

1978

The Affinity Provisions of the Internal Revenue Code: A Case Study in Nonsimplification

Glenn E. Coven

William & Mary Law School

Repository Citation

Coven, Glenn E., "The Affinity Provisions of the Internal Revenue Code: A Case Study in Nonsimplification" (1978). *Faculty Publications*. 505.

<https://scholarship.law.wm.edu/facpubs/505>

Copyright c 1978 by the authors. This article is brought to you by the William & Mary Law School Scholarship Repository.

<https://scholarship.law.wm.edu/facpubs>

TENNESSEE LAW REVIEW

Volume 45

Summer 1978

Number 4

THE AFFINITY PROVISIONS OF THE INTERNAL REVENUE CODE: A CASE STUDY IN NONSIMPLIFICATION

GLENN E. COVEN*

I.	INTRODUCTION	558
II.	AFFINITY PROVISIONS IN GENERAL	561
	A. <i>Classification</i>	561
	B. <i>Historical Development</i>	564
	C. <i>Sections Involved</i>	571
III.	AFFINITY BY FAMILY CONNECTION	572
	A. <i>The Family Relationship</i>	572
	B. <i>Family Attribution</i>	575
IV.	TRUST AND FAMILY AFFINITY	580
	A. <i>Trust and Estate Relationships</i>	580
	B. <i>Definitions</i>	585
	C. <i>Trust and Estate Attribution</i>	587
V.	PARTNERSHIP AFFINITY	593
	A. <i>Partnership Relationships</i>	593
	B. <i>Partnership Attribution</i>	599
VI.	CORPORATE AFFINITY	600
	A. <i>Corporate Relationships</i>	600
	B. <i>Corporate Attribution</i>	609
	C. <i>Nature of Stock</i>	611
VII.	OPTIONS AND CONVERTIBLE SECURITIES	617
VIII.	MISCELLANEOUS RELATIONSHIPS	628
IX.	REATTRIBUTION	628
	A. <i>In General</i>	629

* B.A., Swarthmore College; J.D., Columbia University; Associate Professor of Law, University of Tennessee.

	<i>B. Nature of Operating Rules</i>	633
X.	NONSTATUTORY AFFINITY GROUPINGS	634
	<i>A. "Indirect" Ownership</i>	635
	<i>B. The Special Case of Dividend Equivalence</i>	640
XI.	USE OF AFFINITY SECTIONS BY CROSS-REFERENCE	643
	<i>A. Cross-References to Basic Sections</i>	643
	<i>B. Multiple Cross-References</i>	652
	<i>C. Cross-References to the Family Definition</i>	652
	<i>D. Cross-References to Miscellaneous Sections</i>	656
	<i>E. Defining Relationships by Cross-References to Attribution Rules</i>	660
XII.	THE ULTIMATE IN ATTRIBUTION: SECTION 958	663
XIII.	THE AGGREGATION FORM OF ATTRIBUTION	669
XIV.	TOWARD UNIFORM RULES	675
XV.	CONCLUSION	700

I. INTRODUCTION

The long-overdue surge of public and congressional sentiment for reform of the federal income tax laws that culminated in the Tax Reform Act of 1969¹ had the unintended consequence of dramatically increasing the overall complexity of the reformed Internal Revenue Code.² Critics of the resulting Code have questioned whether, on balance, meaningful reform can be achieved within the framework of such a complex law. It has been suggested that the sheer complexity of the Code is undermining the voluntary compliance system upon which the administration of the tax laws is based while at the same time rendering the laws substantially unenforceable.³ This criticism has resulted in focusing for the first time the attention of the draftsmen of our tax laws on complexity as a separate factor to be considered in the drafting of additions to and revisions of the Code.⁴

1. Pub. L. No. 91-172, 83 Stat. 599 [hereinafter referred to as the 1969 Act].

2. Compare the pre-1969 sections 170 (charitable contributions) and 1201(b) (alternative tax on capital gains applicable to individuals) with their post-1969 counterparts. All references herein to the Code are to the Internal Revenue Code of 1954 unless otherwise indicated.

3. Committee on Tax Policy of New York Bar Association, *A Report on Complexity and the Income Tax*, 27 TAX L. REV. 325, 329-30 (1972).

4. Section 507 of the Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat.

The results of this attention to complexity have been somewhat mixed. Title V of the Tax Reform Act of 1976, "Tax Simplification in the Individual Income Tax,"⁵ amended six provisions of the Code, with changes ranging from reducing the distance that a taxpayer must move before becoming eligible to deduct his moving expenses⁶ to replacing the child care deduction with a credit.⁷ The twenty other, generally more lengthy titles of the 1976 Act, however, contained few, if any, changes related to simplification.

The following year Congress passed the Tax Reduction and Simplification Act of 1977,⁸ which contained a series of minor technical amendments related to changes made by the 1976 Act. The "simplification" of the 1977 legislation was limited to repealing the standard deduction and incorporating its relief into the tax rate tables.⁹ No doubt these changes have simplified the tax laws for many low-income taxpayers—particularly those eliminated from the tax rolls—whose problems were never very complex in the first place. But the unquestionable effect of the changes made by the 1976 and 1977 Acts on businesses and upper-income bracket taxpayers was to complicate significantly the preparation of their tax returns.¹⁰

Perhaps the continued, even increased, substantive complexity of the tax laws applicable to such taxpayers is unavoidable and even desirable. Given the complexity of the wide variety of transactions entered into by taxpayers, a vastly simplified code would not be adequate to allocate equitably the burden of taxation. Furthermore, much of the Code's complexity is a result of

1520, 1569 [hereinafter referred to as the 1976 Act] required the Joint Committee on Taxation to make a "full and complete study" with respect to simplifying the tax laws.

5. Title V of the 1976 Act might just as well have been entitled, and in past years would have been, "Miscellaneous Changes Affecting Individuals."

6. Pub. L. No. 94-455, § 506, 90 Stat. 1568 (amending I.R.C. § 217(c) (1969)).

7. *Id.* § 504, 90 Stat. 1563 (codified at I.R.C. § 44A).

8. Pub. L. No. 95-30, 91 Stat. 126 [hereinafter referred to as the 1977 Act].

9. *Id.* § 101, 91 Stat. 127-30.

10. See, e.g., Tax Reform Act of 1976, Pub. L. No. 94-455, § 204, 90 Stat. 1531 (adding the "at risk" provisions to I.R.C. § 465); *id.* § 602, 90 Stat. 1572 (adding the foreign conventions rules to I.R.C. § 274).

its use by Congress to achieve a variety of social and fiscal objectives, often through the deliberate grant of tax concessions. While such provisions themselves may not be unduly complex, subsequent congressional refinement, perceived as necessary to prevent taxpayer abuse of the concession, often eclipses in length and complexity the original provision.¹¹ Halting this cycle would obviously require that Congress abandon the use of the Code as a tool for social engineering. While there may be merit to such a course of action, it is unlikely that Congress would so limit itself.

Nevertheless, the complex nature of the Code exists on several levels, and the probability of continued substantive complexity does not mean that improvement cannot be sought and achieved on other levels. Below the basic structure of the Code and its substantive policies, lies the mechanical detail employed by the draftsmen in the execution of those policies.¹² In contrast to the substantive tax law, there is no offsetting benefit or social justification for the overwhelming complexity of this mechanical detail. A major improvement in consistency and ease of understanding and application of the Code could be achieved by reform on this level. Because such revisions would, by their nature, have a relatively minor impact on the application of the substantive provisions of the tax law to any given taxpayer, resistance to such changes should be minimal. Therefore, the attainment of mechanical simplification is far more feasible than is enactment of the substantive, structural reforms more commonly suggested in the name of simplification.

As an illustration of the need for simplification at the mechanical level and as an indication of the improvements that

11. See Surrey, *Complexity and the Internal Revenue Code: The Problem of the Management of Tax Detail*, 34 LAW & CONTEMP. PROB. 673, 686 (1969).

12. While the line between questions of policy and "mechanical detail" is not always sharp, the distinction is more than a matter of degree. Altering the details of a statute may affect a small proportion of the taxpayers subject to the provision but will not significantly alter its overall impact. Thus, for Congress to require that a single tax benefit be shared by a taxpayer and his family is clearly a question of policy. Whether the family definition for this purpose is to be broad or narrow may or may not be a matter of congressional policy. But whether the family is to include the brothers and sisters of the taxpayer or the spouses of his lineal descendants is not likely to be more than mechanical detail—reflecting more the preferences of the draftsmen than any question of policy.

could be achieved, the following study has been undertaken of a single class of provisions—herein referred to as the affinity provisions—that appear throughout the Code.

II. AFFINITY PROVISIONS IN GENERAL

Since the enactment of the Revenue Act of 1934¹³ it has been recognized that in certain circumstances to maintain the integrity of the tax laws it will be necessary to treat two or more otherwise independent taxpayers as a single entity or to accord different consequences to transactions among taxpayers standing in a specified relationship to each other than would be the case if the transactions were between totally unrelated taxpayers. Accordingly, the substantive law contains hundreds of exceptions and limitations addressed to related taxpayers. Each such provision, either directly or by way of a cross-reference to another provision of the Code, must define those family, economic, or other interests that for the purpose of the particular provision will be regarded as sufficiently close to warrant application of the exception or limitation. These definitions constitute the affinity provisions of the Code.

A. *Classification*

Affinity provisions are used throughout the Code in a variety of ways and for a variety of purposes. Substantially all of these provisions, however, fall within the two major categories that are of present concern: relationship provisions and attribution provisions.

The relationship provisions constitute definitional adjuncts to specific substantive law provisions that require for their operation a defined relationship among two or more taxpayers. The attribution rules, on the other hand, are used for the purpose of expanding the scope of the relationship provisions.

The relationship provisions are used in the Code to define a class of persons, each member of which constitutes a separate taxpayer for most purposes under the Code but shares a relationship that must be taken into account for a specific substantive law purpose. The most common uses of relationship provisions in

13. Ch. 277, 48 Stat. 680.

the Code occur in substantive sections that either require persons in the prescribed relationship to share a single tax benefit otherwise available to each such taxpayer individually or alter the income tax consequences of transactions among members of the group relative to the tax effect of such transactions among unrelated taxpayers. Within this second category are a large number of relationship provisions governing the income tax consequences of changes in corporate structure, particularly reorganization and liquidation. These provisions generally require a close relationship, generally referred to as "control," among a class of corporations or between a corporation and a class of its shareholders.

