment could be in a tailored, highly immobile, site, the acquisition of specialized equipment and machinery, investments in specialized human capital created through a "learning-by-doing" process, or general investments by the supplier made because of the prospect of selling a significant amount of product to the purchaser. See generally Paul L. Joskow, *Asset Specificity and the Structure of Vertical Relationships: Empirical Evidence*, in *THE NATURE OF THE FIRM*, *supra* note 253, 117, at 126.

²⁶⁴ This naked power could be subject to other legal constraints, if applicable after considering the international context, such as the requirement of good faith dealings among partners or the Uniform Commercial Code requirement of good faith in so-called "output" and "requirements" contracts. See U.C.C. § 2-306 (1990). See generally Steven J. Burton, *Breach of Contract and the Common Law Duty to Perform in Good Faith*, 94 HARV. L. REV. 369 (1980). See also *Austin Instrument, Inc. v. Loral Corporation*, 29 N.Y.2d 124, 272 N.E.2d 533 (1971) (finding economic duress and business compulsion in a price increase demanded by the supplier of goods under a continuing contract where the goods could not be obtained elsewhere).

gard, he offers the example of the A.O. Smith Company which produced automobile frames, almost exclusively, for General Motors for more than fifty years.²⁶⁵ He points to the enduring nature of the relationship under the contract, in spite of the fact that several key terms were left open for subsequent negotiation.²⁶⁶

Other economists have disagreed with Professor Coase's view of long-term contracts as a solution to the hold-up problem. "Due to uncertainty and the difficulty of specifying all elements of performance in a contractually enforceable way, contracts will necessarily be incomplete to one degree or another. This creates the possibility for transactors to take advantage of the contract to hold up their contracting partner."²⁶⁷

Under this view the parties to a long-term contract cannot predict all of the situations that might occur, so future openings for opportunistic behavior are inevitably presented. In the context of an international joint venture or other affiliation, the United States party would not necessarily be dominant. Although the United States party could be providing technology, other intangibles, or capital and could thereby throttle the venture if the technology transfer or capital infusion is subject to termination,²⁶⁸ the United States party might have already invested significant sums in production infrastructure. Moreover, if the host country participant was chosen for political or business influence, that ultimately could be the most irreplaceable contribution to the venture, producing more leverage to the party wielding that power.²⁶⁹

²⁶⁵ See generally Coase, *supra* note 253, at 71-72.

²⁶⁶ For example, prices were set by annual negotiations, subject to changes for modifications in design or changes in costs. Coase, *supra* note 253, at 72. If the parties are otherwise under common control, the appraisal of who ultimately bears certain economic risks of a business transaction is also pertinent to the determination of the appropriate transfer price in several contexts. See, e.g., Treas. Reg. § 1.482-1T(c)(3) (1993) (evaluation of risk bearing in determining comparability); Prop. Treas. Reg. § 1.482-2(g), 57 Fed. Reg. 3751 (Jan. 30, 1992) (sharing of risks in research and development cost sharing arrangements).

²⁶⁷ Benjamin Klein, *Vertical Integration as Organizational Ownership: The Fisher Body-General Motors Relationship Revisited*, in *THE NATURE OF THE FIRM*, *supra* note 253, 213, at 215.

²⁶⁸ "For example, the fact the General Motors of Canada is technologically dependent on its United States parent means that even were it to become 100 percent-owned by Canadian interests, it would still be dependent on the parent to provide the technical assistance necessary for its survival. Again, the stock ownership in such cases has little relevance as a controlling influence, the real control residing at the source of the vital technical assistance." WALLACE, *supra* note 6, at 75.

²⁶⁹ Obviously, the underlying circumstances of specific joint ventures will vary. Some joint ventures will be among equals, among the largest corporations. One writer has termed this as the "global core business venture." Koot, *supra* note 141, at 348. Other ventures will be by large corporations expanding in non-industrialized countries. This has been categorized as the "LDC-

The facts in *Estate of Weiskopf* suggest that the United States company held hold-up power over the venture through its power to terminate the license of the business intangibles. In addition, although the broader issue before the court was whether the foreign subsidiary was a controlled foreign corporation, not a section 482 issue, the determinative factor was the presence of control. The licensing agreement was only one of several factors producing control, so a high degree of “relatedness” already existed. Nevertheless, the result could be applied to find control under section 482 in similar circumstances, for example, where the United States party is a fifty—fifty co-venturer with a foreign party.

