COMMISSIONER v. FIRST SECURITY BANK: ALLOCABILITY UNDER SECTION 482 OF LEGALLY NONRECEIVABLE INCOME

In Commissioner v. First Security Bank, the Supreme Court addressed for the first time the operation and scope of section 482 of the Internal Revenue Code, which authorizes the Commissioner of Internal Revenue to allocate income among taxpayers controlled by the same interests. In an opinion written by Justice Powell, the Court resolved a conflict between the Seventh and Tenth Circuits by holding that the Commissioner may not allocate income under section 482 to a taxpayer who has not actually received the income, if it would violate federal law for him to receive it.

Section 482 also authorizes the Commissioner to allocate deductions, credits, and allowances. This Comment will deal only with the allocation of income.

Section 482 provides:

In any case of two or more organizations, trades, or businesses owned or controlled directly or indirectly by the same interests, the Secretary or his delegate may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any such organizations, trades, or business. INT. REV. CODE OF 1954, § 482.

Section 482 conditions the Commissioner's power to allocate income on two requirements: the taxpayers must be controlled by the same interests, and there must be either an evasion of taxes or a failure clearly to reflect income. This Comment will not discuss the factors necessary to establish the existence of control. For a discussion of the control requirement, see Hewitt, Section 482—Reallocation of Income and Deductions Between Related Persons—Up to Date, N.Y.U. 22D INST. ON FED. TAX., 381, 383-85 (1964). Nor will this Comment discuss what constitutes an evasion of taxes for purposes of § 482. It should be remembered that an evasion of taxes is not an essential element for a § 482 allocation. Section 482 may be invoked alternatively “to prevent evasion of taxes or clearly to reflect the income” of related taxpayers. INT. REV. CODE OF 1954, § 482. These two considerations independently trigger the operation of § 482. Central Cuba Sugar Co. v. Commissioner, 198 F.2d 214 (2d Cir. 1952). A defense of legitimate business purpose, sufficient against a claim of tax evasion, is inadequate to prevent an allocation necessary “clearly to reflect the income” of related taxpayers. Dillard-Waltermire, Inc. v. Campbell, 255 F.2d 433 (5th Cir. 1958); Eli Lilly & Co. v. United States, 372 F.2d 990 ( Ct. Cl. 1967); Oil Base, Inc., 23 CCH Tax Ct. Mem. 1838 (1964), aff’d, 362 F.2d 212 (9th Cir. 1966). In invoking his § 482 powers, the Commissioner usually claims that the allocation is necessary to reflect income clearly; it is that type of claim which was made in First Security and which is treated in this Comment.

Mr. Justice Marshall and Mr. Justice Blackmun, joined by Mr. Justice White, dissented in separate opinions.


The Court indicated that it would have reached the same result if receipt had been
After discussing briefly the purpose of section 482, and the arm’s length standard established in the regulations for the allocation of income under that provision, this Comment will examine the way in which the courts have dealt with allocations to taxpayers who have not received the income in question and who are barred by law from receiving that income. Specifically, it will criticize the approach taken by the Supreme Court in First Security as mechanical and unresponsive to the Congressional intent behind the provision in question. The Comment will point to the inadequacy of the traditional arm’s length standard in cases in which the taxpayer has not received and legally may not receive the income in question. And it will propose a general standard which would be applicable to all section 482 cases, but which would incorporate the arm’s length standard as the most useful expression of the general standard in most cases.

I. BACKGROUND: CONGRESSIONAL INTENT AND THE ARM’S LENGTH STANDARD

Section 482 and its statutory predecessors represent legislative attempts to limit the ability of affiliated groups of taxpayers to reduce tax liability by diverting income and deductions from one member of the group to another. It stems ultimately from section 240(d) of the Revenue Act of 1921, which was aimed at remedying the shifting of income to a foreign subsidiary. Section 240(d) authorized the Commissioner of Internal Revenue to consolidate the accounts of related trades and businesses “for the purpose of making an accurate distribution or apportionment of gains, profits, income, deductions, or capital . . . ”

Section 482’s immediate statutory predecessor was section 45 of the 1939 Code, which contained in pertinent part language identical to that of the present section 482. Section 45 was first enacted in the 1928 Revenue Act. Its purpose, as prohibited by state law, 405 U.S. at 406 n.22, as was the case in Local Finance Corp., 48 T.C. 773, aff’d, 407 F.2d 629 (7th Cir. 1967), cert. denied, 396 U.S. 956 (1969).

7The tax savings which can result from such diversions of income and deductions are of several kinds: income diverted to a foreign subsidiary ordinarily is not subject to United States taxation; income shifted to a trade corporation within the Western Hemisphere is taxed at a lower effective tax rate, see Int. Rev. Code of 1954, §§ 921-22; income transferred to a loss corporation can be sheltered by its losses; income diverted to individuals is taxed at a different rate; and income split among a number of corporate taxpayers can reduce tax liability because of multiple surtax exemptions (although the availability of multiple surtax exemptions is presently being phased out, Int. Rev. Code of 1954, §§ 1562, 1564). B. Bittker & J. Eustice, Federal Income Taxation of Corporations and Shareholders ¶ 15.06, at 21-22 (3d ed. 1971).

8Revenue Act of 1921, ch. 136, § 240(d), 42 Stat. 260.
stated by the House Ways and Means Committee in 1928, was to provide the Commissioner with power to allocate income and deductions among related taxpayers "in order to prevent evasion (by the shifting of profits, the making of fictitious sales, and other methods frequently adopted for the purpose of 'milking'), and in order clearly to reflect their true tax liability."\(^1\)

The regulations promulgated under section 482 provide a more specific statement of purpose: "[t]he purpose of section 482 is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer, by determining, according to the standard of an uncontrolled taxpayer, the true taxable income from the property and business of a controlled taxpayer."\(^2\) They proceed to define the "true taxable income" of a controlled taxpayer as "the taxable income ... which would have resulted to the controlled taxpayer, had it in the conduct of its affairs ... dealt with the other member or members of the group at arm's length."\(^3\)

The standard adopted in the regulations\(^4\) can be illustrated in a case involving \(A\), the parent corporation, \(B\), a foreign subsidiary, and \(C\), an unrelated taxpayer.\(^5\) Let us assume that the rate of the foreign tax, to which \(B\) is subject, is lower than the rate of the United States tax, to which \(A\) is subject. \(A\) has property with a cost basis of $10,000 and a fair market value of $25,000. \(A\) sells the property to \(B\) for $10,000. The amount realized by \(A\) is equal to its cost basis, and \(A\) therefore realizes no income. Immediately after buying the property from \(A\), \(B\) sells it to \(C\) for $25,000, and \(B\) reports a gain of $15,000, the excess of the amount \(B\) realized over \(B\)'s basis in the property. Using the powers granted him in section 482, the Commissioner can allocate $15,000 of \(B\)'s income to \(A\), thereby increasing the total


\(^{2}\)Treas. Reg. §1.482-1(b) (1962). The first regulations interpreting § 482 were promulgated in 1934 and were retained virtually unchanged until 1968. The 1968 amendments incorporated the prior regulations and provided additional guidelines and formulas for the allocation of income and deductions in specific situations. See generally Jenks, Treasury Regulations Under Section 482, 23 Tax Law. 279 (1969).