The second type of affinity provision might properly be referred to as secondary relationship provisions, since the function of these provisions is to supplement the definition of the primary relationship by reference to the secondary relationships existing among the parties. The most common form of such provisions are the attribution rules. If, for example, a particular substantive law provision defines the relevant relationship as that existing between a corporation and an individual owning fifty percent of its stock, the Code may not merely take account only of stock actually owned by the individual because a relationship so narrowly defined might easily be avoided. Rather, the individual may be deemed to own stock that is actually owned by another if such treatment is justified by the relationship existing between the individual and that other person. The attribution provisions define the scope of this secondary relationship and the circumstances under which attribution is to be made.

In more general terms, because of a secondary relationship between two taxpayers (marriage, for example), their interests in a third party (the corporation) are combined for the purpose of determining the existence of the primary relationship (fifty percent stock ownership) between them and the third party. These objectives can be achieved through methods other than attribution. For example, the Code could first define the secondary relationship and then define the primary relationship by reference to the secondary. Thus, the Code could specify that the primary relationship existed if a husband and wife together owned fifty percent of the corporate stock. Such a provision would read very differently from a traditional attribution provision, particularly if a complete set of relationships were used, but would accomplish precisely the same substantive result. This technique is in fact

used in the Code, particularly in more recently enacted sections.¹⁴ While such provisions have the appearance of relationship sections, they are functionally equivalent to attribution sections and are referred to herein as aggregation forms of attribution.¹⁵ Because of the manner in which the aggregation forms of attribution have been drafted in practice, the secondary relationships defined by such provisions differ from the secondary relationships defined by the traditional attribution rules.¹⁶

Normally the attribution rules have the effect of lowering the relationship threshold because of the existence of other indirect relationships among the taxpayers in question. We have used the example of a substantive law provision that requires for its operation the ownership of fifty percent of a corporation's outstanding stock. However, by attributing to a husband the thirty percent interest held by his wife, for example, the husband will be deemed to fall within the prescribed relationship even though he actually owns, for example, only twenty-five percent of the outstanding stock. This result is thought to be justifiable because of the taxpayer's indirect relationship, through his wife, to the corporation.

There is no inherent reason that the persons included in a relationship provision must be the same persons from whom attribution is to be made for the purpose of expanding the relationship provision. For example, it might be concluded that an individual's siblings should not be included in the defined relationship for the purpose of a given transactional provision of the Code on the ground that these persons normally lack a sufficient economic identity of interest. Nevertheless, in measuring the individual's relationship with a corporation for the purpose of the same provision, it might quite consistently be concluded that stock owned by a sibling should be attributed to the individual. Arguably, that

14. See, e.g., I.R.C. §§ 163(d)(7)(B), 613A(c)(8)(B).

15. The attribution rules have been defined in general terms. However, in the overwhelming majority of uses of the attribution rules, the interest being attributed is corporate stock because the corporate relationship is far more commonly used in the Code than is the partner-partnership relationship. However, the primary section of the Code defining the partnership relationship (section 707(b)) employs the same attribution rules for defining ownership of a partnership interest that are applicable to sections defining corporate relationships (section 267(c)).

16. See Part XII *infra*.

is, a lesser identity of interest may be required for attribution than for relationship inclusion. The Code rarely draws such distinctions, however, and generally, for the purposes of a given substantive law provision, the taxpayers included in the defined relationship are the same ones from whom attribution is made for the purpose of expanding the defined relationship.

B. Historical Development

Before examining the current Code, it will be useful to review briefly the historical development of the affinity provisions. This history provides valuable insight into how the existing complexity and irrationality of the Code evolved and, it is to be hoped, how further aggravation of the situation may be avoided.

Not surprisingly, the early internal revenue laws contained few provisions designed to prevent taxpayers from reducing their share of the income tax burden through advance planning. However, even the draftsmen of the first internal revenue law¹⁷ enacted after the adoption of the sixteenth amendment recognized the avoidance potential inherent in the different tax rates applicable to individuals and corporations. While the one percent normal tax was applicable to both, only individual taxpayers were subject to the "additional" tax on net incomes in excess of \$20,000, ranging from one percent to what was undoubtedly regarded as an outrageous six percent. Accordingly, the draftsmen provided that for the purpose of the additional tax, an individual's taxable income would include his allocable share of the undistributed income of a corporation "formed or fraudulently availed of for the purpose of preventing the imposition of such tax through the medium of permitting such gains and profits to accumulate instead of being divided or distributed."¹⁸ Further, the fact that such a corporation had accumulated income beyond the reasonable needs of its business or was "a mere holding company" constituted "prima facie evidence of a fraudulent purpose to escape such tax."¹⁹ This provision is the direct ancestor of both the present accumulated earnings tax²⁰ and the personal holding

17. Act of Oct. 3, 1913, ch. 16, 38 Stat. 114.

18. *Id.* § II.A. Subdivision 2, 38 Stat. 166.

19. *Id.* 38 Stat. 166-67.

20. I.R.C. § 531.

company provisions²¹ of the Code.

Although the Collector actively litigated a wide variety of tax avoidance devices during the subsequent two decades, Congress paid relatively little attention to tax avoidance techniques until the Revenue Act of 1934.²² Experience with a tax avoidance provision based upon a reasonableness test had demonstrated the inadequacy of such an approach and the need to enact self-executing provisions.²³ The solution adopted by the 1934 Act was to retain the predecessor of the accumulated earnings tax²⁴ while carving out a specific type of corporation—the personal holding company—that would automatically be subject to an additional surtax on its income. This new provision, geared to status rather than conduct, required the adoption of precise definitional tests. In addition to a test relating to the nature of the corporate income, section 351(b)(1) of the 1934 Act adopted a relationship provision defining personal holding companies in terms of ownership by not more than five individuals of more than fifty percent in value of the outstanding stock of the corporation. This precision in definition raised the possibility that the impact of the new provision could be negated, without significantly changing the economic benefits from the use of a personal holding company, by causing the stock of such a corporation to be dispersed among a number of legally distinct but economically related individuals or business entities. To prevent that result, the first attribution provision of the Code was adopted. Section 351 provided that

[f]or the purpose of determining the ownership of stock in a personal holding company . . . (C) stock owned, directly or indirectly, by a corporation, partnership, estate, or trust shall be considered as being owned proportionately by its shareholders, partners, or beneficiaries; (D) an individual shall be considered as owning, to the exclusion of any other individual, the stock owned, directly or indirectly, by his family, and this rule shall be applied in such manner as to produce the smallest possible number of individuals owning, directly or indirectly, more than 50 per centum in value of the outstanding stock; and (E) the

21. I.R.C. §§ 541-547.

22. Ch. 277, 48 Stat. 705.

23. H.R. REP. NO. 704, 73d Cong., 2d Sess. 12 (1934), *reprinted in* 1939-1 C.B. (pt. 2) 554, 562.

24. Revenue Act of 1932, ch. 852, § 104, 45 Stat. 814-15.

family of an individual shall include only his brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants.²⁵

Congress had also become concerned that tax losses were being artificially created by the purported sale of property among members of an integrated economic group, particularly among family members and between an individual and a controlled, closely held corporation. Thus, the 1934 Act added paragraph 6 to section 24(a) disallowing a deduction for a

[l]oss from sales or exchanges of property, directly or indirectly, (A) between members of a family, or (B) except in the case of distributions in liquidation, between an individual and a corporation in which such individual owns, directly or indirectly, more than 50 per centum in value of the outstanding stock. For the purposes of this paragraph—(C) an individual shall be considered as owning the stock owned, directly or indirectly, by his family; and (D) the family of an individual shall include only his brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants.²⁶

The affinity provisions of section 351 were primarily attribution rules applicable to the most elementary relationship—stock ownership. Section 24(a)(6), on the other hand, was the earliest relationship provision of appreciable scope. Section 24 supplemented its relationship definition with family attribution rules that were identical to those contained in section 351. Interestingly, however, the entity attribution rules contained in section 351 were not incorporated into section 24. Thus, for example, an individual could not escape personal holding company classification of a corporation by causing a material portion of the stock of the corporation to be held by another controlled corporation or in trust for the individual. Had the individual chosen to so structure his ownership of the personal holding company, however, losses on transactions between the individual and the personal holding company would not be disallowed. The committee reports to the 1934 Act do not disclose the reason for this disparity in treatment; from their very inception, inconsistency has been the rule, not the exception, in the affinity provisions of the Code.

25. Revenue Act of 1934, ch. 277, § 351, 48 Stat. 451-52.

26. *Id.* § 24(a), 48 Stat. 691.

A further characteristic of the attribution rules in these initial affinity provisions should be noted. Both of the substantive law provisions contained relatively high threshold requirements for their application. That is, more than fifty percent of the stock of a corporation must be controlled by five or fewer persons in the case of section 351 or by the individual and his family in the case of section 24 for personal holding company status to arise or for losses to be disallowed, respectively. Thus, the proscribed taxpayer relationships were relatively narrowly defined. On the other hand, the attribution rules adopted in 1934 were very broad. Under section 351 stock was attributed from a corporation, partnership, trust, or estate proportionately to shareholders, partners, or beneficiaries regardless of how nominal the interest of the individual may have been in the entity. Furthermore, except for certain unusual provisions discussed below,²⁷ the definition of family is the broadest ever adopted in the income tax laws.

