William & Mary Law Review

Volume 7 (1966)
Issue 2

Article 12

May 1966

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NEW IMPORTANCE FOR SECTION 482 OF THE INTERNAL REVENUE CODE

Introduction

Under Section 482 of the Internal Revenue Code[1] the Commissioner has been given broad power to allocate income and deductions between related taxpayers. Until recently Section 482 has been a comparatively dormant weapon in the Commissioner's arsenal for use in preventing the evasion of taxes and the distortion of taxable income. The section has mainly been invoked where commonly controlled foreign and domestic taxpayers are involved.

In the spring of 1965 proposed regulations were published[2] which give the clear impression that the Service intends to enforce Section 482 more vigorously in the future, especially where the taxpayers involved are all domestic entities. It also appears from these regulations, however, that the Commissioner has been given power to create income where none was earned and also to allocate income and deductions regardless of the materiality of the distortion of income. In order for the Commissioner to invoke Section 482 no intent to evade taxes need be shown under these new regulations. These extensive powers given to the Commissioner under Section 482 do not seem to be in accord with the Congressional intent of only preventing the evasion of taxes and distortion of income under this section, and unless the proposed regulations are modified, this provision of the Code with its corresponding regulations could be most burdensome to the taxpayer.

Legislative History

Section 482 had its legislative beginnings in the Revenue Act of 1918. Section 240 of that Act provided for the filing of consolidated returns by affiliated corporations. It deemed two or more domestic corporations to be affiliated (1) if one corporation owned directly or controlled "... through closely affiliated interests ... substantially all the stock of the other or others, or (2) if substantially all the stock of two or more corporations is owned or controlled by the same interests."[3] Congress thereby recognized the existence of commonly controlled businesses and sought to define common control or affiliation.

The Revenue Act of 1921 added a proviso to the Act of 1918:[4]

1. Section 482, Internal Revenue Code of 1954.
2. Proposed Regulations, Federal Register, April 1, 1965.
3. Revenue Act of 1918, Section 240(b).
4. Revenue Act of 1921, Section 240 (d).

> that in any case of two or more related trades or businesses (whether unincorporated or incorporated and whether organized in the United States or not) owned or controlled directly or indirectly by the same interests, the Commissioner may consolidate the accounts of such related trades and businesses, in any proper case, for the purpose of making an accurate distribution or apportionment of gains, profits, income, deductions, or capital between or among such related trades or businesses.

Thus as early as 1921 it appears that Congress was cognizant of the arbitrary shifting of income between commonly controlled businesses. Congress also recognized that a corporation could be controlled indirectly and not just directly by the ownership of more than 50% of the corporate stock.

The 1924 Act and also the 1926 Act made reallocation of profits mandatory at the request of the taxpayer.[5]

The Revenue Act of 1928 gave the Commissioner the power to allocate gross income or deductions among businesses controlled by the same interests *to prevent the evasion of taxes* or *to clearly reflect income.*[6] It also revoked the taxpayer's right to demand reallocation of profits. Two points about this Act are noteworthy. One is the omission of the word "related" in referring to commonly controlled businesses. This is probably due to the stress laid on the word "related" taxpayer in a 1931 case.[7] The other is the appearance of a purpose to prevent the evasion of taxes or to clearly reflect income for the first time in the grant of authority to the Commissioner.

The Revenue Act of 1934 added the word "organizations" to the words "trades or businesses," but other than this change, the law has remained consistent through the 1939 Code to the present Section 482 of the 1954 Code, which now reads:[8]

> In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary 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 al-

5. Revenue Act of 1924, Section 240(d); Revenue Act of 1926, Section 240(f).
6. Revenue Act of 1928, Section 45.
7. Nowland Realty Co. v. Comm'r., 47 F.2d 1018 (C.A. 7th, 1931).
8. Section 482, Internal Revenue Code of 1954.

location is necessary in order to prevent evasion of taxes or clearly to reflect the income of any such organizations, trades, or businesses.