\(^{3}\)The portions of the present regulations discussed in this Comment were present in the earlier regulations. The 1968 amendments offer no assistance in understanding the issues and problems treated in this Comment and will, therefore, not be discussed.

\(^{4}\)Treas. Reg. § 1.482-1(a) (1962).

\(^{5}\)The arm's length standard is explained elsewhere in the regulations as "that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer." Treas. Reg. § 1.482-1(b)(1) (1962).

\(^{15}\)E.g., Asiatic Petroleum Co. v. Commissioner, 79 F.2d 234 (2d Cir.), cert. denied, 296 U.S. 645 (1935).
tax liability of the controlled corporate group by reducing the amount of income given preferential treatment and raising A's tax liability to what it would have been had it sold the property to an unrelated party. While there is some authority for allocating income under section 482 on a test of whether a related business entity has a legitimate business purpose, it is the arm's length standard applied in this example that is generally used by the courts to determine whether an allocation is necessary to produce a clear reflection of income.

II. PRECEDENTS UNDER SECTION 482

Before First Security, the Tax Court decided three cases involving allocations of income under section 482 and its predecessor provision to taxpayers who did not receive and legally could not receive that income. The Tax Court struck down the Commissioner's allocation in the first two cases, L.E. Shunk Latex Products, Inc. and Nichols Loan Corp., and it upheld the allocation in the most recent case, Local Finance Corp. 16

16 In Hamburger's York Road, Inc., 41 T.C. 821 (1964), the court held that all the income of a corporation could be allocated under § 482 to its affiliate corporation, for the reasons that there was no substantial business purpose for separate incorporation, that the business was a single, integrated enterprise, and that the taxable earnings of the related businesses could all be attributed to the goodwill and business organization of the taxpayer. The reasoning and result of the court is criticized in Mansfield, The 482 proposed Regs: The problems with which practitioners will have to contend, 28 J. Tax. 66, 67 (1968). Courts have also disregarded a taxable entity on the theory that the principal purpose in establishing a separate corporate taxpayer was avoidance of federal income tax. See J.R. Land Co. v. United States, 361 F.2d 607 (4th Cir. 1966).

The principle that a taxable entity may be disregarded for the reason that it is a mere sham without legitimate business purpose is open to serious question when used in the application of § 482. The operation of § 482 presupposes the existence of at least two taxable entities in order to allocate income from the one to the other. There is a paradox in recognizing the separate existence of a related taxpayer in order to invoke the statute and then to disregard the existence of the related business in order to apply the provision. See Miles-Conley Co., 10 T.C. 754 (1948), aff'd 173 F.2d 958 (4th Cir. 1949); cf. Shaker Apartments, Inc. v. United States, 66-2 U.S. Tax Cas. § 9538 (N.D. Ohio 1966).


18 A court will uphold the Commissioner's allocation unless the taxpayer can show that the allocation is arbitrary or unreasonable, Spicer Theater, Inc. v. Commissioner, 346 F.2d 704 (6th Cir. 1965); Ballentine Motor Co. v. Commissioner, 321 F.2d 796 (4th Cir. 1965).
A. L.E. Shunk Latex Products, Inc.

In the Shunk case, two related manufacturers of rubber prophylactics sold their products to a distributor controlled by the same interests that controlled the manufacturers. In January 1942, the distributor raised its prices, while the manufacturers left their prices unchanged. Subsequently the Office of Price Administration ordered that prices charged by manufacturers of "rubber drug sundries," which included prophylactics, were not to exceed the prices charged on December 1, 1941. The rollback did not apply to retailers. Consequently, the distributor was free to maintain its prices at the 1942 level, and was able to reap large profits by buying at a depressed wholesale price and selling at a comparatively high retail price. Using the authority granted under section 482's predecessor provision, the Commissioner allocated part of the distributor's income to the manufacturers on the theory that a portion of the increased profit caused by the price increase was earned by the manufacturers. The Tax Court held that the allocation was improper, because under the OPA order the manufacturers could not raise wholesale prices and therefore could not receive the income allocated to them.

B. Nichols Loan Corp.

In Nichols, the Commissioner allocated credit insurance commissions received by the officers and principal shareholders of corporations engaged in the small loan business to those corporations, in the face of a state law which prohibited a corporation from acting as an insurance agent and from receiving insurance commissions. Prior to the incorporation of the lending institutions, the loan business had been conducted by several partnerships, and the insurance commissions were paid to the individual partners, who were designated as agents of the insurance companies writing the policies. After incorporation the individual partners, who were now the officers and principal shareholders of the loan corporations, continued to act as agents of the insurance company, to receive the commission income and to report it on their individual returns. When a borrower desired credit insurance, employees of the corporation filled out the

---

374 (8th Cir. 1963). That case refers to a state prohibition against banks engaging in the insurance business for the purpose of the showings that a separate business entity created by bank stockholders to sell insurance was not a mere sham. The application of § 482 is not dependent upon a finding of an absence of business purpose, however, and therefore the case is not relevant. See, note 3 supra. Furthermore, the court in Campbell County State Bank found that the banks did not earn the disputed income, which by itself precludes the application of § 482.

2121 T.C. at 959-61.

2218 T.C. at 959-61.
necessary insurance forms, collected the premiums, and turned over the premiums to the corporate officers, who deducted a commission and forwarded the remainder of the premiums to the insurance company.\(^\text{23}\)

In an opinion which made no reference to section 482,\(^\text{24}\) the Tax Court struck down the Commissioner's allocation of the commission income to the corporation. It went on the theory that none of the corporations acted as an insurance agent or received any of the commission income in violation of the state law — that the corporations merely furnished the individual officers with the accommodations and services that were necessary for the officers to carry on their own business. Consistent with this view of the facts, the court held that each corporation should be disallowed that portion of its business expense deduction attributable to the insurance business conducted on loan company premises by the corporate officers in their individual capacities.\(^\text{25}\)

C. Local Finance Corp.

Local Finance also involved an allocation of income in the form of credit insurance commissions to the lender who generated the credit insurance premiums, but in Local Finance the Tax Court and the Seventh Circuit upheld the Commissioner's allocation. Five finance companies, all wholly owned subsidiaries of Local Finance, were engaged in the business of making small loans and, in connection with that business, made credit insurance available to their debtors.\(^\text{26}\) Initially, the insurance policies were written by an unrelated insurance company, and the insurance commission income (40% of net premiums plus a contingency amount) was received by two general insurance agencies controlled by the same interests that controlled the finance companies. But then Local Finance

\(^\text{23}\) Actually, all the insurance premiums and commissions were received by one of the officers. But the commissions were split among three officers on their tax returns. The reasonableness of that division of income was not at issue in Nichols and is irrelevant for our purposes.