D. Application to Purely Contractual Relationships

Although the United States shareholder in *Estate of Weiskopf* owned an equity interest in the firm, the result might be applied to strictly contractual relationships. Short-term relationships, or occasional transactions, do not involve the same degree of compulsion, beyond the “take it, or leave it” exchanges in the marketplace and should be excluded. This is not a surprising conclusion. The purpose of section 482 is to prevent tax avoidance, not to enforce fairness in dealings. Tax avoidance is difficult to find when an otherwise unrelated taxpayer gets an unusually good or bad deal, from an economic perspective, and another taxpayer enjoys the converse of that situation.²⁷⁰ An unstated basis for section 482 allocations is perhaps the sense that in dealing with related or controlled taxpayers, an incorrect or abusive transfer price now will be “made up” in the future by some future accommodation from the other party, the ultimate receipt of which is assured by the relatedness or control.²⁷¹

A long-term contractual relationship, even without equity aspects, is closer to the facts of *Estate of Weiskopf* and can present some of the “hold-up” opportunities discussed earlier. The relationship due to its duration and greater degree of financial commitment can pro-

joint venture” and “[r]elative inequality of northern and southern partners are a fact of life here.” *Id.* The third type of joint venture is the “continental partnership” which accounted for 90 percent of the writer’s data. With this type of venture “[b]ig, middle-sized, or even small businesses take an option for a capital partner in another industrialized country, with the aim of ‘conquering a continent’ for their capital or product.” *Id.* at 349.

²⁷⁰ With regard to the United States fisc, if United States companies were to consistently negotiate better deals than their foreign counterparts, it seems that such discrepancies would lead to even more enhanced revenues.

²⁷¹ However, Professors Bittker and Eustice have observed that direct pecuniary benefit from an improper allocation is not a prerequisite to application of section 482. *See supra* note 59.

duce greater dynamics in a continuing give and take. There does not appear to be a meaningful difference between ownership rights, under an equity arrangement, and rights provided through contractual alliances.²⁷² Both situations present the opportunity for transfer pricing flexibility which is recouped in other facets of the overall arrangement. With the exception of *Estate of Weiskopf*, there is little judicial precedent and no legislative authority supporting an economic view of control. As with much of the gloss placed on section 482, the Treasury would need to take the lead in its regulations and other administrative pronouncements. In at least one international tax provision, the Treasury has acknowledged that economic factors can produce control, but it has apparently limited that application to such factors in conjunction with an ownership interest.²⁷³

Contractual alliances among near equals would not demonstrate the same degrees of compulsion.²⁷⁴ However, smaller contractors with long-term relationships could be subject to these pressures. That

²⁷² Some economists contrast the rights one has in an enterprise as an owner, as compared with a contractor, on the basis of the "residual rights of control." See generally Oliver D. Hart, *Incomplete Contracts and the Theory of the Firm*, in *THE NATURE OF THE FIRM*, *supra* note 253, 138, at 140-54. Generally speaking, most contracts will be incomplete as to some term, and one of the parties will not be required to act with respect to that term, and therefore has a residual right of control over that term, but over nothing else. In an ownership situation, one has residual rights of control over those factors with respect to an asset or enterprise that exceed those claims of non-owners such as creditors and other parties to a contract that applies to the asset or enterprise. "Of course, control or ownership is never absolute. . . . However, ownership gives the owner all rights to use the [asset] that he has not voluntarily given away or that the government or some other party has not taken by force. . . . [T]he owner of an asset has the residual rights of control of that asset, that is, the right to control all aspects of the asset that have not been explicitly given away by contract." Sanford J. Grossman & Oliver D. Hart, *The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration*, 94 J. POL. ECON. 691, 694-95 (1986). In the case of a very simple case of technology, for example, it is easy to see the greater "bundle of sticks" retained by the owner and licensor of the technology as compared with those held by a licensee for a limited term or limited geographical area. The residual rights analysis does identify some obvious differences between the sole ownership of property and contractual rights, but they are not overly relevant to this issue. In dealing with the shared ownership of underlying property through the ownership of intangibles, like partnership or corporate interests, the relationships are essentially contractual based. See, e.g., John C. Coffee, Jr., *The Mandatory/Enabling Balance in Corporate Law: An Essay on the Judicial Role*, 89 COLUM. L. REV. 1618 (1989).