Judicial Interpretation

As in many of the provisions of the Internal Revenue Code ordinary words do not have their ordinary meaning. The same words often mean different things in different sections of the Code. It therefore becomes important to determine the meaning of various terms in Section 482 as interpreted by the courts and by the Internal Revenue Service in its regulations and rulings. The terms that have been most discussed in judicial opinions and dealt with in regulations are *control, evasion of taxes, to clearly reflect income* (and the related term, *arm's length transaction*), and *allocation of gross income* as opposed to the *creation of income.*

The first of these important terms in Section 482 is control. It is now well settled that "control" of a business as used in Section 482 does not necessarily mean ownership of more than 50% of a corporation's stock but that the actual authority over the business affairs of the corporation is decisive.[9] For example, in *Pauline W. Ach* the taxpayer transferred ownership of a proprietary business to a corporation owned by her children, although she remained a full-time employee and chairman of the board of directors. The court held that in reality she controlled the corporation for purposes of Section 482 and 70% of the corporation's income was allocated to her personally. Furthermore, a presumption of control arises when income or deduction are found to have been arbitrarily shifted.[10]

However, the Commissioner may not ignore the fact that related businesses are separate entities[11] and the mere existence of two or more commonly controlled taxpayers does not give the Commissioner power to invoke Section 482.[12] "The purpose of Sec. 45 (now Section 482) is not to punish the mere existence of common control or ownership, but to assist in preventing distortion of income and evasion of taxes through the exercise of that control or ownership." [13] The Commis-

9. Regs. Sec. 1.482-1(a)(3)—approved by the Tax Court in South Texas Rice Warehouse Co., 43 T.C. 540 (1965); Jesse E. Hall, Sr., 32 T.C. 390, 409 (1959); *aff'd* 294 F.2d 82 (C.A. 5th, 1961); Grenada Industries, Inc., 17 T.C. 231, 254; *aff'd* 202 F.2d 873 (C.A. 5th, 1952); *cert. den.* 346 U.S. 819.

10. Pauline W. Ach, 42 T.C. 114, 125 (1964); Regs. Sec. 1.482-1(a)(3).

11. *Id.* at 123 and 124; Grenada Industries, Inc., *supra,* note 9; Nat Harrison Associates, 42 T.C. 601, 618 (1964).

12. Grenada Industries, Inc., *supra,* note 9.

13. Grenada Industries, Inc., *supra,* note 9 at 254.

sioner may only invoke Section 482 when such control has actually been exercised to reduce, avoid or escape taxes or to distort income,[14] although it is not necessary to prove fraud to invoke the provision.[15]

To sum up, the Commissioner may invoke Section 482 when two or more business entities are controlled by the same interests if:

1) control exists in reality and
2) control is exercised to distort income or evade taxes whether by inadvertence or predesign.

Once it has been determined that the Commissioner may invoke Section 482, it becomes necessary to determine the extent of his powers under this provision. Generally he may distribute, apportion and allocate gross income, deductions, credits, or allowances in order to reflect a taxpayer's true taxable income.[16] "True taxable income" is defined as:

> the taxable income (or, as the case may be, any item or element affecting taxable income) which would have resulted to the controlled taxpayer, had it in the conduct of its affairs (or, as the case may be, in the particular contract, transaction, arrangement, or other act) dealt with the other member or members of the group at *arm's length*.[17]

The key phrase in the above definition is that the controlled businesses deal with each other at *arm's length*. When separate entities deal with each other at arm's length, the Commissioner may not allocate their income under Section 482 even though the entities are commonly controlled and one or more of them was organized solely to reduce tax liability.[18] In a Revenue Ruling[19] the Service stated that to avoid the application of Section 45 of the Code, a corporation organized to take advantage of Section 109 of the 1939 Code (relating to Western Hemisphere Trade Corporations) must deal with the parent corporation at arm's length.