The affinity provisions of both the personal holding company section and the disallowance of loss section were significantly expanded in the Revenue Act of 1937,²⁸ which, in these and other areas, largely implemented the recommendations made by the Joint Committee on Tax Evasion and Avoidance.²⁹ The attribution rules contained in the personal holding company provisions were expanded in two major respects. Partners were to be treated in the same manner as family members because of the "close business relationship existing between members of a partnership."³⁰ Second, ownership of stock was to be attributed to the holders of options to acquire the stock and to holders of securities convertible into stock.³¹

27. See text accompanying notes 52-53 & 229-31 *infra*.

28. Pub. L. No. 75-815, 50 Stat. 813.

29. See JOINT COMMITTEE ON TAX EVASION AND AVOIDANCE, H.R. DOC. NO. 337, 75th Cong., 1st Sess. 1 (1937).

30. S. REP. NO. 1242, 75th Cong., 1st Sess. 9 (1937), *reprinted in* 1939-1 C.B. (pt. 2) 703, 709.

31. Revenue Act of 1937, ch. 815, § 354, 50 Stat. 815. The Revenue Act of 1937 also added the foreign personal holding company provisions to the law. The substantive tax avoidance problem attacked by the foreign personal holding company provisions was essentially identical to that which occasioned the adoption of the personal holding company rules: the shifting of income to an incorporated entity that was subject to a lower tax rate or no tax at all. Accordingly, Congress adopted a similar substantive law vehicle to attack the problem and, further, employed identical attribution of stock ownership rules.

The loss-disallowance provision of section 24 of the 1934 Act could have been expanded in several ways. For example, Congress could have enumerated the entities subject to the provision and disallowed losses with respect to transactions among any persons so enumerated. The Joint Committee, however, had focused on specific transactions and, presumably as a consequence, section 24 was expanded by listing the pairs of individuals or entities between which transactions establishing losses would not be permitted. Furthermore, the attribution provisions of section 24 were expanded to include the provisions governing attribution from entities that in 1934 had been added to the personal holding company section but not to section 24. Direct attribution from a partner was also added to section 24 but with a novel and important qualification: such attribution was not to be permitted unless the individual to whom the stock was to be attributed otherwise owned stock in the corporation either directly or by attribution. Further, for this purpose, only attribution from entities would be counted; attributed ownership from family members would not suffice to permit attribution from an individual's partner. As this provision illustrates and other provisions discussed below confirm, the Revenue Act of 1937 originated the trend that has continued to the present day of establishing highly complex attribution rules varying in minor particulars from section to section.

The 1937 Act also added a new substantive provision disallowing deductions under certain circumstances for interest or other expenses incurred but not paid within two and one-half months following the close of a taxable year. This new section 24(c) was to be applicable if "both the taxpayer and the person to whom the payment is to be made are persons between whom losses would be disallowed under section 24(b)."³² Thus, the 1937 Act also introduced the concept of applying attribution rules by cross-reference to other Code provisions.

The next major development of the attribution rules came with the adoption of the Internal Revenue Code of 1954. Prior to that time, the corporate distributions and reorganization provisions had not been subject to these statutory attribution rules permitting tax results that in certain circumstances were unjusti-

32. Revenue Act of 1937, Pub. L. No. 75-815, § 24(c), 50 Stat. 813.

fiably favorable to taxpayers. Accordingly, the 1954 Code added section 318 to provide for attribution of stock ownership under a limited number of designated sections of the Code (principally within Subchapter C) governing corporate distributions and adjustments. Much of section 318 constituted a distinct improvement over the attribution rules previously contained in the Code, but unfortunately the preexisting rules were not conformed to the changes contained in section 318.³³

33. In one respect, however, section 318 contained a provision resulting in overly broad attribution. Section 318 introduced the concept of "back-attribution" whereby stock owned by a shareholder, partner, or beneficiary could be attributed to the corporation, partnership, trust, or estate if certain threshold requirements were met. While back-attribution itself was, and is, controversial, as section 318 was originally adopted, back-attribution brought with it so-called "sidewise" attribution. Stock held by a shareholder (or partner or beneficiary) could thus be attributed back to the corporation and then re-attributed from the corporation to any other shareholder. Sidewise attribution commonly had the effect of treating individuals who were only incidentally fellow partners or shareholders in a business activity as owning stock in the taxpayer's personal and wholly unrelated ventures.

Back-attribution remains in section 318, but sidewise attribution under section 318 was eliminated in 1964 by Pub. L. No. 88-554, § 4, 78 Stat. 762. After ten years of struggling with sidewise attribution, Congress realized that the tax avoidance prevented by this section was indeed marginal and that general application of the provision was improper since it had "the effect of attributing one person's stockholding to another even though there is neither an economic nor a family connection between the two persons." S. REP. NO. 1240, 88th Cong., 2d Sess. 7 (1964), *reprinted in* 1964-2 C.B. 701, 705.

Nevertheless, sidewise attribution had existed, to a limited extent, under the Code since 1937 when attribution from partners was added to both the personal holding company provision, section 544, and to the predecessor of section 267(c). Moreover, such attribution was directly between these persons and not indirectly through the partnership. Thus, the result of attribution pursuant to these earlier provisions was far more extensive since all of a partner's stock would be attributed to the taxpayer and not merely an amount equal to the taxpayer's proportional interest in the partnership. Consistent with the normal inconsistency in this area, when section 318 was modified in 1964 to eliminate sidewise attribution, the more Draconian provisions of sections 267(c) and 544 were not changed.

As noted previously, many of the attribution rules of section 318 are not applicable unless there is a certain threshold relationship between the entities subject to attribution. For example, in the case of corporations, there was to be no attribution in either direction unless the shareholder owned actually or constructively 50% of the stock of the corporation. The threshold requirements for other entities, however, were substantially lower.

The only major addition to the affinity provisions since 1954 occurred in the Revenue Act of 1964, which added sections 1561 through 1564 in substantially their present form.³⁴ Section 1563(a) provided for the first time in the Code a complete definition of a controlled group of corporations, including not only vertical chains but also horizontally related corporations. For the purposes of determining stock ownership under section 1563, the section provided its own set of attribution rules in subsections (d) and (e). The attribution rules contained in section 1563 drew heavily upon the criticism that had been leveled against section 318 and thus in many respects constituted a considerable advance in draftsmanship. Nevertheless, as in 1954 the adoption of this new set of attribution rules was not accompanied by improvements in existing provisions.³⁵

In one particular, the attribution rules of section 1563 are not appropriate for general use. The purpose of these rules is to define a related group of corporations for the purpose of limiting all such corporations to a single surtax exemption and certain other credits. In a surprisingly early recognition of the independence of women, however, Congress concluded that it would be inappropriate to require that separate businesses run by a husband and wife share a single exemption.³⁶ Accordingly, attribution from family members under section 1563(e), particularly from spouses, is highly limited.

While section 1563 is the only basic addition to the 1954 Code, in the sense that it is widely used by cross-reference, every piece of tax legislation of any significance has included additions to or modifications of the affinity provisions, and the Tax Reform Acts of 1969 and 1976 were no exceptions. The 1976 Act is particularly worthy of mention in this historical summary since by that year the need for simplification apparently had been accepted by those responsible for the drafting of tax legislation. Nevertheless, the 1976 Act developed the "double cross-reference." For exam-

34. Pub. L. No. 88-272, § 235(a), 78 Stat. 116.

35. Section 1563 did not adopt back-attribution but rather employed a sufficiently extensive definition of the intercorporate relationships that were to be subject to the substantive law restriction, so that back-attribution became unnecessary.

36. H.R. REP. No. 749, 88th Cong., 1st Sess. 7 (1963), *reprinted in* 1964-1 C.B. (pt. 2) 123, 244.

ple, section 999, the new provision governing international boycotts, defines a controlled group of corporations by a cross-reference to section 993(a)(3), one of the domestic international sales corporation (DISC) sections³⁷ that does not itself define a controlled group of corporations but rather refers, with certain modifications, to the definition in section 1563(a). In addition, section 464(c)(2)(E), also added by the 1976 Act, provides the most unusual definition of family in the Code. The definition is extraordinarily broad and includes not only aunts and uncles and all of the descendants of aunts and uncles, but also great-aunts and great-uncles. However, the definition appears to exclude the individual's own spouse (presumably through a drafting error).

C. Sections Involved

The result of all of the foregoing legislative developments has been considerable diversity, inconsistency, and confusion. Section 267(b) contains the only general relationship provision focusing on individuals. A single provision governing partnership relationships is contained in section 707(b). There are two principal provisions describing corporate relationships, contained in section 1504 and section 1563(a), which are used throughout the Code by a cross-reference; but similarly complete definitions are also contained in section 368 and section 1551. There are three commonly used, relatively complete attribution sections: sections 267(c), 318, and 1563(e). There are also three complete attribution provisions used to a lesser extent throughout the Code: sections 544, 554, and 958. In addition to these provisions, there are a large number of sections that prescribe relationships for the purposes of a single section that may or may not vary in significant degree from the sections of broader application; a smaller number of sections supply attribution provisions for only a single section. In all, over eighty sections employ either the relationship provisions or the attribution provisions contained in these sections, ranging from a mere cross-reference to the definition of family to a full incorporation of both the relationship and attribu-

37. I.R.C. §§ 991-997. A domestic international sales corporation or DISC is a domestic corporation, substantially all of whose income is derived from export sales. In general effect, through the DISC device the income from such sales is taxed at a reduced rate.

tion rules of a provision. As shall be seen, most of these sections also modify the relationships or attributions specified in the basic sections. The lack of uniformity is staggering indeed.

The statutory inconsistency can be better appreciated if the various types of commonly used relationships and attributions are considered as a unit rather than on a section-by-section basis. There is necessarily a degree of artificiality in such classifications. Nevertheless, the general pattern of the relationship and attribution sections should become apparent.

III. AFFINITY BY FAMILY CONNECTION

A. *The Family Relationship*

The family relationship is the one most commonly used in the affinity provisions of the Code. In view of the constant modifications that have been made in other areas, it is noteworthy that the definition of family relationships contained in section 267(b) remains unchanged and is the only definition used with any frequency throughout the affinity provisions of the Code. That definition, which has remained unchanged since 1934,³⁸ includes the taxpayer, his or her spouse, ancestors, lineal descendants, and brothers and sisters by the whole or half blood.

Neither the Code nor the regulations thereto modify the reference to a spouse, and thus the term presumably must be given a broad interpretation.³⁹ More recently enacted affinity provisions, however, exclude from the definition of "spouse" individuals legally separated under a decree of separate maintenance or divorce. A similar rule prevails under other major Code provisions.⁴⁰ Since the different statutory language of section 267 may be either deliberate or unintended, the absence of regulatory clarification is regrettable.