\(^\text{24}\) For this reason alone, a court dealing with an allocation under § 482 should not feel constrained to reconcile its holding with Nichols. See Local Finance Corp., 48 T.C. 773, 796, 798 (Tannenwald, J., concurring).

\(^\text{25}\) CCH Tax Ct. Mem. at 811.

\(^\text{26}\) Credit insurance offers advantages to both the lender and the borrower. The borrower relieves his family or estate from the obligation to repay the debt in the event of loss of his earning power. The lender receives additional security on the loan and an extra source of income. Aside from the benefits of security and income, a lending institution is often obliged to make credit insurance available to its borrowers in order to offer services comparable to those offered by his competitors. Local Finance Corp., 48 T.C. at 776-77. See Alinco Life Ins. Co. v. United States, 373 F.2d 336, 337-38 (Ct. Cl. 1967).
formed its own insurance company, Grand National, which entered into a reinsurance agreement with the independent insurance company, under which Grand National received 90\% of the premiums. The Commissioner allocated 50% of Grand National's net premium income to the finance companies, and alternatively to the general insurance agencies.

The finance companies in *Local Finance* never received any of the insurance commissions and were apparently barred from receiving any monetary compensation for their insurance activities by the relevant state loan and insurance laws. But the Tax Court held that the state laws' prohibition on the finance companies' reception of the income did not preclude the taxation of that income to the companies. "It is well established," observed the court, "that Congress establishes its own criteria for the application of tax statutes . . . ."\(^{27}\) Applying those criteria, the court felt that the Commissioner's allocation to the finance companies was necessary in order clearly to reflect their income, "[s]ince the finance companies performed all the work of selling and servicing the insurance and earned the right to compensation therefor and had the power of disposition over such income . . . ."\(^{28}\) On appeal, the Seventh Circuit agreed with the Tax Court that the finance companies' generating and processing of the credit insurance justified the Commissioner's allocation, regardless of the prohibitions of state law.\(^{29}\)

Both the Tax Court and the Seventh Circuit in *Local Finance* attempted to distinguish the *Shunk* and *Nichols* cases, but neither court was convincing. The courts in *Local Finance* noted that in *Shunk* the taxpayer had no income over which it could exercise the power of disposition because it "could not have raised its price whether to a controlled or wholly independent distributor."\(^{30}\) But the same can be said of the finance companies in *Local Finance*; they could not have charged a price greater than zero for their insurance referrals to a controlled or an uncontrolled

---

\(^{27}\)48 T.C. at 793. The court went on to say that "a tax statute should be interpreted so as to give a uniform application to a nationwide scheme of taxation." *Id.* Uniformity would, of course, be attained if the courts were guided by a federal law prohibiting receipt of income. But in light of the Tax Court's subsequent reliance upon *Local Finance* in upholding the Commissioner's allocation in *First Security*, in which the legality of receipt turned upon federal law, uniformity as such does not emerge as a pivotal consideration. Rather, the crucial consideration appears to have been that taxability should be determined by the principles of federal tax law, not by any other law.

\(^{28}\)48 T.C. at 793.

\(^{29}\)407 F.2d 629, 633 (7th Cir. 1969). The Seventh Circuit indicated that it was not uniformity as such but rather federal tax considerations that prevented state prohibitions on receipt of income from determining federal tax liability. "Federal taxing statutes apply their own criteria of what constitutes income." *Id.* at 633. *See* note 27 *supra*.

\(^{30}\)407 F.2d at 634. The Tax Court expressed the same sentiments, 48 T.C. at 795, as did Justice Blackmun in distinguishing *Shunk* in his dissenting opinion in *First Security*, 405 U.S. 394, 426 (1972).
business entity. Inability to raise prices is not a distinguishing feature of \textit{Shunk}. And the alleged distinction becomes no more satisfying when the Seventh Circuit offers it in the following form: "[t]he OPA regulations in \textit{Shunk} prevented the generation of the income which the Commissioner sought to allocate; here Indiana law merely prohibited the receipt of the Commission income by the finance companies."\textsuperscript{31} What this statement overlooks is that the taxpayer in \textit{Shunk} did generate the distributor's income which the Commissioner sought to allocate, without the necessity of raising its own prices, in the same way that the finance companies in \textit{Local Finance} generated the commission income without raising their prices for the referrals above zero.\textsuperscript{32}

The Tax Court in \textit{Local Finance} attempted to distinguish \textit{Nichols} by emphasizing that in \textit{Nichols} the loan business and the insurance agency existed as separate enterprises prior to incorporation, and that only the loan business was transferred to the corporation:

They [the officers and principal shareholders], in the conduct of their insurance agency business, sold the insurance on the lives of the debtors of the corporations, and received in their own right the commissions. This was the decisive factor in that case. The corporations had no right to the commissions or any power over the disposition thereof.\textsuperscript{33}

But it defies economic reality to explain the result in \textit{Nichols} by saying that only the loan business was transferred to the corporations and that the individuals retained the insurance agency business, for it was the loan business that produced the credit insurance customers for the insurance agency and thereby generated the insurance agency's income. The court's reference to the absence of a right on the part of the corporations to the commissions provides no explanation. That reference was not to prohibitions of state law, for similar prohibitions were ignored in the \textit{Local Finance} case itself; rather it was to the legal arrangements made by the parties at the time of incorporation. But these arrangements are entitled to no more consideration for tax purposes than the anticipatory assignments of income.

\textsuperscript{31}407 F.2d at 634-35.
\textsuperscript{32}Judge Tannenwald, in his concurring opinion in the Tax Court, 48 T.C. at 796, 798-99, and the Seventh Circuit, in a footnote, 407 F.2d at 634 n.8, also distinguished \textit{Local Finance} from \textit{Shunk} on the basis that only in \textit{Local Finance} did the taxpayer perform the services for which the allocated payments were made. But it is not at all clear that payments made to the distributor in \textit{Shunk} were made only for the services performed by the distributor. \textit{See} text accompanying note 75 infra.
\textsuperscript{33}48 T.C. at 794.
disregarded in *Lucas v. Earl* and *Helvering v. Horst.* The *Local Finance* courts, having surmounted the obstacle posed by the illegality of receipt in the *Local Finance* case, should, then, have concluded that *Nichols* was wrongly decided.