The court has rejected the Commissioner's argument that under Section 45, even though transactions were carried on at arm's length, if

14. Regs. Sec. 1.482-1(c); Bush Hog Manufacturing Co., Inc., 42 T.C. 713, 725 (1964).
15. Simon J. Murphy Co., 22 T.C. 1341 (1955); Jesse E. Hall, Sr., *supra*, note 9.
16. Regs. Sec. 1.482-1(b)(1).
17. Regs. Sec. 1.482-1(a)(6).
18. Polaks' Frutal Works, Inc., 21 T.C. 953 (1954); Interior Securities Corp., 33 T.C. 339 (1962).
19. Rev. Rul. 15, C.B. 1953-1, p. 141.

the taxpayer could have made the sales or performed the services that the other businesses in the controlled group made or performed, all the earnings of the related enterprises should be allocated to the taxpayer.[20] The taxpayer is "... under no obligation to so arrange its affairs and those of its subsidiary as to result in a maximum tax burden. On the other hand, it (has) a clear right by such a real transaction to reduce that burden." [21] Thus the power to allocate gross income is not the power to lump together the income of two or more legally distinct enterprises, even though the sole purpose in the organization of one or any of them was to reduce tax liability; provided always that transactions between or among the members of the controlled group must be at arm's length or the Commissioner may allocate income or deductions where he finds that such non-arm's length transactions distort income or were made to evade taxes.

To deal at arm's length is to deal as one would in an open market where both buyers and sellers are willing and uninfluenced by outside forces. Thus a fair market price must be used in the transactions among members of a controlled group or the difference must be justified for business reasons other than to affect or shift income between the controlled entities. The courts have held that sellers must receive full market price from co-members of their controlled group for their commodities[22] or services[23] and that rents[24] should be equivalent to what outsiders would have to pay. New regulations have been proposed as a guideline in determining proper charges to be made among the commonly controlled businesses for products, services, rents and interest.[25]

The question now arises how may the Commissioner allocate income? Until recently, it had been held that he must allocate *gross* income as in the literal words of the statute and not *net* income. However, the Second Circuit, with its decision in *Advance Machinery Exchange, Inc.* v. *Comm'r*,[26] adopted the view that in certain instances an allocation of net income is proper as a logical short cut in allocating gross income

20. Seminole Flavor Co., 4 T.C. 1215, 1235 (1945); Miles Conley Co., Inc., 10 T.C. 754, 762 (1948).

21. Koppers Co., 2 T.C. 152, 158 (1943) and cases cited therein.

22. Grenada Industries, Inc., *supra*, note 9. As to dealings in securities see: G.U.R. Co. v. Comm'r., 117 F.2d 187 (C.A. 7th, 1941); National Securities Corp. v. Comm'r., 137 F.2d 600 (C.A. 3rd, 1943).

23. Seminole Rock and Sand Co., 19 T.C. 259 (1952); Grenada Industries, Inc., *supra*, note 9.

24. Welworth Realty Co., 40 B.T.A. 97 (1939).

25. Prop. Regs. Sec. 1.482-2.

26. Advance Machinery Exchange, Inc. v. Comm'r., 196 F.2d 1006 (C.A. 2nd, 1952).

and deductions.[27]

The Tax Court has followed the lead of the Second Circuit in two recent cases[28] and has allocated net rather than gross income. In the case of *Ballantine Motor Co.*,[29] inventory on which a profitable sale could assuredly be made was transferred from one corporation to another in a commonly controlled group. When the transferee corporation's loss carryover was used up by the net profits realized from the sale of the transferred inventory, the unsold inventory was transferred back to the original transferor. The *net* income from the sales of this inventory was allocated to the transferor corporation. In *Hamburgers York Road, Inc.*,[30] the entire net income from a newly organized suburban store was allocated to its sister corporation downtown store. The downtown store still effectively controlled the entire operation of the suburban store by doing its advertising, purchasing, accounting and supervision of personnel. In these cases the effect of the transactions between the controlled corporations was to effect a transfer of net income and not just gross income or expenses. It therefore appears that where net income is transferred so as to violate Section 482, the Commissioner does not have to examine each transaction to allocate gross income and deductions, but may allocate all or part of the net income so transferred, depending upon the specific circumstances.

