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CA-7's Wisconsin Big Boy case has dire implications in 482 area

by JOHN W. LEE

The Seventh Circuit, in Wisconsin Big Boy, has recently indicated that arm's-length charges may not prevent a Section 482 reallocation among integrated multiple corporations. Mr. Lee analyzes this recent development and suggests that in the future the proper defense to a 482 attack may lie in a reasonable division of profits.

SECTION 482 IS ONE of the primary tools used by the Service in attacking preferential tax treatment of multiple corporations,¹ including the preference arising from multiple surtax exemptions. Since Reg. 1.482-1(a)(1) provides that "the standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm's-length with another uncontrolled taxpayer," the principal defense to a proposed Section 482 reallocation has traditionally been that the taxable income of the taxpayer in question is the same as if the members of the related group had dealt with each other at arm's-length² or at least has been that a reconstruction of income to comply with the arm's-length standard thwarts a 100% allocation of taxable income from one controlled taxpayer to another. However, in a recent decision (*Wisconsin Big Boy Corp.*, 452 F.2d 137 (CA-7, 1971)), the court sustained the Government's and the Tax Court's reallocation of the entire gross income and deductions of ten separately incorporated restaurants and two commissary corporations to the common parent and management entity, Wisconsin Big Boy Corporation (WBB), indicating that an arm's-length defense may not be available in all reallocations. The court held that the segments of the highly integrated business were so interwoven that reconstruction of intercompany charges, primarily licensing fees, to comply with the arm's-length standard was probably neither realistic nor feasible. Based on this holding and the fact that taxpayers had made no effort to demonstrate a less than 100% allocation consistent with that standard, the court concluded that the taxpayers failed to show that the Commissioner's 100% allocation was unreasonable, arbitrary, or capricious.

WBB had obtained a restaurant franchise covering a multi-state area and entered into subfranchise or licensing

agreements with the restaurant subsidiaries obligating it to perform substantial advisory, administrative, accounting, and personal services for such subsidiaries. Complete control over personnel was centralized in WBB. Master insurance policies and a single pension plan covered the employees of all the subsidiaries (with one exception) and WBB. The two principal shareholders in WBB served as officers and directors of all the corporations and performed the chief management functions for them all. They also arranged the financing, locating and leasing of restaurant sites. The Seventh Circuit agreed with the Tax Court below that there was a single, integrated restaurant conducted and controlled by WBB.

Generation of income

The Tax Court (52 TC 1073 (1969)), too, had found that the taxpayers had failed to show that the Commissioner's 100% allocation was arbitrary, capricious, or unreasonable, but it also held in the alternative that WBB so completely managed and controlled each subsidiary that it generated and earned the income arising from their operations. The significance of its opinion lies in the latter holding,³ the seeds of which are contained in two earlier lines of cases. The first arises from those opinions sustaining allocation of net income, which differs only semantically from allocation of gross income and deductions. In the first decision so to apply Section 482, *Advance Machinery Exchange*, 196 F.2d 1006, 1008 (CA-2, 1952), the court encountered manipulations of net profit through altered purchase invoices. It was determined that, while there were four tax entities, only one earned the income which had been divided among all four. This case served as the basis for an early prediction that meeting the arm's-length standard might not be available as a defense to Section

482 allocations of the entire net income of a controlled taxpayer.⁴ The Tax Court, ironically, at first opposed reallocations of the entire net income of corporate taxpayers⁵ relying on Reg. 1.482-1(b)(5), which prohibits reallocations producing a result equivalent to a computation of consolidated taxable income of taxpayers not filing consolidated returns. Subsequently, however, the Tax Court did approve Section 482 allocations of net income in cases described by commentators as actually involving "sham" corporations.⁶ The most widely known of these decisions is *Hamburgers York Road, Inc.*, 41 TC 821 (1964), where a long established downtown retail men's wear store set up a suburban branch operated in a sister corporation. The downtown corporation handled the advertising, selection and display of merchandise, supervision of sales forces, alterations, accounts receivable, books of account, payroll and bank accounts for both stores. The Tax Court held that the two stores were in substance actually parts of a single, integrated business with the downtown serving as the headquarters and with the suburban store serving merely as a branch or division. The separate corporate existence of the inert sister corporation was, in effect, ignored.⁷

The second trend foreshadowing *Wisconsin Big Boy* (sub. nom. *Marc's Big Boy*) is contained in the "alphabet" or multiple real estate corporation sham cases relying on an integrated business concept. For example, in *Kessmar Construction Co.*, 39 TC 778 (1963), *aff'd*, on other grounds, a small group of promoters carried out the construction of a subdivision of over 300 single-family dwellings through 16 corporations. The Tax Court found that the construction of the subdivision was a single, integral

¹ See Surrey, *Treasury's need to curb tax avoidance in foreign business through use of 482*, 28 JTAX 75 (February, 1968).