The regulations to the section 267 definition of family provide that "the term 'ancestors' includes parents and grandpar-

38. The apparent consistency of the family definition is somewhat misleading. The principal use of the section 267(c)(4) definition is by cross-references from other Code sections and a great number of such sections modify the definition of family. See Part X *infra*.

39. See *Deyoe v. Commissioner*, 66 T.C. 904 (1977).

40. See, e.g., I.R.C. § 152 (defining a dependent); I.R.C. § 6013(d)(2) (defining eligibility for filing joint returns).

ents, and the term 'lineal descendants' includes children and grandchildren."⁴¹ The use of the word "includes" in this regulation is obviously ambiguous, and it is not at all clear whether the regulation suggests a limitation on the normal definition of those terms or is merely, and pointlessly, illustrative. The regulation further provides that in determining the existence of these relationships, full effect shall be given to a legal adoption. This construction is consistent with the express statutory language of more recently enacted affinity rules and finds strong factual support in contemporary society. The statutory basis for this expansion of the family definition is weak, however, since the term "lineal descendant" suggests biological issue and may be contrasted with the broader word "children," which is used elsewhere in the Code⁴² and which more appropriately would include adopted children. While it is not being suggested that the regulations are invalid, it is interesting to compare the more aggressive construction of "lineal descendants," used to expand section 267, with the absence of any definition of "spouse," any narrowing of which would be favorable to taxpayers.

Section 544 (and the virtually identical section 554), added to the law at the same time as section 267, contains the identical statutory definition of family. However, there are no regulations under the personal holding company definition. Given the historical relationship of these definitions, a forceful argument can be made that they should be interpreted similarly and that the regulatory modification of section 267 should be equally applicable to section 544. Nevertheless, in the absence of any authority, the status of great-grandparents, great-grandchildren, and adopted children for personal holding company purposes is uncertain.

Section 704(e) also contains a definition of family for relationship purposes, but that section has application only to section 704(e) itself, which pertains to family partnerships, and to section 1375(c), which pertains to family stockholders of Subchapter S corporations. The definition of family contained in section 704(e) is identical to the section 267 definition except that section 704(e) does not include brothers and sisters. As in the case of section 544, there are no regulations concerning this definition of family. For

41. Treas. Reg. § 1.267(c)-1(a)(4) (1960).

42. *E.g.*, I.R.C. § 318(a)(1).

certain purposes of the collapsible corporations provision, section 341(e)(8)(A)(i) also contains a definition of family. This provision, not used elsewhere in the Code, is also identical to section 267 except that it does not include brothers and sisters.

A small number of sections contain even more limited definitions of family. Section 613A, which limits the quantity of oil subject to percentage depletion, requires that the allowance be allocated among members of the same family, which is defined in subsection (c)(8)(D)(iii) as including only an individual's spouse and minor children.⁴³

Section 1239, which treats gain on the sale of certain depreciable property as ordinary income rather than capital gain, also contains a family definition for relationship purposes that is limited to a husband and wife. This extreme limitation on the family definition is particularly striking when contrasted with the broad definition in the somewhat related section 267.⁴⁴ Section 1313(c), which defines related taxpayers for purposes of the complex mitigation of the statute of limitation provisions, also limits the definition to a husband and wife.

Section 672(c) defines a "related or subordinate party" for the purposes of the grantor trust rules. Presumably under the influence of the estate planning purposes of a grantor trust, this section defines "family" to include a spouse who is living with the grantor and the grantor's parents, issue, and brothers and sisters. Grandparents, but not grandchildren, are thus excluded from the definition.

Section 152 defines "dependents," rather than "family," for the purpose of the personal exemption and for certain similar purposes, such as the designation of persons related to the taxpayer who may be included in a medical reimbursement plan under section 105(b) or the cost of whose medical care is deducti-

43. The inclusion of only minor children in an affinity provision was first introduced as a drafting technique in section 1239 and later much expanded in section 1563. These are both attribution sections and are discussed in the following text. Section 613A is the first use of the minor children limitation in a relationship section.

44. Sections 1239 and 267 both attack techniques of obtaining a tax benefit through artificial dispositions of property although the techniques are quite different (the substantial provisions of section 267(a) disallow losses on the sale of property).

ble under section 213. On rare occasions when Congress has intended a very broad definition of family, reference has been made to the definition in section 152. For example, section 50B, which defines the wages for which a work incentive program credit is allowed, excludes wages paid to most of the individuals enumerated in section 152.

In addition to the above provisions, two Code sections contain a definition of family relationships for the purpose of defining "prohibited" transactions with various types of exempt organizations. The definition of "disqualified persons" with respect to private foundations in section 4946(d) contains its own definition of family, which is identical to the language of section 267 but eliminates references to brothers and sisters and includes spouses of lineal descendants. This same definition of family was adopted in the prohibited transaction provision of the Employee Retirement Income Security Act of 1974⁴⁵ (ERISA) and is contained in section 4975(e)(6).

B. Family Attribution

In contrast to the single, widely applied family relationship definition of section 267, there are several frequently used family attribution rules, each of which has been the subject of considerable modification. As a result, these provisions are the most inconsistent of the Code's affinity rules.

The definition of family for attribution purposes contained in section 267(c), the oldest of the affinity rules, is identical to the definition used for relationship purposes.

Section 318 was added to the Code in 1954 to serve as a uniform rule, at least for the purposes of Subchapter C, governing the attribution of stock ownership. The section provides somewhat more precise definitions than are contained in the earlier provisions. The members of an individual's family are defined in section 318 to include his spouse, children, grandchildren, and parents. Deviating from sections 267 and 544, section 318 excludes from the definition of a spouse an individual who is legally separated under a decree of divorce or separate maintenance. In addition, this section specifically provides that

45. Pub. L. No. 93-406, § 3, 88 Stat. 879.

a legally adopted child shall be treated as a biological child. Thus, by 1954, brothers and sisters were no longer included in the family affinity group, and recognition had been extended to the realities of separation agreements and adoption. A grandparent continued to be regarded as possessing economic control or identity of purpose with his grandchildren, although grandchildren were no longer regarded as dominating their grandparents.

The most recently enacted of the basic attribution rules is contained in section 1563(e) and marks a considerable departure in the definition of family. In part, these rules reflect an attempt to limit attribution to circumstances having the strongest factual basis. The resulting statutory distinctions have produced an inordinately complex set of attribution rules. To some extent, however, these rules reflect policy considerations that are unique to section 1561, and therefore certain of the limitations on attribution contained in section 1563(e) are not suitable for general application. Nevertheless, as discussed in greater detail below, section 1563 is applied by cross-reference to a significant number of unrelated sections.

Congress wished to exclude from the definition of corporations under common control the separate businesses of a husband and wife. Accordingly, attribution between spouses is subject to special limitations. This policy seems to have influenced the limitations on attribution among other family members as well. Under section 1563(e)(5), stock is generally attributed from a spouse unless the parties are legally separated under a decree of divorce or separate maintenance. This section, however, specifies that the decree of divorce may be either interlocutory or final and thus extends the limitations added by section 318. This general rule is subject to the exceptions that stock is not to be attributed to an individual from his or her spouse if (1) the individual does not directly own stock in the corporation and is not a director or employee of the corporation and does not participate in the management of its business, (2) not more than fifty percent of the corporation's gross income was derived from passive sources, and (3) the stock owned by the spouse is not subject to any restrictions on his or her right to dispose of the stock that run in favor of the individual or his or her minor children.⁴⁶ In other words, under

46. These requirements must be met not only at the time of the transac-

1563(e) the stock of a corporation actively engaged in business is not attributed between spouses if the attributee spouse has no actual contact with the business or ownership rights in the stock. Whatever the merits of such a rule for the purposes of section 1563, it appears to be too restrictive for general application.

Attribution under section 1563(e) involving parents and children is more limited and far more complex than under prior attribution rules. Stock is universally attributed to an individual from his children only if the children have not attained the age of twenty-one years. However, if the individual owns more than fifty percent of the stock of the corporation in question (measured either by value or by vote) stock owned by adult children is also attributed to him.⁴⁷ For the purpose of determining whether the individual owns more than fifty percent of the corporation's stock, his ownership is determined after the application of all of the other attribution rules provided by section 1563(e) except the rules attributing stock owned by an individual's ancestors, grandchildren, or adult children. Thus, in computing this fifty percent, stock attributed to an individual from his or her spouse and minor children is taken into account. This "domination" test is, of course, far more restrictive of attribution than is the limitation on attribution from spouses and is unique to this section.

Stock owned by an individual's parents is attributed to him only if he has not attained the age of twenty-one years or if he has met the fifty percent test referred to above. Stock owned by an individual's grandparents and grandchildren is only attributed to him if he has met the fifty percent test. As in the case of

tion in question but throughout the entire taxable year of the corporation in which the transaction occurs.

47. This provision is the first use of the domination test in family attribution. The test, however, resembles, and may have been derived from the threshold requirements for attribution from corporations introduced by section 318. See text accompanying note 135 *infra*. In connection with corporate attribution, however, the test serves a somewhat different purpose of defining whether the relationship between the corporate-attributor and its shareholder-attributee is sufficiently close to justify attribution, and under section 318 the relationship is not deemed sufficiently close unless the shareholder owns 50% of the stock of the corporation. In family attribution, the family relationship itself between the attributor and the attributee has been regarded as sufficient to support attribution. The domination test imposes the further requirement that the attributee also have a close relationship with the corporation, the stock of which is to be attributed.

section 318, a legally adopted child is included within the definition of child.

Thus, under section 1563, brothers and sisters remain excluded from the family group, and grandparents have reappeared, albeit in limited circumstances. A domination test for family attribution has been introduced; and a distinction first drawn in section 1239, between adult and minor children, has been expanded and joined with the precondition introduced in section 267(c)(3) that the attributee otherwise own stock.

Section 1563 is a classic example of the tension between substantial justice and undue complexity that faces the draftsmen of tax legislation. The factual basis for family attribution under the highly refined section 1563(e) doubtlessly is far greater than under other attribution sections, but the price for such precision in terms of mechanical complexity is obviously very high, particularly in view of the position of section 1563(e) as only one of several different family attribution provisions.