The power to allocate gross income and deductions is not the power to create income where none exists[31] nor to disallow a deduction entirely.[32] Although many times a deduction should be disallowed or income added in order to clearly reflect income, the Commissioner may not do so under Section 482, but, as the words of the statute clearly state, may only distribute, apportion or allocate the income and expenses of the controlled taxpayers. There must be income or expense present in order for the Commissioner to allocate it between or among the entities in the controlled group. This power to allocate implies that where income or a deduction of one controlled taxpayer is reduced, the income or a deduction of another member of the controlled group must be correspondingly increased. This correlative adjustment is made

27. See also: Ballantine Motor Co., 39 T.C. 348, *aff'd* 321 F.2d 796 (C.A. 4th, 1963); Hamburgers York Road, Inc., 41 T.C. 821 (1964); Pacific Northwest Food Club, Inc., T.C. Memo 1964-8; Nat Harrison Associates, *supra*, note 11.

28. Ballantine Motor Co. and Hamburgers York Road, Inc., *supra*, note 27.

29. *Supra*, note 27.

30. *Supra*, note 27.

31. Tennessee-Arkansas Gravel Co. v. Comm'r., 112 F.2d 508 (C.A. 6th, 1940); Smith-Bridgman & Co., 16 T.C. 287 (1951); cf., Hugh Smith, Inc., 8 T.C. 660 (1947).

32. Hearst Corp., 14 T.C. 575 (1950); Hypotheek Co. v. Comm'r., 200 F.2d 390 (C.A. 9th, 1952); General Industries Corp., 35 B.T.A. 615, 617 (1937).

mandatory by the new proposed regulations.[33]

One test of whether Section 482 is applicable when goods have been rented or transferred between controlled taxpayers is that, if the goods so transferred or rented produce income from outside the controlled group, such income will be allocated to the transferor. This brings about the question whether such income from outside the commonly controlled group should be allocated to the transferor in the year of transfer or the year of sale. The *Ballantine* case, supra, and the proposed regulations[34] both provide for allocation in the year of transfer. Such allocation would be to create income in a year when none was earned and this is clearly beyond the Commissioner's power under Section 482. This procedure is also contra to sound accounting principles. Nonetheless, it appears that if the proposed regulations are not changed or judicially overruled, taxpayers will be hard put to defend an action brought under Section 482 on the grounds that the Commissioner is creating income. All the Commissioner need do is make the required offsetting adjustment and he may create income under Section 482 in a year when none was earned or even anticipated. This indeed is a powerful tool in the Commissioner's hands, especially when coupled with the procedural burden on the taxpayer to prove Section 482 inapplicable,[35] or to prove the Commissioner's allocation was arbitrary or outside the bounds of his broad discretionary powers.[36]

THE PROPOSED REGULATIONS

On April 1, 1965 the Treasury Department published its proposed regulations for Section 482. The new paragraph (d) which was added to Regs. Sec. 1.481-1 (pertaining to methods of allocation) has been discussed above. A new section, Regs. Sec. 1.482-2, has also been proposed. This section outlines the methods of determining income and deductions in certain situations. Paragraph (a) deals with interest rates. It enables the Commissioner to allocate income or deductions to properly reflect an arm's length interest rate on intra-controlled group loans. Arm's length interest is defined as whatever is the interest rate

33. Prop. Regs. Sec. 1.482-1(d)(1), "Whenever the district director makes distributions, apportionments, or allocations to properly reflect the true taxable income of one member of a group of controlled taxpayers, he shall also make appropriate correlative adjustments to reflect the true taxable income of any other affected member of the group."

34. Prop. Regs. Sec. 1.482-1(d)(4).

35. Oppenheims, Inc. v. Kavanaugh, 90 F. Supp. 107 (1950); Seminole Flavor Co., *supra*, note 20.

36. G.U.R. v. Comm'r., *supra*, note 22; National Securities Corp. v. Comm'r., *supra*, note 22; Bush Hog Manufacturing Co., Inc., *supra*, note 14.

actually charged, if between 4% and 5%, and if the interest rate is not between those two figures, then 5%.[37] The taxpayer is permitted to justify a different rate and, if the lender borrows money to loan to the borrower, the rate is the same as the lender actually pays.