As *Shunk, Nichols* and *Local Finance* are essentially indistinguishable, the cases simply represent two different approaches to the question whether income can be allocated under section 482 to taxpayers who have not and could not legally receive the income. It was that question which was before the courts in *First Security.*

### III. COMMISSIONER V. FIRST SECURITY BANK

#### A. The Facts

In *First Security* the Commissioner allocated income consisting of credit insurance premiums to two banks who did not actually receive the income, and who were considered barred by federal banking law from receiving insurance premiums. The financial arrangements in *First Security* involved First Security Corporation (Holding Company), five wholly owned subsidiaries, and an unrelated insurance company (National). Holding Company’s subsidiaries included: two national banks, First Security Bank of Utah and First Security Bank of Idaho (Banks); a management company, First Security Company (Management Company); an insurance agency, Ed. D. Smith and Sons (Smith); and an insurance company, First Security Life Insurance Company of Texas (Security Life). Beginning in 1948 the Banks offered to arrange credit insurance for their borrowers, which was written by two independent credit insurance carriers. Whenever a customer of the Banks took out a loan, a

---

34281 U.S. 111 (1930) (assignment of income from personal services ineffective for tax purposes under predecessor to INT. REV. CODE OF 1954, § 61).

35311 U.S. 112 (1940) (assignment of income from property ineffective for tax purposes under predecessor to INT. REV. CODE OF 1954, § 61).

36See 48 T.C. at 796, 798 (Tannenwald, J., concurring).

37The Act of Sept. 7, 1916, ch. 461, 39 Stat. 753, provided that a national bank may act as an insurance agent in any place where “the population . . . does not exceed five thousand inhabitants . . . .” This provision, added to § 5202 of the Revised Statutes in 1916, was omitted from the 1918 amendment and reenactment of § 5202 of the Revised Statutes by § 20 of the War Finance Corporation Act, ch. 45, 40 Stat. 506, 512. Recent editions of the United States Code have continued this omission.

The implicit prohibition against a bank in a community over 5,000 acting as an insurance agent is incorporated in the current regulations of the Comptroller of the Currency, 12 C.F.R. § § 2.1-2.5 (1971), and the Fourth and Fifth Circuits have indicated that the prohibition remains in force. *Saxon v. Georgia Ass'n of Independent Ins. Agents, Inc.* 399 F.2d 1010 (5th Cir. 1968); *Commissioner v. Morris Trust,* 367 F.2d 794 (4th Cir. 1966).
banking employee informed the borrower of the availability of credit insurance. If the borrower desired the insurance, the employee provided the necessary forms and collected the premiums. The premiums and completed forms were forwarded to Management Company, which kept records of the insurance purchased, forwarded the premiums to the independent insurance carriers, and processed claims filed under the policies. The cost to Banks and Management Company of providing these credit insurance services was negligible.  

During the years from 1948 to 1954, the independent insurance carriers paid commissions to Smith, which was designated the carriers' agent, in an amount ranging from forty to fifty-five percent of the net insurance premiums collected. These payments were included in the income of Management Company.

In 1954, at the suggestion of American National, another unrelated insurance company, Holding Company organized its own insurance company, Security Life. Security Life reinsured the credit life insurance policies taken out with National by debtors of the Banks. Security Life received eighty-five percent of the insurance premiums for assuming the risk under the policies, and National retained fifteen percent of the premiums as compensation for actuarial and accounting services. No commissions were paid under the new arrangements.

Security Life reported the entire eighty-five percent of the insurance premiums in its income for the years 1955-1959. The Commissioner used his powers under section 482 to allocate forty percent of Security Life's premium income to the Banks and alternatively to Management Company. This allocation increased the total tax liability of the controlled group, because Security Life was taxed at an effectively lower rate than either the Banks or Management Company.

During the years from 1948 to 1954, the independent insurance carriers paid commissions to Smith, which was designated the carriers' agent, in an amount ranging from forty to fifty-five percent of the net insurance premiums collected. These payments were included in the income of Management Company.

In 1954, at the suggestion of American National, another unrelated insurance company, Holding Company organized its own insurance company, Security Life. Security Life reinsured the credit life insurance policies taken out with National by debtors of the Banks. Security Life received eighty-five percent of the insurance premiums for assuming the risk under the policies, and National retained fifteen percent of the premiums as compensation for actuarial and accounting services. No commissions were paid under the new arrangements.

Security Life reported the entire eighty-five percent of the insurance premiums in its income for the years 1955-1959. The Commissioner used his powers under section 482 to allocate forty percent of Security Life’s premium income to the Banks and alternatively to Management Company. This allocation increased the total tax liability of the controlled group, because Security Life was taxed at an effectively lower rate than either the Banks or Management Company.

---

38 The yearly cost to each organization for providing insurance-related services was approximately $2,000. 405 U.S. at 397.

39 National proposed a reinsurance arrangement to Holding Company and other financial institutions because the high potential profits from writing credit insurance offered lending institutions an incentive to form their own insurance companies. The reinsurance arrangement whereby National would receive a percentage fee for services was intended to salvage a portion of American National's investment in the credit insurance business. See 26 CCH Tax Ct. Mem. 1320, 1323 (1967).

40 On advice of counsel, the Banks never directly received commission income, acting on the assumption that a receipt would violate federal banking law. Id. at 1325.

B. The Tax Court and Tenth Circuit Decisions

The Tax Court in First Security upheld the Commissioner's allocation on the authority of its decision in Local Finance. But the Tenth Circuit reversed, holding that the mere generation and channeling of income are insufficient bases for taxation. The Tenth Circuit interpreted section 482 as a codification for controlled taxpayers of the assignment-of-income doctrine, developed by the courts under section 61 as a general weapon against anticipatory arrangements to spread income. Under that doctrine, section 61 has been held to allow the taxation of a nonrecipient on income which he earned and was entitled to receive, but which he voluntarily assigned to another person.

But in viewing the First Security case as controlled by section 61 assignment-of-income notions, the Tenth Circuit relied heavily on a case in which a sharply divided Tax Court refused to apply the assignment-of-income doctrine, Paul A. Teschner.

In Teschner, the taxpayer won an annuity contract in a contest. But, as he had been required to do by the rules of the contest, the taxpayer had, at the time of entry, designated a person under the age of eighteen (his daughter) to receive the prize. The Tax Court held that the taxpayer was not taxable on the contest income, because he had never had a right to receive the prize — because he had not voluntarily given up the right to receive the income which he had earned. The court stated: "the taxpayer, while he had no power to dispose of income, had a power to appoint or designate its recipient. Does the existence or

42 CCH Tax Ct. Mem. 1320, 1326 (1967). For an elaboration of the holding in Local Finance, see text accompanying notes 25-29 supra.