²⁷³ In defining "effective practical control" for purposes of the taxation of controlled commercial entities of foreign governments, the regulations acknowledge that control might be achieved through "creditor, contractual or regulatory relationships." Treas. Reg. § 1.892-5T(c)(2) (1988). An example is also given of "a substantial creditor of the entity or [control of] a strategic natural resource which such entity uses in the conduct of its trade or business." *Id.* The regulation, in each case, notes that such practical control is in conjunction with an ownership interest. However, the statute provides an ownership test and an alternate control test, the latter not requiring any ownership stake on its face. See I.R.C. § 892(a)(2)(B) (1988).

²⁷⁴ See *supra* note 269.

typically was the situation of the lower tier subcontractors in the vertical keiretsu.²⁷⁵ In the vertical keiretsu many lower-level subcontractors were reportedly forced into financial ruin by the "Yen shock" economic pressures that percolated down to their level from the upper tiers.²⁷⁶ The economic concessions demanded by the parent companies were so great that many of the subcontractors could not survive. This arguably demonstrated that the long-term reciprocal benefit relationship, under stress, was reduced to the predictable arm's length survival conduct of the marketplace of everyone for themselves. "The parent companies that once supported them in good times or bad can no longer afford to do that. The social contract has been broken. . . . If the parent firm can no longer give them enough work, the market principle will take over."²⁷⁷

One could argue that it is improper to evaluate the relationship in terms of an extreme case, ultimate disassociation upon insolvency, rather than according to its normal operating pattern. Even parent companies could permit wholly-owned subsidiaries to fail; that possibility does not negate the non-arm's length nature of the relationship that previously existed.²⁷⁸ On the other hand, with a parent and subsidiary relationship it is clear who bears the risk of interim profit or loss, or ultimate failure; it is the parent. In a subcontractor relationship, on the other hand, in an absolute failure it would seem that through the contract all or a portion of the ultimate loss of capital would be shifted onto the subcontractor. Although that response is intuitively appealing, section 482 control principles do not neatly fall along the lines of which party bears the ultimate risk of loss, or preponderance of the loss,²⁷⁹ because control can be separated from ownership or pecuniary gain.²⁸⁰

Even if one accepts this interesting premise, the enforcement of an even broader standard would be difficult to administer. It is particularly an improbable option in the international environment, since it

²⁷⁵ See *supra* text accompanying notes 205-09.

²⁷⁶ MIYASHITA & RUSSELL, *supra* note 192, at 159-60, 199-200.

²⁷⁷ MIYASHITA & RUSSELL, *supra* note 192, at 201.

²⁷⁸ If marriage created an absolute related party situation one could likewise downplay the related party aspects in the present due to the possibility of dissolution of the marriage. Of course, there are a number of important factors, like the degrees of separate wealth, the share of wealth upon dissolution, etc.

²⁷⁹ In a joint venture, for example, with two parties risking their capital, the control person under this model would be the party with the most at risk, which would often correlate with equity ownership and voting.