A tax danger exists here for the individual taxpayer who also owns a corporation in which he takes an active interest. Many taxpayers owning small corporations treat the business as a proprietorship and draw money out for their own use whenever necessary. These withdrawals are usually termed stockholder or officer loans on the books of the corporation and, of course, the taxpayer does not report any income on his individual tax return. In most cases there is no intention that these loans will ever be repaid. They are therefore dividend distributions or returns of capital. In the past, if the I.R.S. questioned these loans, the taxpayer might be able to prove their validity by some artificial device such as transferring personal tangible or intangible personal property to the corporation in part repayment. Thus he would establish an intent to repay and would not be taxed on these withdrawals as dividends.

Under the proposed regulations the corporation can be credited with interest income on these loans if a proper interest charge has not been made,[38] with a corresponding interest deduction on the taxpayer's 1040 return.[39] This will be detrimental to the taxpayer's interests if the corporation is in a higher tax bracket than he is as an individual. The following example will illustrate this point.

Assume married taxpayer A has owned 100% of corporation B for all five years of its existence. A draws a taxable annual salary of $7,200. Therefore, assume his tax bracket to be 20%. During the previous five years A has withdrawn a total of $50,000 for his personal use and the corporation has treated this as loans to officers. Assume the corporation must pay the surtax and its tax rate is therefore 48%. The interest income allocated to B on account of these loans would be $2,500 ($50,000 x 5%) if no interest had been charged on these loans. A's corresponding deduction would also be $2,500. The additional tax to B would be $1,200 ($2,500 x 48%) but the reduction in A's taxes would be only $500 ($2,500 x 20%). Because A owns 100% of B, the net effect of these tax adjustments reduces A's net worth by $700 ($1,000–$500). Under the new regulations, therefore, the taxpayer would not

37. Prop. Regs. Sec. 1.482-2(a)(2).
38. Prop. Regs. Sec. 1.482-2(a).
39. Prop. Regs. Sec. 1.482-1(d)(1).

be able to completely avoid all taxation on these loans.[40]

Paragraph (b) of Regs. Sec. 1.482-2 deals with services. Allocation will be made on the basis of the benefit received.[41] Thus, if a subsidiary has done some research work and the parent company has done the same work as a check on the subsidiary, no portion of the cost of the parent's research work can be allocated to the subsidiary because the subsidiary received no benefit. Any reasonable allocation by the taxpayer will not be disturbed.[42] Both direct costs such as wages, materials and supplies and indirect costs such as utilities, rent and clerical wages must be allocated[43] and on the basis of full cost and not incremental cost.[44] For example, if one member of a controlled group rents office space, and other members of the group also use that space, but their use does not thereby increase the rental cost, nevertheless a portion of the rental cost must be allocated to each member receiving benefit. Income may be allocated at an arm's length rate (fair market charge for the service) in lieu of costs to render the service, if the member of the commonly controlled group that performs the service is in the business of rendering such services.[45]

Paragraph (c) of the proposed regulations refers to the rental of tangible property. The Commissioner is empowered to allocate income to reflect an arm's length rental charge for the intra-controlled group leasing or borrowing of tangible assets. The arm's length rent is determined as follows when the owner is not in the business of renting property to unrelated parties: 1) depreciation allowable for the taxable year using taxpayer's usual method (provided such depreciation shall not be less than the amount that would be allowable if the adjusted basis at the beginning of the year were 20% of the unadjusted basis), plus 2) 5% of the adjusted basis (at the beginning of the year) multiplied by the fraction of the year the property was owned by the owner, plus 3) the expenses connected with the property The sum of these three items is to be multiplied by the ratio of the number of days of use by the user in question to the number of days of total usage by all

40. It must always be remembered, however, that Section 482 is only one of many sections of the Code that may affect these transactions and that all pertinent sections must be considered (such as Section 541 pertaining to personal holding companies and Section 1372 pertaining to the small business election). This area is a very common trap for the unwary and all practitioners should keep an eye on their clients to make sure they do not fall into it.

41. Prop. Regs. Sec. 1.482-2(b)(2)(i).

42. Prop. Regs. Sec. 1.482-2(b)(1).

43. Prop. Regs. Sec. 1.482-2(b)(3).

44. Prop. Regs. Sec. 1.482-2(b)(5).

45. Prop. Regs. Sec. 1.482-2(b)(6)(i).

users in the period. The expenses referred to are both direct and indirect (e.g. real estate taxes, repairs and utilities) but do not include interest. An example will make the computation.