² Pomeroy, "Allocation of Income, Deductions, Credits, and Allowances Among Related Taxpayers," 15 W. Res. L. Rev. 250, 265 (1964).

³ Lee, "Section 482 and the Integrated Business Enterprise," 57 Va. L. Rev. 1376, 1409-12 (1971).

⁴ See Note, "Multiple Incorporation To Obtain Additional Accumulated Earnings Credits and Surtax Exemptions," 44 Minn. L. Rev. 485, 496 (1960).

⁵ E.g., *Chelsea Products, Inc.*, 16 TC 840 (1951), *aff'd*, 197 F.2d 796 (CA-4, 1962).

⁶ Hoefs, "Intercompany Operations, Joint Use of Employees, Services, Plant, Equipment and Intangibles," N. Y. U. 28th Inst. on Fed. Tax 603, 615, n. 45 (1970).

⁷ See Kalish and Bodner, *Planning to avoid difficulties with 482 adjustments for related entities*, 33 JTAX 2 (July, 1970).

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business venture and not 16 different businesses; therefore, no business purpose was served by the use of 16 corporations instead of one. It is evident that these cases used the term integrated business to refer to a unitary business in which all the business activities of the enterprise were carried out by but one corporation with the others being only inert paper corporations.⁸

Thus, while precedent permitting allocation of gross income and deductions in reliance on the presence of a single, integrated business exists, it is by and large distinguishable as involving sham corporations or manipulations of income in which the shareholders themselves ignored the multi-corporate entities.⁹ Furthermore, a determination that operating subsidiaries which have their own employees and carry on substantial business activities earn no portion of the income from their operations, i.e., that the management entity, WBB, generated and therefore earned their income, is in conflict with *Philipp Brothers Chemicals, Inc.*, 435 F.2d 53 (CA-2, 1970), in the Second Circuit.¹⁰ Although it is possible to reconcile the principle of that case (that Section 482 does not give the Commissioner authority to disregard corporate entities by a 100% allocation where they perform some business function) with the Tax Court's *Big Boy* opinion by carving out an exception for an integrated multi-corporate enterprise,¹¹ neither the lower nor appellate court opinions in *Philipp Brothers* indicate such an excep-

tion. Furthermore, the Government in its brief in *Wisconsin Big Boy* acknowledges a conflict between the Tax Court's decision and *Philipp Brothers*. In addition, the generation-of-income theory espoused by the Tax Court in *Marc's Big Boy* is difficult to reconcile with the Tenth Circuit's decision in *First Security Bank of Utah*, 436 F.2d 1192 (CA-10, 1971), *aff'd*. S. Ct. 3/21/72, which rejected the Commissioner's argument that whoever generates income is taxable on that income.¹²

Significance of CA-7's opinion

The Seventh Circuit's opinion does not hold directly on the generation of income doctrine so significant in the Tax Court opinion. Thus, the appellate court left unanswered the question whether the entire taxable income of an integrated enterprise is earned by the management entity. Rather the critical aspects of the Seventh Circuit's decision in *Wisconsin Big Boy* are the incidence of the burden of proof and the conclusion that reconstruction of intercompany transactions in a highly integrated enterprise conducted through multiple corporations in order to comply with the arm's-length standard is probably neither realistic nor feasible.

The taxpayers on appeal did not claim that the licensing and management fees charged by WBB to the subsidiaries met the arm's-length equivalency test, but instead argued that each restaurant operation must have contributed in some degree to the overall net income of the controlled group so that a 100% allocation was unreasonable, arbitrary, and capricious. Their conclusion was that since the Commissioner failed to prove that any less extreme allocation was supportable, the taxpayers should prevail. The Commissioner in turn contended that the Tax Court's decision was correct since "faced

with clear evidence that some allocation was necessary, taxpayers refrained from introducing any real proof supporting a lesser allocation."