43 436 F.2d 1192 (10th Cir. 1971).

44 While the Tax Court upheld the Commissioner's allocations in Local Finance and First Security, and did so under § 482, the Tax Court's opinion in Local Finance contained language which would support the contention that the Commissioner's powers are functionally similar under § 61 and § 482. The court cited its own opinion in Grenada Industries, Inc., 17 T.C. 231 (1951), aff'd, 202 F.2d 873 (5th Cir.), cert. denied, 346 U.S. 819 (1953), for the proposition that § 482 "explicitly authorized the commissioner to unscramble any such situation, so that income may be charged to the organization that earned it," even though § 61 would be sufficient to accomplish the same result. 48 T.C. at 789. In fact, the Tax Court in Grenada said that § 61 adds nothing to the Commissioner's powers under § 482, not that the operation of § 482 is limited by the assignment-of-income concepts developed under § 61. Other courts, while not expressly limiting § 482 by § 61, have linked the two provisions together, in a manner which would suggest that § 61 is the foundation of § 482. The Second Circuit stated: "[Section 482] rests on the well-settled policy that income is taxable under [section 61] of the 1954 Code to the party who earns it . . . ." Philipp Bros. Chemicals, Inc. v. Commissioner, 435 F.2d 53, 57 (2d Cir. 1970).


exercise of such a power alone give rise to taxable income in his hands? We think clearly not."

The Tenth Circuit in *First Security* quoted *Teschner* in rejecting the suggestion that the mere generation and channeling of income, without a right to receive that income, provided a sufficient basis for taxation:

> If this were the law, agents, conduits, fiduciaries, and others in a similar capacity would be personally taxable on the proceeds of their efforts. The charity fund-raiser would be taxable on sums contributed as the result of his efforts. The employee would be taxable on income generated for his employer by his efforts. Such results, completely at variance with every accepted concept of Federal income taxation, demonstrate the fallacy of the premise.

The Tenth Circuit stood on weak ground in resting its decision on *Teschner*. The product of a narrow majority in the Tax Court, the *Teschner* decision was not acquiesced in by the Commissioner. It stands as an exception in a line of cases in which transferors of income have been held to have received the beneficial enjoyment of that income, and it has not become a cornerstone of the law under section 61.

The precedential value of *Teschner* is even weaker in section 482 cases, for the Commissioner’s powers of allocation under section 482 should not be limited by the assignment-of-income notions developed by the courts under section 61. Such a limitation would not render section 482 superfluous, but it

---

47Id at 1009.
48436 F.2d at 1197, quoting Paul A. Teschner, 38 T.C. at 1007.
49Seven dissenting judges would have taxed the taxpayer on the basis that his efforts alone generated the income, and that he had the power to control the disposition of the income by designating the recipient of the prize. 38 T.C. at 1010-11 (Atkins, J., dissenting).
501964-1 CUM. BULL. 6.
51The Third Circuit has suggested: “In every case in which § 482 is applied its application will necessarily result in an apparent conflict with the literal requirements of some other provision of the act. If this were not so § 482 would be wholly superfluous.” National Securities Corp. v. Commissioner, 137 F.2d 600, 602, cert. denied, 320 U.S. 794 (1943). While it may be true that an allocation of income under § 482 often will not comport with the literal provisions of other sections of the Code, few provisions are so closely related as § 61 and § 482.

Hinging the allocability of income under § 482 on the same right to receive that is required for taxation under § 61 does not render § 482 superfluous under the following reading of the sections: before income may be allocated under § 482 it must first be defined, and for that one must turn to § 61. Section 482 provides the Commissioner with a standard for allocating less than the entire amount of income arising from a particular transaction, an option not available to him under the more general provisions of § 61. In § 482 the Commissioner has a more precise instrument for dissecting the financial arrangements of related taxpayers than he does in § 61 for taxing income generated by unrelated taxpayers. Rubin v. Commissioner, 429 F.2d 650, 653 (2d Cir. 1970).
would do violence to section 482's purpose of placing the related taxpayer on a tax parity with the unrelated taxpayer. The related taxpayer, unlike the unrelated taxpayer, has access to the pocket of the income-receiving entity; any income which a related income-generating entity has no right to receive directly is accessible to it indirectly. While, therefore, the absence of a right to receive the income in question may be of some significance when the income generator is an unrelated taxpayer, it is of minimal significance when the income generator is a related taxpayer. In the case of related taxpayers, allocation of income to the generator of that income produces the clearest reflection of income. Even assuming, then, that Teschner remains strong authority in section 61 cases, the crucial elements of control and indirect access to income which are present in section 482 make the reasoning of Teschner and the fears expressed in Teschner with respect to the inevitable consequences of taxing the income generator inapposite to section 482 cases.

C. The Supreme Court Decision

The Supreme Court in First Security affirmed the Tenth Circuit's holding that the Commissioner's allocation of premium income to the Banks was improper. The Court agreed with the Tenth Circuit that the "origination of business does not necessarily result in [taxable] income," but rested its holding on a different ground. Like the Tenth Circuit, the Supreme Court held that legal entitlement to receipt is a necessary

52Note 12 supra & accompanying text. In comparing the scope of § 61 and § 482, one should bear in mind the advice of the Second Circuit in Rohmer v. Commissioner: "the concepts employed in construing one section of a statute are not necessarily pertinent when construing another with a distinguishable background." 153 F.2d 61, 65 (2d Cir. 1946).

53See text accompanying notes 48 supra & 76-78 infra.

54Even if a court takes the unlikely position that Teschner is correct and § 61 defines the outer limits of the Commissioner's power under § 482, there remains a basis for arguing that Teschner does not forestall an allocation of income in the credit insurance cases. Teschner held that the taxpayer could not be taxed on the amount of the contest prize, because he was required to designate a recipient other than himself when he entered the contest. The taxpayer could have sold the right to be designated as the recipient on his entry to a third party. This designation had a small market value before the taxpayer won the contest. But, within the limits of the Teschner holding, the taxpayer could have been taxed on the amount of that value, for the reason that that amount was available for the taxpayer to possess.

On a similar theory, the lending institution in a credit insurance case could pass on the nonreceivable insurance commissions to its borrowers in the form of lower insurance rates. The institution would thereby generate more loan business and more interest income. If the potential increment in income could be measured, it might be allocable to the lending institution. See note 64 infra.

55405 U.S. 394, 401 n.11.
condition of taxation. But rather than resting this conclusion on the judicially developed assignment-of-income doctrine under section 61, as the Tenth Circuit did, the Supreme Court found the legal entitlement requirement within section 482 itself. The Court cited the following sentence contained in the regulations promulgated under section 482: "[t]he 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." From this sentence the Court concluded that the operation of section 482 is conditioned upon the "complete power" of the controlling interests to cause the taxpayer to receive the income in question. The Court observed that "Holding Company had no such power unless it acted in violation of federal banking law," and indicated that the statute and regulations did not presume that the controlling interests would possess the power to force a subsidiary to violate law. The crucial elements of "complete power" and control were, therefore, missing in the Court's view.