Assume entity A of a controlled group owns an old office building which it does not use. The building has an adjusted basis of $10,000 on January 1, 1966. This is 10% of the original cost of $100,000 and is considered to be the salvage value. Therefore the building may not be depreciated any more by A because you are not permitted to depreciate an asset below its salvage value under Section 167(f)(1) of the Code. Depreciation had been taken in prior years on a straight-line basis at a rate of 5% per annum. A lets another company in the group, B, use the building for 90 days in 1966 without charge and leases it 90 more days during the year to C, a company outside of the controlled group. Upkeep on the building is $2,000, taxes $4,500 and mortgage interest $500 during 1966. A sells the building to C on November 1, 1966. The rental charge to B for 1966 is computed as follows:

1) 5% x $100,000 x 10/12	=	$4,167	(10 mos. deprec. which would be allowable if the adjusted basis were $20,000, i.e. 20% x $100,000)
2) 5% x $10,000 x 304/365	=	417	(5% of adjusted basis at beginning of year times fraction of year owned by A)
3) $2,000 + $4,500	=	6,500	(allowable expenses)
Total		$11,084	
4) $11,084 x 90/180	=	$5,542	(amount allocated to B based on time in use by B compared with total time in use by all users)

Thus B's rental charge for 1966 is $5,542 with an offsetting amount of income credited to A.

CONCLUSION

In the past, Section 482 has been rather dormant and its use by the Commissioner was usually in connection with an alternative argument under Section 269 (sham corporations) or where a foreign business was involved. With the issuance of the new proposed regulations, it seems evident that this section will be used more on its own merit in the future. Undoubtedly the main purpose and use of the Section is to prevent the arbitrary shifting of taxable income to foreign corporations and thereby depriving the United States of tax dollars. However, Section 482 also affects the tax planning of small and medium sized entrepreneurs who own more than one business or who pay both corporate and personal income taxes and who have no connection with foreign trade. These taxpayers must therefore be aware of Section 482 and its consequences. Some danger areas are discussed below.

Clients whose businesses have just been incorporated are, more often than not, prone to deal with corporate assets in the same manner as before incorporation and they can easily run afoul of Section 482 as outlined above in reference to interest on loans between controlled entities. Where these loans have accumulated over the years, the interest on them becomes substantial. Also, the balance sheet is distorted by the overstated assets and retained earnings.

Where an individual continues to run his closely held corporation and the corporation is dependent upon his activity for continuance, if his salary is not adequate, such stockholder or officer loans to him by the corporation may be considered as additional salary to him under Section 482 as an allocation of income for services rendered. This is detrimental if his individual tax bracket exceeds the corporation's.

Use of personally owned trucks or machinery or office space by the corporation necessitates a fair rental charge by the individual taxpayer or again Section 482 may come into play.

Any time a corporate client decides to split up or spin off a new corporation owned by the same interests and doing the same business, Section 482 becomes a factor. The corporations must deal with each other at arm's length and have little or no co-mingling of assets and personnel if they do not plan a consolidated return. This is true also in organizing subsidiary corporations which act as branch stores or regional divisions of the parent. In transferring or setting up businesses for relatives, the client must be warned to exercise minimal control over the new business, even indirectly, or he may find himself with the income of the new business allocated to him.

At present the defenses to Section 482 attacks which still appear to be valid are:

1) non-control by the same interests

2) arm's length transactions
3) valid, separate entities created for business purposes
4) arbitrary or unreasonable allocations by the Commissioner
5) non arm's length transaction due to outside factors such as government regulation.

The defenses of creation of income, disallowance of deductions, and allocation net income appear to be unavailable in view of the recent court decisions and the new proposed regulations as outlined above.

The best defense, however is adequate tax planning and, even though other sections of the Code will undoubtedly be involved in a Section 482 situation, this Section must not be overlooked in any tax plan because of its limited use in the past. It gives the Commissioner broad discretionary power and can be a tax trap for the unwary or unprepared.

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