The Seventh Circuit agreed that the issue on appeal boiled down to the incidence of the burden of proof and that the Tax Court had fairly placed this burden of the taxpayers. It is also noted that owing to the degree of integration of the taxpayers it was very doubtful that unrelated entities would have arrived at a comparable division of functions. Indeed, it concluded that due to the interdependence and overlapping among the separately incorporated functions of the integrated enterprise it would be very difficult, merely by adjusting the fee structure, to construct a situation which would conform to the arm's-length standard. The circuit court agreed with the Tax Court that the taxpayers failed to show that the Commissioner's allocation was unreasonable, arbitrary, or capricious because a hypothetical reconstruction to comply with such standard would be fanciful and unreal, the taxpayers had made no effort to justify the intercompany transactions as meeting the arm's-length test or to establish the feasibility of reconstructing them so as to comply, and, in the view of the Tax Court, WBB generated all the income.

Burden of proof. While there is some case support for requiring a taxpayer to establish a different allocation consistent with the arm's-length standard in order to show that the Commissioner's allocation was arbitrary,¹³ there is contrary precedent in the *Cohan* rule (once a taxpayer shows that he is entitled to some adjustment, the fact-finder must approximate the amount of the adjustment) as applied in several cases in which the Commissioner attempted 100% Section 482 allocations.¹⁴ It would appear that the taxpayers in the instant case demonstrated that the management entity did not earn the entire income of the integrated enterprise, with the result that they were entitled to some adjustment to the 100% allocation for the following reasons:

1. The Seventh Circuit, unlike the Tax Court, did not hold that the management entity earned all of the income reported by the operating subsidiaries, rather it stated that the Tax Court's findings were not clearly erroneous.
2. The Commissioner (as represented

⁸ See *Alper*, TCM 1962-38.

⁹ See *Pickus*, TCM 1963-342.

¹⁰ See *Substantial business activity, reasonable allocations needed to thwart 482 adjustment*, 34 JTAX 113 (February, 1971).

¹¹ See Kalish and Bodner, *supra* note 7.

¹² See Aland, "Section 482: 1971 Version," 49 *Taxes* 815, 840 (1971). The Supreme Court affirmed *First Security Bank* on another ground, but agreed that generation of business does not necessarily result in taxable income. See also *No 482 reallocation from insurance co. to bank*, p. 348 of this issue.

¹³ *Grenada Industries, Inc.*, 17 TC 231 (1951), *aff'd*. 202 F.2d 873 (CA-5, 1953).

¹⁴ E.g., *Nat Harrison Associates, Inc.*, 42 TC 601 (1964); *Challenger, Inc.*, TCM 1964-338.

¹⁵ Plumb and Kapp, "Reallocation of Income and Deductions Under 482," 41 *Taxes* 809, 830 (1963).

¹⁶ *Young & Rubicam, Inc.*, 410 F.2d 1233 (Ct. Cls., 1969). It may be argued, however, that since the Seventh Circuit stated that the findings of the Tax Court were not clearly erroneous (implicitly including its finding that WBB generated the income in issue), the taxpayers' premise that WBB did not earn the entire income was not accepted. Thus, it may be reasoned the taxpayers did not prove that the very basis of the Commissioner's allocation was erroneous and the more favorable allocation discussion was *dictum*.

¹⁷ See, generally, Hamlin, *Correct allocations under Section 482 are still difficult despite new Regs.*, 33 JTAX 358 (December, 1970).

¹⁸ *Woodward Governor Co.*, 55 TC 56 (1970); *PPG Industries, Inc.*, 55 TC 928 (1971); see Seghers, *The recent PPG case: Is it a blueprint to balance the IRS's 482 allocation powers?*, 34 JTAX 370 (June, 1971).

by the Department of Justice on the appellate brief) agreed with the taxpayers that the mere existence of an integrated business does not call for the automatic application of Section 482 and ignoring the generation-of-income alternative holding of the Tax Court concluded in his brief that the trial court "did not sustain the Commissioner because the taxpayers were an integrated corporation but because taxpayers failed to prove that the Commissioner's allocation was arbitrary and capricious."