In addition to these basic provisions, other sections define the family for particular attribution purposes. Section 544 prescribes the attribution rules that are to be applied for certain purposes under the personal holding company provisions. The use of this section has been limited to these provisions with only rare exceptions. At present, section 341(d) is the only unrelated section that adopts, by cross-reference, the family attribution rules of section 544.⁴⁸ The definition of family in section 544 has remained unchanged since the enactment of the predecessor to that section in 1934⁴⁹ and is identical to the definition contained in section 267(c). This definition also appears in section 425(d).⁵⁰

The 1976 Act, for no apparent reason, relied heavily on the aggregation form of attribution;⁵¹ and, in the course of prescribing these rather awkward new rules, it introduced two definitions of family, one quite narrow and the other uniquely broad. Section 163(d)(7)(B) provides an aggregation type of attribution rule for the purpose of determining whether fifty percent or more of the

48. Prior to its amendment by the Revenue Act of 1964, section 1551 also employed such a cross-reference.

49. Revenue Act of 1934, ch. 277, § 351, 48 Stat. 751-52.

50. These attribution rules are used only for the substantive purposes of the statutory stock option sections. See I.R.C. §§ 421-425.

51. See text accompanying note 15 *supra*.

stock in a corporation is owned by members of the same family. Consistent with the current trend, family is defined relatively narrowly to include only the taxpayer, his spouse, and his children. None of these terms are elaborated upon in the statute.

Section 447 and the related section 464 form part of a series of provisions that were added to the Code in 1976 and designed to limit the availability of several popular types of tax shelters. Both sections seek to reduce the attractiveness of farming operations as a tax shelter by changing the tax accounting rules that previously had applied to such ventures. However, neither section was designed to change the tax accounting rules available to family-owned farms, even when most of the family interest was held by individuals not actively engaged in farming. For the purposes of these exclusions, Congress evidently thought it desirable to adopt an extraordinarily broad definition of family.

Section 447 is only applicable to incorporated farms and excludes farms in which fifty percent of the stock is owned by members of the same family. In this section, family is defined as including the individual, his brothers and sisters, the brothers and sisters of both his parents and grandparents, the ancestors and lineal descendants of all of the foregoing, and the spouses of all of the foregoing (apparently including the spouses of ancestors and lineal descendants). The section specifically provides that legally adopted individuals shall be treated as though they were biologically related, but it does not define the word "spouse." In view of the number of spouses that the definition includes, this omission is most regrettable. The general effect of this provision is to include all of the descendants (and their spouses) of each of an average individual's four pairs of great-grandparents. In a typical family, the number of persons so described will be in the hundreds, and the degree of identity of economic interest among them will be far less than is the mutuality of interest with one's neighbors.⁵² In any event, section 447 has added a new and perhaps unfortunate dimension to the definition of family.

The related section 464, applicable only to unincorporated

52. In any such family group, one might suppose, there would be several individuals who may think that their farming tax shelter is no longer attractive. One can conceive of an entire new line of business for the nation's genealogists: locating wealthy members of the same section 447 family so they can join together in a farming tax shelter.

farms, also exempts from its application family-owned farms and employs a broad definition of family. Interestingly, however, the family definition here employed is not only different in substance from section 447 but is also different in form. Rather than providing its own definition, section 464 proceeds by way of a highly modified cross-reference to section 267. Because the problems presented by section 464 are characteristic of the "affinity by cross-reference" provisions, section 464 is considered in detail below in connection with the other cross-referencing provisions.⁵³

IV. TRUST AND ESTATE AFFINITY

Although there are numerous inconsistencies throughout the Code in the definition of family for attribution and relationship purposes, with minor exceptions the various rules are relatively clear and unambiguous. By contrast, the provisions governing relationships among and attribution to and from entities are more uniform throughout the Code but are subject to considerably greater interpretive difficulties.

A. *Trust and Estate Relationships*

As in the case of family affinity rules, section 267(b) is the primary provision setting forth relationships between trusts and various taxpayers that is employed through cross-reference by various substantive provisions throughout the Code. Section 267(b) lists the following specific pairs of relationships:

- (a) a grantor and a fiduciary of a trust;
- (b) different fiduciaries of different trusts having the same grantor;
- (c) a fiduciary and a beneficiary of the same trust;
- (d) a fiduciary of a trust and a beneficiary of a different trust if both trusts have the same grantor; and
- (e) a fiduciary of a trust and a corporation more than

53. See text accompanying notes 229-30 *infra*. Prior to 1976, section 1239 also contained a highly limited aggregation form of attribution rule that served a purpose similar to the present section 163(d)(7)(B). The 1976 Act replaced this special rule with a cross-reference to section 318. The former version of section 1239 is of historical interest because the scope of the family was limited to minor children and minor grandchildren, the first distinction in the Code between adult and minor descendants.

fifty percent in value of the outstanding stock of which is owned by either the trust or the grantor of the trust.

Section 267(b) makes no reference to estates or executors of estates in its enumeration of related taxpayers.⁵⁴ This omission is one of several substantial defects in section 267 that have undermined its usefulness as a generally applied relationship provision. The Commissioner has taken steps through litigation to remedy this omission, but after an initial hint of success⁵⁵ it is now apparently established that section 267(b) cannot be expanded to encompass estates. In *Estate of Hanna*⁵⁶ the taxpayer's estate had sold stock to a corporation more than fifty percent of which was owned by the beneficiaries of the estate. The Commissioner argued that since under the attribution rules of section 267(c) the beneficiaries of an estate are treated as owning stock owned by the estate, the sale should be regarded as a transaction between such individual beneficiaries and the corporation. The court rejected this analysis on the ground that the sale was in fact between the estate and the corporation, rather than between individuals and the corporation and that sales by estates were not included in section 267.⁵⁷ The Commissioner has only recently conceded the existence of this omission in section 267.⁵⁸

The only other provision of the Code containing a comprehensive list of trust-oriented relationships is section 1313, which provides rules that are applicable to the mitigation provisions. In somewhat more concise language, section 1313(c) lists the following categories:

54. It is the position of the Internal Revenue Service, however, that if the administration of an estate is unduly prolonged, the estate will be regarded as a trust for all income tax purposes. Treas. Reg. § 1.641(b)-3 (1960).

55. See *Estate of Ingalls*, 45 B.T.A. 787 (1941), *aff'd on other grounds*, 43-1 U.S.T.C. ¶ 9276 (6th Cir. 1943), *nonacq.* 1942-1 C.B. 24.

56. 320 F.2d 54 (6th Cir. 1963).

57. Minor variation of this argument succeeded in expanding the scope of section 267 to partnerships. See text accompanying notes 99-102 *infra*. On the other hand, the Commissioner was not permitted to expand the application of section 267 to transactions between trusts and corporations prior to the amendment of section 267(b) to specifically include those relationships. See *John A. Snively, Sr.*, 20 T.C. 136 (1953); *Lexmont Corp.*, 20 T.C. 185 (1953). But see *Wisconsin Memorial Park Co.*, 20 T.C. 390 (1957) (trust was regarded as a mere conduit).

58. Rev. Rul. 77-439, 1977-2 C.B. 230.

- (a) grantor and fiduciary;
- (b) grantor and beneficiaries;
- (c) fiduciary and beneficiary, legatee or heir; and
- (d) decedent and decedent's estate.

While common sense suggests that certain limitations on these categories must be made, the regulations have not addressed the issue. Presumably, the grantor, fiduciary, and beneficiary must be of the same trust.

A few sections create limited trust or estate relationships. Section 704(e), which establishes special rules for family partnerships, includes rather vaguely in its definition of members of a family any "trusts for the primary benefit of such person."⁵⁹ The prohibited transaction provisions applicable to private foundations include as a disqualified person the owner of a twenty percent or greater beneficial interest in a trust that is a substantial contributor to the charity⁶⁰ as well as trusts or estates in which persons who are otherwise disqualified persons in the aggregate hold more than thirty-five percent of the beneficial interest.⁶¹ The similar prohibitions enacted by ERISA⁶² include trusts or estates in which disqualified persons hold more than fifty percent of the beneficial interest.⁶³

The most flagrant omission from the Code relationship provisions is the absence of a generally applicable definition of related entities of all types. As discussed below in connection with cross-referencing to relationship provisions,⁶⁴ most sections imposing a broader scope on the defined relationship rely on cross-references to several different relationship provisions: generally section 267(b) for family and trust relationships, section 707(b) for partnership relationships, and section 1563(a) for corporate relationships. These separate cross-references, however, do not result in

59. Section 704(e)(3) reads in pertinent part: "The 'family' of any individual shall include only his spouse, ancestors, and lineal descendants, and any trust for the primary benefit of such persons." This definition also applies, by cross-reference, to section 1375(c), which deals with distributions of electing small business corporations.

60. I.R.C. § 4946(a)(1)(C)(iii).

61. I.R.C. § 4946(a)(1)(G).

62. Pub. L. No. 93-406, 88 Stat. 978 (1974).

63. I.R.C. § 4975(e)(2)(E)(iii).

64. See Part X *infra*.

the inclusion of relationships between the different types of entities (for example, between trusts and partnerships).

Beginning in 1969, the draftsmen of tax legislation began experimenting with new forms of all-inclusive relationship provisions, each of which is used only by a single Code section. While each such section is different, two basic approaches have been taken. The initial approach is contained in section 613A, which disallows, with several exceptions, the use of percentage depletion with respect to oil and gas production. One exception is for a specified quantity of production by so-called independent producers. The independent-producer allocation must be shared by specified related persons, and for this purpose section 613A(c)(8)(B) provides that any two or more trusts and estates, together with corporations, that are under common control must share a single allocation. The distinguishing feature of this approach is that common control is defined by an aggregation form of attribution rule.⁶⁵ Common control exists if fifty percent or more of the beneficial interest in two or more entities is owned by the same or related persons. However, only the holdings of persons owning a five percent or greater interest in the entity are counted. The required secondary relationship among the beneficial owners is defined by the traditional cross-reference with certain modifications to the relationship provisions contained in sections 267, 707, and 1563.