It should be noted at the outset that the Court's holding rested upon a dubious interpretation of federal banking law: that while the Banks would have violated the law by receiving commission income, they did not violate the law by offering credit insurance to their borrowers and by collecting and forwarding premiums, eighty-five percent of which eventually went to a related insurance company. If the prohibition of the banking law were read to extend to the performance of insurance services as well as the reception of insurance commissions the conduct of the Banks would clearly be illegal,

56Because the Tax Court upheld the Commissioner's allocation to the Banks, it rejected his alternative allocation to Management Company. That alternative allocation was not, therefore, before the Tenth Circuit and the Supreme Court. If it had been, it might well have been upheld, because Management Company did not operate under the same legal prohibition against receiving insurance commission income as did the Banks. The allocation to Management Company could be justified under the arm's length standard by the following analysis. The Banks and Management Company would be viewed together as the controlled taxpayer. The arm's length test asks what income would be realized by the controlled taxpayer in a transaction with an unrelated entity, in this case an unrelated insurance company. The answer is that the unrelated insurance company would pay the commission income to Management Company.

58305 U.S. at 404-05.
59Id. at 405.
60Id.
61Id. at 402-03 n.16, 405. The Court noted that the Commissioner, the Tax Court, the Tenth Circuit, and the Solicitor General all assumed that the Banks' conduct was lawful. Id. at 403 n.16. In his dissenting opinion, Justice Marshall concluded that the Banks' solicitation of insurance premiums violated the federal statute. Id. at 412-13.
and the Court's holding would be insupportable. For it could no longer be argued that the Commissioner's allocation improperly assumed that Holding Company had the power to force a subsidiary to violate the law, for Holding Company would already have done just that. Holding Company would have demonstrated its "complete power" to control the income generated and received by its subsidiaries, regardless of the command of the law, and the Commissioner's power to allocate income under section 482 could no longer be questioned. The doctrine that income earned through illegal activities is taxable, 62 coupled with the assignment-of-income notions developed under section 61 and codified for related taxpayers in section 482, would result in taxable income to the Banks. 63

Assuming that the Court's interpretation of federal banking law is acceptable, its decision remains open to question on two grounds. First, it is by no means clear that the Court was correct in suggesting that the controlling interests could exercise the power contemplated by that part of the regulations quoted by the Court only through a violation of the law. There seem to be several legal means by which the controlling interests could have exercised "power to cause each controlled taxpayer so to conduct its affairs that its transactions and accounting records truly reflect" income. They could simply have forgone any benefit from insurance sales either by causing the Banks not to offer credit insurance, or by causing the Banks to allow those profits to fall into the hands of an unrelated insurance company. Or they could have sought to retain some benefit by causing the banks to pass on the profits from the insurance to borrowers in the form of reduced premium rates. 64 Of course, any of these alternatives would have produced tax consequences different


63 In Estate of Geiger v. Commissioner, 352 F.2d 221 (8th Cir. 1965), cert. denied, 382 U.S. 1012 (1966), the Eighth Circuit held that a bank employee embezzling bank funds through the device of crediting the checking accounts of her friends when no deposits had been made was taxable on the illegally credited amounts, even though these funds did not pass directly through the taxpayer's hands. It was sufficient for taxation that the taxpayer's conduct made the funds available to others. See also Barbara M. Bailey, 52 T.C. 115, aff'd per curiam, 420 F.2d 777 (5th Cir. 1969).

64 That the Banks might have followed this course suggests that a different allocation by the Commissioner might have been upheld by the First Security Court. If the Banks did reduce their premiums, the reduction presumably would have attracted new borrowers and increased the interest income from the loan business. The Commissioner might have sought to allocate to the Banks the increment in interest income which would have resulted had the Banks passed on the insurance profits in this way.

The most obvious problem with this approach is the difficulty of determining the amount of additional income that could be generated by a reduction in insurance premium rates. This difficulty is complicated by the possibility that competitors in the credit insurance and loan businesses would respond by reducing their rates. Furthermore, if the taxpayer did not have extra capital available for loans beyond current borrower
from those sought by the Commissioner. And as the allocation actually chosen by the Commissioner was based on a course of conduct that was illegal, it might be argued that the controlling interests, in their inability through any of these devices to truly reflect that income which the Commissioner sought to attribute to the Banks, did not possess the "complete power" referred to in the regulations.

Second, if the quoted sentence of the regulations is interpreted to deal only with the power to compel the controlled taxpayers to report income in a manner consistent with a true reflection of income, regardless of whether the taxpayer actually demand, it could receive no benefit from the increase in business that could otherwise be derived from a reduction in insurance rates.

These measurement problems could be avoided by a scheme under which the lender would increase his interest rates for borrowers taking credit insurance by an amount equal to the reduction in insurance rates, so that the total cost of an insured loan remains the same. On the basis of this alternative arrangement, the Commissioner could have allocated all the commission income to the Banks on the reasonable assumption that customer demand for the taxpayer's insured loans would remain unchanged. The problem is that this banking arrangement would merely change the label of the income from commission income to interest income and would probably violate federal banking law. The arrangement by which premium rates are lowered and interest rates remain unchanged may also violate federal banking law, but the fact that the amount of the increased interest income would differ from the amount of the potential commission income may make any violation less obvious.

Even if it is legal under the federal banking law, the allocation of income that the taxpayer could have received from borrowers by lowering premium rates is of questionable validity under the arm's length standard. The income which the Commissioner sought to allocate to the Banks was the same income that was generated by the transactions that did take place. But if the Commissioner were to allocate interest income that the Banks would have received by passing on the insurance profits to borrowers in the form of reduced premium rates, he would be hypothesizing income from a transaction that did not take place. Several decisions under § 482 call into question the propriety of such an allocation. The Tax Court has held that income may not be allocated under § 482 on the theory that a taxpayer passed up an opportunity to earn certain income and permitted it to be earned by a related taxpayer. Miles-Conley Co., 10 T.C. 754, 762 (1948), aff'd, 173 F.2d 958 (4th Cir. 1949); Seminole Flavor Co., 4 T.C. 1215, 1230 (1945). The theory of the allocation suggested above is that the Banks generated the disputed income but passed up the opportunity to earn the income in a manner that would have permitted legal receipt.