3. The applicability of the principle that Section 482 does not give the Commissioner the authority to disregard separate corporate entities where they perform some business function and carry on substantial business activities.

Commentators had raised the question whether a taxpayer who once establishes that the Commissioner's 482 allocation is arbitrary must then go forward and prove the allocation.¹⁵ Based on *Taylor*, 293 U.S. 507 (1935), the answer was thought to be that in the Tax Court if the taxpayer could prove that the very basis of the Commissioner's allocation was arbitrary, but could not establish the correct distribution of income and deductions, the showing of arbitrariness was sufficient. For in the Tax Court the taxpayer is required merely to prove that the Commissioner's determination is invalid; he need not establish the correct amount of tax as would be required in a refund suit. Although the taxpayers in *Wisconsin Big Boy* relied on *Taylor* on appeal (the Government argued on brief that *Taylor* "did not involve Section 482 or its predecessors and the special rule of proof developed by the courts in order to permit the Commissioner to meaningfully carry out the broad congressional mandate of that section"), it was not discussed by the Seventh Circuit in its opinion. Apparently it felt the problem was made moot by requiring the taxpayers, at least where operating a single integrated enterprise, to demonstrate an allocation consistent with the arm's-length standard and more favorable than the Commissioner's allocation in order to show that the latter was arbitrary. Whether the more favorable allocation must also be the correct allocation is unclear, but in any event this holding increases immeasurably the already heavier than normal burden of proof of establishing arbitrariness which is placed on taxpayers contesting Section 482 allocations.¹⁶

Unavailability of arm's-length equivalency defense. The court also stated that it was not feasible to demonstrate an allocation based on adjustments of the franchising fees among the integrated group which would comply with the arm's-length standard. The question whether any allocation in an integrated group is available to show that a 100% allocation is arbitrary where the separately incorporated functions carry on substantial business activities and, therefore, earn some portion of the overall net income of the enterprise was left unanswered.

One possible interpretation of the court's conclusion is that *Wisconsin Big Boy* represents merely an updating by two decades of the first 100% allocation of net income case, *Advance Machinery Exchange*, in which the net income of four businesses had been so manipulated that it was impossible to determine where one business began and another ended. In effect, the Service was permitted there to allocate the net income of three of the businesses to the fourth because the independence of the four tax entities had been disregarded by their controlling interests. In *Wisconsin Big Boy*, however, the Tax Court expressly found that the restaurant corporations were not shams, there was no indication of manipulation of income or disregarding of their corporate integrity, and the Seventh Circuit did not conclude independently of failure of proof by the taxpayers that WBB earned all the income of the enterprise. Accordingly, the problem does not seem to lie in a disregard of the tax individuality of the corporations.

Nor does the problem appear to be that the arrangements among the segments of the business were fitted into the wrong intercompany arrangement; for example, that the taxpayers could have reconstructed an allocation consistent with the arm's-length standard under one of the four specific intercompany transactions¹⁷ other than transfers of intangible property (the fee structure). In fact, the taxpayers for the years in question (fiscal 1963 through 1965) could have elected under *Rev. Proc.* 68-22, 1968-1 CB 819, to have the original proposed 482 amendatory Regulations apply to WBB's rendering of management services to the restaurant subsidiaries (it was through this management and control that the Tax Court found that WBB earned the income from the subsidiaries' operations), in

which case the deemed arm's-length charge would have been WBB's cost without a profit mark-up. However, the Seventh Circuit's emphasis on the interdependence and overlapping among segments of the business as well as the failure of either court's opinion to cite any of the specific intercompany transaction provisions of the Regulations indicate that the court thought it impractical to fragmentize the entire course of dealings among these segments into the separate intercompany transactions and then reconstruct the intercompany charges to comply with the various safe havens, deemed arm's-length charges, arm's-length charges, etc., contained in the various provisions. The question now remains whether there is any method of allocation (either as a means of reconstruction or as a means of initial reasonable pricing) consistent with Section 482 apart from the specific intercompany transaction Regs that are available to an integrated group.