Section 613A contains two additional trust and estate relationship provisions. Section 613A(c)(9) creates an exception to the independent-producer exception for production derived from proven property acquired by the taxpayer after December 31, 1974. This exception does not apply to acquisitions from certain related persons as defined in section 613A(c)(9)(B). Trusts, estates, and corporations that are related for the purpose of paragraph (8)(B) are also regarded as related for the purpose of paragraph (9)(B). Paragraph (8)(B), however, does not regard individuals as related to entities. The draftsmen of paragraph (9)(B), on the other hand, desired to exempt acquisitions between individuals and related trusts, although evidently not acquisitions between individuals and related estates or corporations. Thus, section 613A(c)(9)(B) provides, in effect, that a trust is related to

65. The aggregation formula is criticized below. *Id.*

individuals to the extent that the individuals are beneficiaries of the trust.

Finally, the entire independent-producer exception is not applicable, with several exceptions, if the taxpayer either directly or through a related person sells oil or gas products at retail. For this purpose, an extremely broad definition of related person was desired, and therefore section 613A(d)(3) provides that a trust or estate (or partnership or corporation) will be regarded as related to the taxpayer if the taxpayer owns five percent or more of the beneficial interest in the trust, the trust owns a five percent interest in the taxpayer, or a third party owns a five percent interest in each. For the purpose of computing this five percent interest, the subsection prescribes limited rules of attribution.⁶⁶

In 1976 the section 613A(c)(8) form of relationship provision was adopted in section 48(k), which governs the investment tax credit on motion picture film and video tapes. Section 48(k), an all-inclusive relationship provision, expanded the list of related business entities to include not only trusts, estates, and corporations but also partnerships, proprietorships, and "other entities." As under section 613A, section 48(k)(3)(D) provides that two or more trusts or estates or other entities will be regarded as related if fifty percent or more of the beneficial interest in each entity is owned by the same or related persons. Related persons are defined by the same cross-reference to sections 267, 707, and 1563. The five percent *de minimis* rule is increased to ten percent in section 48(k).

Draftsmen of the 1974 ERISA amendments adopted a different approach to the drafting of an all-inclusive relationship provision. The approach taken in section 414 was to adopt by cross-reference the rules of section 1563, which defines a group of commonly controlled corporations, and to require the adaptation by regulation of those rules to trusts, estates, and other entities. While this provision, along with the similar section 52 that was added in 1977, creates new trust and estate relationship provisions, they can better be understood after the corporate relationship provisions of section 1563 are considered.⁶⁷

66. I.R.C. § 613(A)(d)(3) (flush language).

67. Pub. L. No. 93-406, § 3, 88 Stat. 879.

B. Definitions

The Code does not provide a definition of a trust, an estate, or a beneficiary for use in connection with the affinity rules. These terms are defined, however, in substantially identical language in the regulations to sections 318⁶⁸ and 1563.⁶⁹ Under these sections, property is considered to be owned by an estate if the property is subject to administration for the purpose of paying claims against the estate and expenses of administration regardless of whether under local law title to the property vested in the decedent's heirs immediately upon his death. The property that is subject to these attribution rules, therefore, is essentially the property included within the probate estate and not the property included in the gross estate for federal estate tax purposes. For the most part, this regulatory definition is adequate, and there is little ambiguity concerning commencement or termination dates of a trust or estate.

On the other hand, there has been somewhat greater difficulty in determining the beneficiaries of an estate or trust and their proportionate interest in the assets. Regulations to both section 318 and section 1563 provide that with respect to an estate a "beneficiary" includes any person entitled to receive property pursuant to a will or the laws of descent and distribution. A person ceases to be considered a beneficiary when (1) he has received all the property to which he is entitled, (2) he no longer has a claim against the estate attributable to his having been a beneficiary, and (3) there is only a remote possibility that it will be necessary for the estate to seek payment from him to satisfy claims against the estate or the expenses of administration. The Service has ruled that this definition of a beneficiary is equally applicable to the attribution rules contained in section 544.⁷⁰ While a definition of beneficiary for the purposes of section 267 has never been provided, the statutory language of section 267(c)

68. Treas. Reg. § 1.318-3(a), T.D. 6969, 1968-2 C.B. 129.

69. *Id.* § 1.1563-3(b)(3)(ii), T.D. 7181, 1972-1 C.B. 291.

70. Rev. Rul. 71-353, 1971-2 C.B. 243. Technically, this ruling was limited to construing the definition of "beneficiary" in section 544 for the purposes of applying that section by a cross-reference from section 341. However, it is unlikely that a different definition would be used for any other purpose unless the deviation were clearly mandated in order to prevent avoidance of the substantive law provision.

with respect to the beneficiary of an estate is identical to the language contained in section 544. It is therefore reasonable to assume that a definition of "beneficiary" similar to that of sections 318, 544, and 1563 would be used.

It is not clear whether a residuary legatee may cease to be regarded as a beneficiary prior to the formal closing of an estate. The Service has ruled that the regulatory language governing when a person ceases to be a beneficiary pertains only to a specific legatee and is not applicable to a residuary legatee whose interest cannot be determined prior to the closing of the estate.⁷¹ In a prior case, *Renton Investment Co. v. Commissioner*,⁷² the Third Circuit held that if an estate were insolvent and no assets would be distributed to a residuary legatee, the legatee would not constitute a beneficiary for the purposes of the attribution rules contained in the predecessor to section 544.⁷³ Although the later ruling did not refer to *Renton Investment*, it hypothesized that the assets of the estate were insufficient to make any payment to the residuary legatee but nevertheless required attribution, thereby clearly indicating disagreement with the earlier decision.

The conflict between these authorities raises the more general problem of the extent to which these rules must be applied solely on the basis of technical definitions rather than with regard to underlying realities. While the position of the Service is doubtlessly based in part upon a desire to protect revenues, it also evidences an understandable disinclination to permit affinity definitions to be controlled by difficult questions of valuation and legitimacy of claims. Traditionally, affinity definitions have not turned on such factual inquiries. Recently, however, the Treasury Department has adopted flexible rules of attribution involving trusts⁷⁴ that seem more consistent with *Renton Investment* than with the conflicting ruling of the Service. The rule of *Renton Investment*, with its stronger factual basis, is the preferred approach and, given substantial proof of the estate's insolvency, should be followed.⁷⁵

71. Rev. Rul. 60-18, 1960-1 C.B. 145.

72. 131 F.2d 330 (3d Cir. 1942).

73. Revenue Act of 1937, ch. 815, § 354, 50 Stat. 815.

74. See the discussion of the regulations to sections 958 and 1563 at text following notes 94 & 257 *infra*.

75. The adoption of the *Renton Investment* rule with respect to estates

Clearly, the assets held by an estate may vary from time to time by virtue of interim distributions or for other reasons. Under the regulatory definition of a beneficiary, the identity of the beneficiaries of an estate and the extent of their proportional interest may also change occasionally. In Revenue Ruling 58-111,⁷⁶ the Service acknowledged this fluctuation and required that attribution be made as of the date of the transaction subject to the attribution provision.

In at least one context, the Service has ruled that a trust that was not in existence nevertheless constituted a trust. Stock owned by the decedent passed under his will to a residuary trust that was not to be formed until the conclusion of the estate. The question presented was whether the stock held by the estate could be attributed to the beneficiaries of the trust under the attribution rules of section 318. Literally, attribution from the estate would be limited to the trust, and there would be no attribution from the trust to its beneficiaries since the trust did not exist. However, under Revenue Ruling 67-24,⁷⁷ a residuary testamentary trust is to be treated as if it were in existence even if no assets have been transferred to the trustee.

C. Trust and Estate Attribution

The same three Code sections that provide the basic family attribution rules also provide the trust and estate attribution rules that are used in most sections of the Code.

Section 267(c), the oldest of the attribution rules, provides only for attribution from entities to their owners. Thus, section 267(c)(1) provides that stock owned by an estate or trust shall be considered owned proportionately by the beneficiaries. For years it was unclear whether the beneficiaries to which the section referred were the present beneficiaries of a trust or whether remain-

could open similar avenues of inquiry with respect to other entities, although there does not appear to have been any litigation in analogous areas in the 30-plus years that have elapsed since the decision. For example, should stock owned by a corporation be attributed to the corporation's shareholders at a time when the corporation has a negative net worth? Presumably, attribution should be made at least until such time as the corporation has formally entered bankruptcy or receivership.

76. 1958-1 C.B. 173.

77. 1967-1 C.B. 75.

dermen, either vested or contingent, were also included. In *Steuben Securities Corp.*,⁷⁸ a case arising under the predecessor to section 544 (which made applicable for the purposes of the personal holding company provisions an attribution rule identical to section 267(c)(1)), the Tax Court was faced with a factual setting in which the corporate taxpayer would escape classification as a personal holding company if its stock were regarded as owned by the remaindermen constructively through a trust as well as by the holders of a present interest in the trust. The court concluded that to give full effect to congressional basis intent, it was required to hold that the term "beneficiary" was limited to those having a "direct present interest" in the trust and excluding those whose interest "will or may become effective at a later time."⁷⁹ After fifteen years of silence, the Service issued a ruling adopting the *Steuben Securities* rule, apparently settling the question.⁸⁰

Within a year following this ruling, the United States Court of Appeals for the Fifth Circuit, in *Phinney v. Tuboscope Co.*,⁸¹ reviewed the definition of beneficiary contained in the predecessor to section 544 in connection with the application of an obscure provision of the Excess Profits Act of 1950.⁸² The trust involved was a spendthrift trust for the benefit of an individual's children. While the children were the sole beneficiaries of the trust, the trust income was being currently accumulated, and the father argued that the children did not have a present interest under the *Steuben Securities* rule. On these facts the court held for the government without expressly overruling *Steuben Securities*.⁸³

78. 1 T.C. 395 (1943).

79. *Id.* at 399.

80. Rev. Rul. 58-325, 1958-1 C.B. 212 (issued under section 421(d)(1)(C), now repealed but substantially replaced by section 425(d), which contains an attribution provision identical to sections 267(c)(1) and 544).

81. 268 F.2d 233 (5th Cir. 1959).

82. Pub. L. No. 909, 64 Stat. 1137.

83. The holdings of the trust could have been attributed to the children without disturbing the application of the *Steuben Securities* rule to trusts pursuant to which the income was not being accumulated for the benefit of the remaindermen.