²⁸⁰ See *supra* text accompanying notes 54-88.

requires cooperation among international taxing authorities.²⁸¹ The earnest United States interest in transfer pricing abuses has at times raised concerns with trading partners, particularly when stances considered as very extreme are assumed by the Treasury. The Treasury's regulations interpreting section 482, in particular the "commensurate with the income" intangible pricing provisions, have produced significant discontent among other countries.²⁸² The introduction of a control standard based on more subtle economic control bases would probably not be welcomed. On the other hand, as transfer pricing becomes important to more of the public treasuries of an increasingly interrelated global business environment, United States positions could gain wider acceptance.²⁸³

Several countries have already adopted very broad definitions of control in their transfer pricing rules. China has reportedly included in its definition of an "associated enterprise" situations where "the business operations of an enterprise depend upon franchises, indus-

²⁸¹ "From the standpoint of section 482, this means that if each taxing jurisdiction picks the arm's-length standard that maximizes that jurisdiction's tax revenues, double taxation will inevitably be the result. . . . In this context, therefore, it is not tax avoidance, but double taxation, that is at issue, and this, presumably, is exactly the appropriate setting for appeal to competent authority involving the tax authorities of both nations." Berry et al., *supra* note 47, at 737. The 1981 Model Treaty proposed by the Treasury as its starting point in treaty negotiations, provides for a "Mutual Agreement Procedure" between the so-called "competent authorities" of the two contracting jurisdictions. Among other things, the two competent authorities can agree "to the same allocation of income, deductions, credits, or allowances between persons." U.S. Treasury, 1981 Model Treaty, Article 25, ¶ 3(b) (June 16, 1981), *reprinted in* sec. 211 Tax Treaties (CCH) 10,573, 10,583 (1981). Cooperation is the key to more long-range solutions, like a formula apportionment approach. *See, e.g.,* HUFBAUER & VAN ROOI, *supra* note 25, at 149-51 (urging continued cooperation first, in applying Advanced Pricing Agreements among competent authorities and "baseball style" arbitration, as preparation for other measures, like formula sharing).

²⁸² *See, e.g.,* European Organization Says Transfer Pricing Rules May Obstruct Flow of Goods and Services, 92 TAX NOTES INT'L 31-48 (Jul. 29, 1992); Japanese Exporters Comment on Transfer Pricing Regs., 92 TAX NOTES INT'L 32-36 (Aug. 5, 1992); Transfer Pricing Regs Should Follow International Standards, Swiss Group Says, 92 TAX NOTES INT'L 32-32 (Aug. 5, 1992); GULCNFTC Conference Paper Discussing a German Perspective of the Temporary U.S. Transfer Pricing Regulations, 93 TAX NOTES INT'L 51-7 (Mar. 17, 1993); International Chamber of Commerce Issues Comments on Temporary 1993 U.S. Transfer Pricing Regulations, 93 TAX NOTES INT'L 206-18 (Oct. 26, 1993).

²⁸³ The United States, for example, was one of the first countries to adopt anti-abuse provisions aimed at controlled foreign corporations, so-called "Subpart F." Industrialized countries like the United Kingdom, Germany, France, and Japan ultimately followed that lead in adopting similar systems. The United States also took the lead in the application of the arm's length standard to international transactions, although the United Kingdom's Inland Revenue department has been notably aggressive in dealing with perceived transfer pricing abuses. *See generally* Hunston & Turner, *supra* note 249. Japan has adopted the arm's length standard, but the Japanese view the United States as adopting unilateral measures, without international cooperation, when considered necessary to protect the tax base. *See generally* Guttentag, *supra* note 116.

trial property rights, or proprietary technology provided by another enterprise.”²⁸⁴ Such relationships also include those “where raw materials . . . are controlled or supplied by another enterprise.”²⁸⁵ Japan has also adopted affiliation tests that look to the business reality of control. The Japanese provisions are in part keyed to fifty percent stock ownership.²⁸⁶ However, the Cabinet Order implementing the legislation includes as potential control situations the presence of loans or guarantees between corporations in business transactions and cases where one corporation’s business is very dependent on the other corporation.²⁸⁷ The Japanese tax authorities have extended inquiry into these “special relationships” to the area of interest deductions and thin capitalization.²⁸⁸ Aggressive enforcement of the broad language will be the crucial test.²⁸⁹

The ultimate product of these developments may not be related status for purely contractual ties, but the inquiry will surely raise the level of scrutiny of such points of influence as applied to situations in which some ownership positions are held. This promises to be a de-

²⁸⁴ PRICE WATERHOUSE, *supra* note 15, at 9.