Reasonable division of profits

A current trend in intercompany pricing of sales of tangible property, a reasonable division of profits, may provide an answer. In several recent decisions, the Tax Court has utilized the comparable uncontrolled price method, a deemed arm's-length charge under Reg. 1.482-2(2)(1)(ii), but has also held that the intercompany pricing policies were reasonable and produced a reasonable division of profits.¹⁸ In other words, although the opinions were couched in terms of an arm's-length standard, the courts were obviously influenced by the reasonable division of profits. While the Seventh Circuit in its recent decision in *U. S. Gypsum*, 452 F.2d 445 ((CA-7, 1971) has announced that a reasonable price different from that which would have been reached in arm's-length dealing does not clearly reflect income for the purposes of Section 482, the Tax Court in *Lufkin Foundry & Machine Co.*, TCM 1971-101, stated that if a division

IMPACT OF 482 REALLOCATIONS

REALLOCATIONS OF income and expenses under Section 482 can create a significant impact upon a corporation's tax bill.

It has been reported, for example, that Fairchild Camera & Instrument Corporation may be assessed as much as \$23 million for 1964-1969.

of pre-tax profit is reasonable it is the equivalent of an *arm's-length division* of pre-tax profit. However, neither *Lufkin* nor *PPG Industries, Inc.*, 56 TC 928 (1971), indicate what standard is to be applied to determine what is a reasonable division of profits.¹⁹ In a controlled group where the segments of the integrated enterprise are independent and overlap so that it is not feasible in the eyes of the Seventh Circuit to reconstruct each intercompany transaction

to comply with the arm's-length standard contained in the amendatory 482 Regs, it would appear that each segment's reasonable portion of the net profit of the integrated enterprise could be determined on the basis of the proportion of assets, compensation paid and number of employees, and expenses of the entire business attributable to each segment.²⁰ Such a formula should yield a reasonable division of profits, for a similar formula was adopted in the

House version of the Revenue Act of 1962 to enable an allocation of taxable income, *i.e.*, a division of profits, presumably reasonable. The theory underlying such a formula is that "every dollar of the cost of producing an item generates a ratable portion of the profit from its sale."²¹ Furthermore, a proportionate-profits test is being currently considered as an alternative safe haven for intercompany sales of tangible property.²² Therefore, it should result in a reasonable division of the entire income of an integrated group if it is a valid approach for division of profit from sales of tangible property. Fortunately, *Lufkin* and *PPG* supply accounting principles and methods for allocating expenses to each segment, which has been thought to be one of the more difficult aspects of application of such a formula. Furthermore, lessons in application may be drawn from the utilization of similar formulas in state taxation of multi-state integrated businesses conducted through multiple corporations.²³

Whether a division of profits based on such a formula will satisfy the requirement of a reconstruction (or original pricing arrangement) *approximating* the arm's-length standard will probably only be answered by future litigation. But it is clear that in the Seventh Circuit, at least, some reconstruction meeting that test will be necessary to prove that a 100% allocation is arbitrary even where the taxpayer which reported the re-allocated income carries out substantial business activities. It is equally clear that a reconstruction of pricing of intangibles or adjustments to any other specific intercompany transaction is unlikely to do the trick where the group of taxpayers is highly integrated. ★

¹⁹ See Seghers, *How "reasonable" pricing can defeat an IRS reallocation attack under Section 482*, 33 JTAX 232 (October, 1971); Crawford, *Are the courts expanding the scope of Section 482?*, 36 JTAX 150 (March, 1972).

²⁰ Such a formula approach has been suggested as an objective allocation rule to be applied to all intercompany transactions (rather than being limited, for example, to intercompany sales) of a multi-corporate integrated enterprise. Lee, *supra* note 3 at 1429-30.

²¹ *North Carolina Granite Corp.*, 56 TC 1281, 1289 (1971) (Section 613).

²² Cole, *A Treasury view of problems and progress in the international tax field*, 36 JTAX 124 (February, 1972); Kaudner, "Tax Legislation and Regulations Affecting Foreign Trade and Investment: Recent Changes and Current Problems," 8 *Houston L. Rev.* 498, 511 (1971). Similar formulas are contained in Regs. 1.613-3(d) (1) and 1.863-3 (b) (2) ex. 2.

²³ See Miller, "State Income Taxation of Multiple Corporations and Multiple Businesses," 49 *Taxes* 102 (1971).

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