Judge Brown summarized his decision in *Tuboscope* as follows:

As we struggle through this intricate web of definitions, exclusions, provisions, exceptions, cross references, limitations, provisos and a general but unavoidable obscurity, it is our conclusion that § 430(e)

Nevertheless, the Internal Revenue Service determined that its interests would be better served by the *Tuboscope* rule and accordingly announced its intention to follow the rule of the Fifth Circuit, thereby revoking its earlier adoption of the *Steuben Securities* formula. This new ruling provided that henceforth stock held in trust would be considered as owned by "its present or future beneficiaries in proportion to their actuarial interests."⁸⁴

Curiously, both *Steuben Securities* and *Tuboscope* involved an interpretation of the predecessor to section 544.⁸⁵ Both rulings involved an interpretation of section 421(d) (now section 425(d)), although Revenue Ruling 62-155 stated that its holding was also applicable to section 544.⁸⁶ None of these authorities, however, made any reference to the identical attribution provision contained in the much more frequently applied section 267(c), nor has there been any authority arising under that provision interpreting the word beneficiary. Nevertheless, it is reasonable to presume that the rule applicable to section 267, whatever its current form may be, would be the same as the rule applicable to identical provisions found elsewhere in the Code. Indeed, the trend has favored the actuarial rule currently applicable to section 544, and it would be safe to assume that section 267 would be similarly interpreted, at least with respect to attribution from trusts.⁸⁷

In an attempt to avoid the interpretive problems arising with respect to beneficiaries of trusts under prior laws, section 318 adopted explicit provisions governing the determination of pro-

(2)(B)(i), expressly incorporating § 445(g)(2)(B), impliedly carries with it § 445(g)(3), though not necessarily that portion of § 461 impliedly incorporated by reference to § 462(g) in § 445(g)(1), so that the attribution rules of § 503(a)(1)(2)(5) make ownership of the corporate stock by the minor beneficiaries of a trust the ownership of the father, and thus pushes the stock ownership beyond the critical 50 per cent to make thereby a new corporation an old one.

Perhaps this needs some elaboration.

268 F.2d at 234.

84. Rev. Rul. 62-155, 1962-2 C.B. 132.

85. Int. Rev. Code of 1939, ch. 2, § 503, 53 Stat. 106.

86. Rev. Rul. 62-155, 1962-2 C.B. 133. It is difficult to evaluate the significance of the fact that all four authorities held against the taxpayer.

87. It is difficult to predict on what basis stock would be attributed under section 267 from an estate to its beneficiaries. See text accompanying notes 90-92 *infra*.

portional ownership. Thus, section 318(a)(2)(D) provides that stock owned by a trust shall be considered owned by its beneficiaries in proportion to their actuarial interest in the trust. This rule is subject to two exceptions: (1) there is no attribution from an exempt trust described in section 401(a), and (2) stock owned by a grantor or Clifford trust⁸⁸ is treated as owned by the person who is considered the owner of the trust under sections 671-678.⁸⁹

Shortly before the Internal Revenue Service issued Revenue Ruling 58-325 adopting the *Steuben Securities* rule for trusts, regulations were issued under section 318.⁹⁰ By way of an example in these regulations, and without textual discussion, the Treasury adopted the *Steuben Securities* rule for estates.⁹¹ The example provided that the interest of an individual to whom a remainder interest in property passed under a will should be disregarded in determining the proportionate interest of other beneficiaries in stock held by the estate since the remainderman had "no direct present interest" in the estate assets.⁹² Although the Internal Revenue Service has now reversed its endorsement of *Steuben Securities* with respect to trusts under other provisions of the Code, the regulatory provision under section 318 remains with respect to estates.

Section 318 also provides for "back-attribution"—attribution to entities from their owners. Thus, stock owned by the beneficiary of a trust or estate is considered owned by the trust

88. If the grantor or another retains or acquires greater than a defined interest in, or powers over, a trust, all or the affected portion of the items of income and expense incurred by the trust are taxed directly to such person. The trust is in general effect disregarded.

89. It is not clear whether the general rule attributing stock to beneficiaries is applicable to a grantor trust so that stock held by the trust may be attributed both to grantors and beneficiaries. In general, the attribution rules permit stock held by one person to be attributed to various other persons depending upon which attribution would result in the greatest attributed ownership. Presumably, therefore, stock held by a grantor trust may be attributed either to the deemed owner or to the actuarially determined beneficiaries.

90. T.D. 6152, 1955-2 C.B. 61.

91. Treas. Reg. § 1.318-3(a), ex. (2), T.D. 6969, 1968-2 C.B. 129. As noted above, this situation renders it somewhat unclear how attribution from estates is to be made under section 267 and similar provisions in which express authority is lacking and the analogies are in conflict.

92. *Id.* This was the same language employed in the *Steuben Securities* opinion.

or estate. However, back-attribution is not made from a beneficiary holding only a remote contingent interest, defined as including a value (computed actuarially and assuming a maximum exercise of discretion in favor of the beneficiary) of five percent or less of the value of the trust property.⁹³ Similarly, stock owned by the grantor (or other person considered the owner) of a grantor trust is considered as owned by the trust.⁹⁴

Section 1563(e) substantially modified the rules governing attribution from trusts and estates applied by section 318. Attribution on an actuarial basis was extended to include estates as well as trusts, thus eliminating the *Steuben Securities* rule from this provision altogether. Furthermore, section 1563 introduced a five percent threshold requirement for attribution from all entities including trusts and estates.

The most significant change introduced by section 1563 was an attempt to limit attribution to those beneficiaries of a trust or estate who actually held a beneficial interest in the stock being attributed. It had long been recognized that ownership interests in entities are not always of the same quality. The dissimilarity is most acute in the case of a trust or estate where quite commonly either the remainder interest in a particular asset or the income attributable thereto would be the exclusive property of less than all of the beneficiaries. Under the prior attribution rules, if an estate consisted of only two items, land and stock, and A held a present interest in the stock, B held a remainder interest in the stock, and C was entitled to the entire interest in the land, ownership of the stock would be attributed to A, B, and C in accordance with their actuarial interest in the trust or estate. Even less justifiably, under the *Steuben Securities* rule, ownership of the stock would be allocated between only A and C even though the interest of B in such stock was clearly superior to the interest of C.

Under section 1563, attribution of the ownership of stock held by trust or estate is made on the basis of the actuarial interest of each beneficiary in the stock alone and not in accordance with

93. The five percent threshold requirement was added to the back-attribution provision of section 318 in order to blunt the criticism that back-attribution did not accord with economic reality to the same extent as did the normal attribution rule.

94. I.R.C. § 318(a)(3)(B)(ii).

his interest in the trust or estate assets generally.⁹⁵ The interest of a beneficiary who cannot under any circumstances obtain an interest in the stock, including income attributable to the stock or the proceeds of any disposition, is ignored. Thus, in the illustration above, no interest in the stock would be attributed to C. The interests of A and B would depend upon their actuarial interest in the stock as if the stock were the only asset of the trust or estate.

As noted, sections 544 and 425(d) contain estate and trust attribution rules identical to those contained in section 267(c).⁹⁶ On the other hand, section 447 is unique in several respects, including the combination of the aggregation with the traditional form of attribution. The primary relationship subject to this section, a family-owned incorporated farm, is defined as a farm in which fifty percent of the stock is owned by members of the same family—the aggregation form of attribution. Stock owned by trusts, partnerships, and corporations is attributed in the traditional manner to the individual family members, but stock owned by estates is not. Instead, the members of the family are uniquely defined as including estates of deceased family members. Thus, all stock owned by an estate is taken into account in establishing the primary relationship, regardless of whether any of the surviving members of the family are beneficiaries of the estate and regardless of the extent of their interest. This treatment of an entity as an individual and attributing the entire amount of its holdings is most uncommon. Assuming that this breadth of attribution was deliberate, it seems peculiar that traditional attribution from estates was omitted. By virtue of that omission, stock held by the estate of an individual who was not a member of the defined family is not taken into account even though a member of the family is a principal beneficiary of the estate. The differing treatment of trusts and estates can produce questionable results. If stock passes from the estate of a nonfamily member to a trust, attribution commences. If stock passes from the estate of a family member to a trust having nonfamily beneficiaries, attribution is reduced—even if the family interest in the trust is greater than their interest in the estate as a whole.

95. Treas. Reg. § 1.1563-3(b)(3), T.D. 7181, 1972-1 C.B. 300.

96. Compare I.R.C. § 267(c)(1) with I.R.C. §§ 544(a)(1) and 425(d)(2).

V. PARTNERSHIP AFFINITY

A. *Partnership Relationships*

Neither section 267(a), pertaining to the disallowance of losses incurred on transactions between related taxpayers, nor section 1239, which characterizes gain on the sale of depreciable property as ordinary income in similar although more restricted situations, directly applies to partnership transactions. However, section 707(b) provides rules analogous to both such sections and establishes its own definition of the relevant relationship for each provision. Thus, paragraph (1) disallows losses on transactions between a partnership and a partner owning more than fifty percent of the interest in the partnership or between two partnerships in which the same persons own more than fifty percent of the interest in each partnership.⁹⁷ Paragraph (2) of section 707(b), which characterizes gain as ordinary income, contains the same definition of relationship except that, consistent with the narrower section 1239, the partner or partners must own eighty percent of the capital or profits interest. For all purposes under section 707(b), a partnership interest is defined as either an interest in capital or an interest in profits, and satisfaction of the fifty percent or eighty percent requirement with respect to either interest is sufficient to invoke disallowance or recharacterization under this section. The relationship definition contained in section 707(b)(1) is commonly used throughout the Code in defining partnership relationships.⁹⁸

Section 707(b)(3) provides that for the purposes of both paragraphs (1) and (2) of this section, ownership of a capital or profits interest is to be determined by the attribution rules contained in section 267(c), excepting the provisions of section 267(c) providing for direct attribution from one partner to another. This requirement conforms the disallowance-of-losses provisions of section 707 to the similar provision contained in section 267.

While the Code does not establish partnership relationship provisions under section 267 (the 1954 Code appeared to leave this area exclusively to section 707), the omission of partnerships

97. In the latter respect, section 707(b)(1) is broader than section 267(b), which lacks a general brother-sister corporation relationship definition.