The Tax Court has also held that § 482 may not be used to create income when none has been realized in the actual transaction between the related taxpayers. See Kerry Inv. Co., CCH TAX CT. REP. ¶ 31425, at 2772 (1972); Kahler Corp., [1972 Transfer Binder] CCH TAX CT. REP. ¶ 31426, at 2783 (1972); Smith-Bridgman & Co., 16 T.C. 287, 293 (1951). Contra, B. Forman Co. v. Commissioner, 453 F.2d 1144, 1155-56 (2d Cir. 1972). Thus, if a parent makes an interest-free loan to a subsidiary and the subsidiary invests the proceeds of the loan in nonincome-producing property, the Tax Court will not allocate imputed interest income to the parent. See Kahler Corp., supra. But see B. Forman Co., supra. Under the approach suggested above for the First Security case, the Commissioner would impute legally receivable income to the generating taxpayer when no legally receivable income resulted from the actual transactions. But income not legally receivable by the taxpayer was realized by the related insurance company. The suggested approach does not, then, create income from a transaction in which no income was realized; rather, it seeks to change the character of realized income in order to justify an allocation to the generating taxpayer.
received the income attributed to him, the controlling interests
could have maintained the same financial arrangements but
cause the Banks to report the commission income. If it is the
actual receipt of commission income rather than the underlying
conduct that is the mark of illegality, then the reporting of
income generated but not received by the taxpayer would not
violate the law. The reporting of income not actually received
would impose no strain on the Banks in light of their access to
the funds of their related companies.

Even if the Court was correct in suggesting that the
controlling interests could not exercise the power contemplated
by the regulations without violating the law, its decision is
subject to a second, and far more important, criticism: the
decision gives more recognition to the legality of receipt than to
the economic realities of transactions among related taxpayers.
The majority of the Court saw no distinction between a related
and an unrelated taxpayer with regard to the Commissioner’s
powers of allocation. But, as this Comment has previously
argued, the distinction is a crucial one. Regardless of what
standards are appropriate for the application of the assignment-
of-income doctrine under section 61, the application of section
482 should depend not on the legality of receipt by the taxpayer,
but on the ability of the controlling interests to divert any funds
of the related group to the taxpayer. While the controlling
interests will generally not divert particular income to an entity
who may not legally receive that income, they can at any time
divert whatever funds they wish to that entity. The right (legal or
other) of the entity to receive the particular income assumes
minimal significance in light of the indirect access of related
parties to the funds of the group. Justice Marshall advanced this
position in his dissenting opinion in First Security:

It makes absolutely no sense to examine this case with a
technical eye as to whether respondents actually

65 See text accompanying notes 61-63 supra.
66 The Court stated:
The fact of affiliation, enabling referral of the business to another subsidiary
in the holding company group, does not alter the character of what was
done. The act which is relevant, in terms of generating insurance premiums
and commissions, is the referral of the business. Whether this referral is to an
affiliated or an unaffiliated insurance company should make no difference
as to whether the bank, which never receives the income, has earned it.
405 U.S. at 401, n.11. Without indicating any distinction between § 61 and § 482, the
Court concluded:
We know of no decision of this Court wherein a person has been found to
have taxable income that he did not receive and that he was prohibited from
receiving. In cases dealing with the concept of income, it has been assumed
that the person to whom the income was attributed could have received it.
Id. at 403.
67 Text accompanying notes 51-52 supra.
received or had a "right" to receive any commissions. This is not a case involving independent companies or private individuals where we must scrupulously avoid taxing someone on money he will never receive regardless of his will in the matter. This is a case involving related corporations, and § 482 recognizes that such corporations may be treated differently from natural persons or unrelated corporations for certain tax purposes.

... this entire complicated economic structure—established, designed, administered, and amendable by the holding company—had the right to the proceeds. 68

IV. BEYOND THE ARM'S-LENGTH STANDARD: A PROPOSAL FOR A GENERATION-OF-INCOME TEST

In section 482 Congress created a weapon to destroy the tax advantages which inured to related taxpayers by reason of their ability to shift assets freely among one another. The Supreme Court in First Security limited the range of that weapon by elevating the legal right of one related taxpayer to receive the income in question over the economic fact that that related taxpayer retained the ability to receive the income through indirect means. The justification for the Commissioner's powers of allocation under section 482 is that the taxpayer who diverts income to a related taxpayer retains the benefit of that income because of his indirect access to the assets of his related taxpayer. That a taxpayer can not legally receive income which he diverts to a related taxpayer in no way impairs that indirect access.

In First Security the controlling interests, through the creation of an additional controlled insurance company, reduced the tax liability incurred by members of the controlled group on income derived from credit insurance referrals. The reduction was a result of the tax preference given to the income of insurance companies during the years in question. Congress certainly did not intend that this preference protect income generated by an ordinary corporation and diverted to a related insurance company. 69 It was section 482's underlying purpose to deny taxpayers the use of separate but controlled business enterprises as a device for reducing tax liability, 70 and a Court more responsive to that purpose would have upheld the Commissioner's allocation of the commission income to the Banks.

68405 U.S. at 410 (citations omitted).
69 See note 41 supra.
70 See text accompanying notes 8-12 supra.
At the same time, however, the Court would have had to acknowledge that a strict application of the arm’s-length standard does not fully support the Commissioner’s allocation. It is clear that the Banks and Security Life, the related insurance company, did not deal with each other at arm’s length. But the illegality factor makes the application of the arm’s-length standard problematical. The Commissioner concluded that the allocation to the Banks was necessary to clearly reflect income because “in any arm’s length arrangement, [the Banks] would have been compensated for their services.” The Court, on the other hand, concluded that the allocation was inconsistent with section 482’s purpose of placing the controlled taxpayer on a tax parity with the uncontrolled taxpayer, and could not be upheld under the arm’s-length standard, because an uncontrolled bank dealing at arm’s length could not legally receive premium income. Neither the Commissioner’s nor the Court’s conclusion is completely satisfactory, for each depends on an assumption with respect to an uncontrolled taxpayer’s disposition to violate the law.

In order to apply the arm’s-length transaction standard, it is necessary to know what disposition an unrelated taxpayer would make of the potential income in a similar transaction. But that information is not available. An unrelated taxpayer offering credit insurance in connection with a loan business has the following alternatives with respect to the disposition of the generated commission income: receive the income in violation of federal banking law; divert the income to an unrelated taxpayer; or forego the commission income and pass it on to borrowers in the form of reduced insurance rates, in the hope of increasing interest income. It is unlikely that many national banks would directly receive commission income in violation of the law or divert the income to unrelated taxpayers. Most banks with no related business entity to whom they could divert the income would probably pass the commission income on to their borrowers in the form of reduced insurance rates or not provide the service at all. Neither of these remaining alternatives provides a satisfactory basis for making allocations under the arm’s-length standard.