²⁸⁵ PRICE WATERHOUSE, *supra* note 15, at 9. The definition also includes situations “[w]here funds borrowed from or lent to another enterprise are more than 50% of the . . . funds of an enterprise or where more than 10% of the funds borrowed from or lent to an enterprise is guaranteed by another enterprise . . . [and] [a]ny other associations with mutual benefits whereby actual control can be exercised over an enterprise’s business.” *Id.*

²⁸⁶ A party is related if “[e]ither the foreign corporation has direct or indirect ownership of the foreign corporation equal to at least 50% of the issued shares or contributed capital, or . . . 50% or more of the issued shares or contributed capital of both the corporation taxable in Japan and the foreign corporation are directly or indirectly owned by the same person.” Paul Lacy and Nobuhiro Shirasu, *Inter-Company Transfer Pricing; Japan’s New Tax Code Puts Burden of Proof Onto the Taxpayer*, Reuter Textline, *Int’l Tax Rep’t*, Sept. 16, 1986, at 5-6, available in WESTLAW, INT-NEWS file.

²⁸⁷ *Id.* “Transactional dependence means that a considerable part of the business activities of either corporation depends on transactions with the other corporation, including a situation in which either corporation conducts its business based on the industrial property rights or know-how (which form the basis of its business activities) offered by the other corporation. Financial dependence means that a considerable part of the funds required for the business activities of either corporation is procured through borrowings or guarantees from the other corporation.” Guttentag, *supra* note 116, at 12.

²⁸⁸ The interest deduction of a Japanese company is reportedly limited if it is both foreign owned and thinly capitalized. “A company is foreign owned if either (1) 50% or more of its capital is owned, directly or indirectly, by a foreign company or (2) it has a special relationship . . . with a foreign company.” PRICE WATERHOUSE, 19 INT’L TAX REV. 9 (May/June 1993). In finding a special relationship, “[w]hether or not the Japanese company can operate without industrial property rights . . . which are supplied by the foreign company” or if “[m]ore than half of the directors . . . are, in substance, selected by the foreign company” will be factors. *Id.*

²⁸⁹ After describing the broad Japanese control rules, one commentator noted “[t]he Japanese definition of ‘control’ appears clearer and somewhat broader than the U.S. definition. However, in practice, there may not be any substantial difference between the two.” Guttentag, *supra* note 116, at 12.

veloping area with the anticipated increase in the number of cooperative arrangements crossing international borders.

V. SUMMARY

In structuring global investments controlled foreign corporation status has dominated the literature. This article has investigated the case law interpreting the control requirements of section 482 with a view toward its application to international business transactions. Although control for this purpose shares many of the same factors found in the controlled foreign corporation inquiry, there are some differences. Because of these differences, it may be possible to structure transactions that accomplish controlled foreign corporation objectives, while avoiding section 482 status.

Reflecting a facts and circumstances inquiry, the section 482 control case law is very pliable and shifting. It is difficult to fashion a narrower definition of control that will serve the anti-avoidance purposes of section 482. However, with the apparent proliferation of less than wholly-owned business vehicles, purely contractual, non-equity business alliances, and the importation of other nontraditional arrangements like the keiretsu, it appears that the control aspects of section 482 will demand closer scrutiny in years to come. Resolution of those issues will, in typical 482 litigation fashion, turn upon often murky details of relationships and other facts and circumstances. Administrability of any standard is, of course, an ever-present concern. Apart from continued development of fact patterns, the current views of control will need to be expanded to meet the challenge of the keiretsu and contractual alliances. The first step will require administrative action by the Service in that direction. With some notable exceptions in the Chinese and Japanese laws, that will be an ambitious step for the international trading partners who have followed the United States' lead in transfer pricing matters, but generally with less conviction.