72 405 U.S. at 407.
73 It is, of course, possible that this course of conduct would violate federal banking law.
74 For an explanation of the problems posed by applying the arm’s length standard on the basis of the assumption that an unrelated taxpayer would pass on the commission income to borrowers, see note 64 supra.
This Comment has taken the position that, because of the Banks’ indirect access to the income diverted to the related insurance company, the Commissioner’s allocation produces the clearest reflection of income and therefore advances section 482’s underlying purpose. The fact that the allocation is not fully supported by the arm’s-length standard should not be considered fatal. While the arm’s-length standard is a convenient and usually reliable method for apportioning income among taxpayers, it should not be viewed as the sole standard for judging the applicability of section 482, or as the sole method for apportioning income after section 482 is found to be applicable. The Supreme Court should have taken the opportunity in *First Security* to adopt a general standard under section 482 which would permit the Commissioner to allocate income to a controlled taxpayer whenever the controlled taxpayer generates income which the controlling interests divert to a related taxpayer.

The propriety of the Commissioner’s allocation under the broader generation-of-income test is demonstrated by the following analysis. Under the initial arrangements Management Company received commission income ranging from forty to fifty percent of the net insurance premiums (the customary commission in the insurance business). Under the new arrangements, no commissions were paid, and Security Life retained eighty-five percent of the premiums. That eighty-five percent of the premiums was far more than Security Life had to receive in order to be adequately compensated for assuming the risk under the policies and far more than an independent insurance company would have realized on the policies (as was demonstrated by the experience of the independent insurance carriers who retained fifty to sixty percent of the premiums under the original arrangements). Section 482 is applicable because the Banks generated income that was diverted to a related taxpayer, and the Commissioner’s allocation of forty percent of the premium income was reasonable because it left all parties to the transaction adequately compensated for the services performed and the risks undertaken.

Under the proposed generation-of-income test, the *Shunk* case would be decided in favor of the government. *Shunk* does differ from the credit insurance cases in two respects, but neither is significant. First, the manufacturers in *Shunk* did nothing more than was absolutely necessary for them to receive the legal wholesale price, while the lending institutions in the credit insurance cases performed extra services (providing and filling out insurance forms, collecting premiums and performing other administrative and accounting services) which were not essential.
to their earning the legal interest income. But this difference is insignificant—certainly not significant enough to justify a difference in result—since the actual cost to the lending institutions was characterized by the First Security courts as negligible. Second, the income in *Shunk* was received directly by the related business entity from the consumer, while in the credit insurance cases the premiums were received by the lending institutions and then diverted to the related entity. For this reason, the conduct of the controlling interests in *Shunk* does not arouse the same feeling of indignation as does the conduct of the controlling interests in the credit insurance cases. But the taxpayer in *Shunk* did generate the contested income and did have access to the pocket of the related income-receiving entity. These facts should be sufficient to justify the Commissioner's allocation.

It is unnecessary to reconcile the proposed generation-of-income test with the holding and the language in *Teschner*. Even if that case was correctly decided, it was decided under section 61 and not under section 482, to which the proposed test is limited. If *Teschner* were decided under section 482 and the proposed test, it would come out in favor of the government. The proposed generation-of-income test would not produce the results feared by the *Teschner* court—namely, that the employee and the fundraiser would be taxed on the amounts received by the employer and the charity because of their efforts. The primary reason why these fears are unfounded is the absence of the control factor necessary to call section 482 into operation. But even if section 482 were applicable to the fundraiser and the employee, the proposed test would not justify an allocation, for reasons which are instructive of the limits of the generation-of-income test. The employee is compensated for his efforts by his wages, and the profits received by his employer represent compensation for capital risk. Without a showing that the employee is receiving less than others in a similar position or less than he deserves, there would be no evidence of a diversion of income generated by him, and no allocation could be made. The fundraiser is not taxed on the contributions he solicits, because his efforts alone do not generate the contributions. The charity, through its reputation for good works, is largely responsible for the contributions. It might be argued that the

---

75405 U.S. at 397.
76As Judge Tannenwald indicated in his concurring opinion in *Local Finance*, when an allocation can be sustained under § 482, there is "good reason for not entering the mare's nest of the decided cases under § 61." 48 T.C. at 799.
77Note 48 *supra* & accompanying text.
Commissioner could allocate to the volunteer fundraiser the income which the charity would have to pay individuals to solicit contributions in the absence of volunteers. However, were the Commissioner to make such an allocation, he would have to allow the fundraiser a charitable deduction equal to the allocated amount, and thereby remove the net effect of the allocation.78

V. CONCLUSION

The Supreme Court's rejection of the Commissioner's allocation of income to the Banks in First Security will not have any great effect on tax revenues. Except for some questionable assumptions concerning federal banking law,79 the tax dispute in that case would have presented no difficult issues. The cases discussed are noteworthy primarily for the reason that they offer an opportunity to examine the interplay between judicial decisions and the development of federal income tax law.

Starting from a very general provision of the Code (section 482) with a limited legislative history, the Tax Court, the Tenth Circuit and the Supreme Court each adopted a different approach for resolving a somewhat difficult, but nontechnical, tax question. This Comment has suggested that none of these approaches was entirely satisfactory. The Tax Court decided in favor of the government—probably the result intended by Congress—by manipulating conflicting case precedent (Shunk and Nichols) and adding one more confusing case to an already murky area.80 The Tenth Circuit rejected the Tax Court's result largely through the simplistic application of a questionable limitation (Teschner) on an uncontrolling tax principle (the assignment-of-income doctrine under section 61).81 And the Supreme Court affirmed the decision of the Tenth Circuit by reading an ambiguous sentence in the regulations in a manner which was unresponsive to economic reality and the underlying purpose of section 482.82

This Comment has suggested that section 482's purpose of achieving tax parity between controlled and uncontrolled taxpayers is best served by taxing the controlled taxpayer on

78The Internal Revenue Code limits charitable deductions to payments. INT. REV. CODE OF 1954, § 170. If income were allocated to a fundraiser, the implication would be that he could have received payment for his efforts from the charity. By foregoing this payment, he would have made the equivalent of a deductible charitable contribution.79See notes 61-63 supra & accompanying text.

80See text accompanying notes 43-54 supra.

81See text accompanying notes 55-68 supra.
income which he generates but which the controlling interests divert to a related entity, regardless of the taxpayer's legal right to receive the income directly. The traditional arm's-length standard admittedly does not compel the Commissioner's allocation in cases such as *First Security*, but neither does it preclude the allocation. Rather, the arm's-length standard simply provides inadequate guidance for adjudging the propriety of allocations in illegality-of-receipt cases. We have suggested that the courts should view the arm's-length standard as a particularized version of the proposed generation-of-income standard, which should serve as the general test for allocations of income under section 482 and which would have provided a basis on which the Supreme Court could have upheld the Commissioner's allocation of commission income to the Banks in *First Security*. 