98. See Part X *infra*.

from the enumeration of related taxpayers opened an obvious avenue for tax avoidance. In *Commissioner v. Whitney*⁹⁹ the Commissioner challenged, pursuant to section 267(a)(1), the allowance of losses incurred in connection with the sale by a partnership of all of its assets to a corporation, 78.2% of the outstanding stock of which was owned by the partners and members of their family. The Second Circuit acknowledged that the predecessor to section 267(b)¹⁰⁰ did not encompass transactions involving partnerships but undertook to determine whether the transaction in question could be characterized as occurring between the corporation and the partners in their individual capacity. After a lengthy review of the conflicting characterization of partnerships under the tax laws as entities or as mere aggregations of individuals, the court held that for the purposes of section 267, a partnership should be treated as an association of individual co-owners and the partnership entity disregarded. Since each partner constructively owned over fifty percent of the stock of the corporation by virtue of the direct attribution from partners permitted by section 267(c) and its predecessor, the court disallowed the losses taken on each of the partner's individual tax returns. Although the validity of the characterization of partnerships by the court under the 1954 Code may be questioned, regulations to section 267, adopted in 1958, incorporated the aggregation concept used in *Whitney*.¹⁰¹

The regulations to section 267 concede that transactions between partnerships and the members of the partnership are not within the scope of section 267 but rather are governed by section 707. However, the regulations provide that transactions between a partnership and a nonpartner shall be deemed as occurring between the nonpartner and each member of the partnership separately. Accordingly, if a partner and the nonpartner, after application of the attribution rules (which includes direct attribution from a partner), fall within a section 267(b) relationship, a portion of the loss or deduction subject to section 267(a) shall be disallowed. Specifically, if the transaction results in a loss or deduction to the partnership, the portion thereof allocable to the

99. 169 F.2d 562 (2d Cir. 1948).

100. Int. Rev. Code of 1939, ch. 1, § 24(b)(1)(B), 53 Stat. 16.

101. See Treas. Reg. § 1.267(b)-1(b)(1) (1958).

related partner under the partnership agreement is disallowed. When the transaction results in a loss or deduction to the non-partner, a portion of such loss or deduction equal to the interest of related partners in the partnership is to be disallowed.

Prescribing a proportional application of a substantive law provision when the prescribed relationship exists is extremely rare in the Code. Presumably, this position was adopted in the regulations because of the case support provided by *Whitney* and because a greater extension of section 267 to partnership transactions clearly would constitute an impermissible construction of the statutory provision. Viewed in isolation, the compromise adopted in the regulations is not necessarily an unsatisfactory approach for substantive law provisions based upon taxpayer relationships. In some contexts, at least, its effect may be more precise and tailored to the abuse under attack than the complete disallowance otherwise provided by the Code if the prescribed relationship, which may involve a low threshold definition, exists. Nevertheless, it is totally inappropriate for a single provision of the Code to provide for a proportionate disallowance with respect to one entity while prescribing a different rule in all other circumstances. Indeed, the results obtained through the application of this regulatory rule for partnerships is completely inconsistent with all other Code affinity provisions. Thus, for example, if a sixty percent partner sells property at a loss to his partnership, section 707(b)(1)(A) disallows the loss entirely. Similarly, if a sixty percent shareholder sells property to his corporation at a loss, section 267(a)(1) and (b)(2) completely disallow the loss. Furthermore, if an individual owns one hundred percent of each of two corporations and property is sold at a loss from one to another, the entire loss is allowed because of the omission of a general brother-sister corporation relationship in section 267.¹⁰² However, under the above regulations, if A is a sixty percent partner in a partnership that sells property to a corporation wholly owned by A, sixty percent of the loss is disallowed. While the need to close an obvious gap in the statutory pattern is clear, the approach of the regulations to section 267 is not satisfactory. Rather, the regulations evidence the need for a complete congressional overhaul of section 267.

102. *Fort Walton Square, Inc. v. Commissioner*, 54 T.C. 653, 658 (1970).

In *Liflans Corp. v. United States*¹⁰³ a court considered the other side of the partnership relationship question—the situation in which the other entity, not the partnership, is the taxpayer in question. This decision, arising under the 1954 Code, expressly approved the analysis of the *Whitney* case and reached the result prescribed by the regulations to section 267 but without referring to those regulations. In *Liflans* a partnership owned debentures issued by a corporation, sixty-seven percent of the stock of which was actually and constructively owned by one of the partners and twenty-eight percent of the stock of which was constructively owned by the other partner. The Commissioner disallowed a deduction to the corporation for interest accrued but unpaid on the debentures under section 267(a). The court sustained that disallowance with respect to the fifty percent of the interest deduction attributable to the debentures proportionately owned by the partner owning sixty-seven percent of the stock but permitted a deduction for the fifty percent of the interest apportioned to the partner who owned less than fifty percent of the stock of the corporation. In view of the judicial adoption of this approach, the proportional relationship prescribed by the regulations to section 267(b) is probably beyond challenge. Legislative action, therefore, will be required to correct this inconsistent application of section 267.

Solely for the purposes of section 267, the regulatory provision, while undesirable because of its inconsistency, appears workable. As discussed below, however, the sections of the Code that cross-reference the relationships established under section 267(b) presumably incorporate the regulatory elaboration of that subsection, including the special partnership rule. It is not at all clear how the partnership rule is intended to operate for the various purposes of these cross-references. Consider, for example, section 179, which excludes from the definition of a "purchase," for the purpose of that section, acquisitions of property from a person whose relationship to the person acquiring the property would result in the disallowance of a loss under section 267. An acquisition of property by a corporation from a partnership in which a partner owns over fifty percent of the stock of the corporation would, under section 267, result in a partial disallowance

103. 390 F.2d 965 (Ct. Cl. 1968).

of a loss. But there is no suggestion in either section 179 or the regulations thereto that an acquisition can be treated as a purchase in part, and it would seem unlikely that such an assertion by the Service would be upheld. Yet it is not at all clear whether the transactions described would fall within the exception to the definition of purchase provided under section 179. The interaction between the general relationship provisions and the sections cross-referencing to these provisions is perhaps the best argument against the sort of ad hoc patching of inadequate relationship provisions exemplified by the section 267 partnership regulations. The need for legislative clarification is apparent.

Of the three complex relationship provisions of section 613A, only the related retailer provision of section 613A(d)(3) includes partnership relationships.¹⁰⁴ The provision is analogous to the trust provision described previously¹⁰⁵ and requires ownership of a five percent interest in "profits or capital." As seen in connection with trusts,¹⁰⁶ section 48(k) was drafted along the general lines of section 613A(c)(8)(B). While the earlier section does not include partnerships, such entities are included as business entities under section 48(k) in the same manner as trusts. Again, the primary relationship is established by reference to the relationship among the owners of fifty percent of the beneficial interest in the partnership. As under section 613A(d)(3), ownership of a beneficial interest is defined as ownership of an interest in profits or capital. However, the application of this "either/or" test to section 48(k), in which control can be found in a large number of related (aggregated) persons, is somewhat more complex than under section 613A(d)(3), in which normal attribution is used and ownership of a five percent interest must be found in one person. Presumably, under section 48(k) only like interests may be added. For example, if there were only two related partners, one owning a thirty percent interest in profits and a fifteen percent interest in capital and the other owning a fifteen percent interest in profits and a thirty percent interest in capital, control should be lacking since the related persons only own a forty-five percent

104. For the purposes served by the other relationship provisions, partnerships are "looked through" under the aggregate conception and thus the substantive law operates at the partner level. See I.R.C. § 613A(c)(7)(D).

105. See text preceding note 66 *supra*.

106. See text following note 66 *supra*.

interest in profits and a forty-five percent interest in capital.

Section 163(d)(7), also added by the 1976 Act, contains a similar but far simpler entity-owner relationship provision. As in the case of sections 613A and 48(k), the substantive law operates with respect to a fifty percent owned partnership or corporation, and the ownership must be held by a defined group of related persons. Under section 163(d)(7)(B), however, the only related persons are the taxpayer, his spouse, and his children. Also, in contrast with the other two sections, ownership under this provision is defined solely in terms of capital interest—different ownership interests in profits are ignored.

Partnerships are included in both section 414 and section 52, the all-inclusive provisions that rely upon an adaptation of section 1563. These sections are considered below.¹⁰⁷

Section 1313 provides that a partner is a related taxpayer for the purpose of the mitigation provisions. Since a partnership is not a taxpaying entity, it was not necessary to define a partner and a partnership as related taxpayers.

The prohibited-transaction provisions¹⁰⁸ also include partnership relationships. For purposes of the private foundation rule, a disqualified person includes (1) the owner of a twenty percent interest in profits of a partnership (interest in capital is ignored) if the partnership is a substantial contributor to the private foundation¹⁰⁹ and (2) a partnership in which disqualified persons own, in the aggregate, more than a thirty-five percent interest in the profits.¹¹⁰ On the other hand, the usually similar section 4975(e), defining a disqualified person for ERISA purposes, includes a partnership if over fifty percent of the interest in profits or capital is owned by a disqualified person.¹¹¹ In addition, section 4975(e) includes a partner of specified disqualified persons provided that the partner owns a ten percent or greater interest in capital or profits.¹¹²

107. See text accompanying note 267 *infra*.

108. See text accompanying note 45 *supra*.

109. I.R.C. § 4946(a)(1)(C)(ii).

110. I.R.C. § 4946(a)(1)(F).

111. I.R.C. § 4975(e)(2)(G).

112. I.R.C. § 4975(e)(2)(I).

B. Partnership Attribution

Although section 267 does not include partners and partnerships within its enumeration of relationships, section 267(c) attributes stock owned by a partnership to its partners under the entity attribution rules of paragraph (1). In addition, section 267, together with the similar and historically related section 544, discussed below, are unique in requiring so-called sidewise attribution from one partner in a partnership to another.¹¹³ Such attribution can be quite broad. For example, stock owned by a partnership and attributed to each of its partners may again be reattributed, under the sidewise rules, to each of the partners. The result is that each partner is not merely treated as owning an interest in the stock that corresponds to his proportionate interest in the partnership but is treated as owning all of the stock owned by the partnership. In the case of section 267, this rule is limited by requiring as a precondition to sidewise partner attribution that the attributee partner otherwise own stock in the corporation. For this purpose, an individual is treated as owning the stock that he actually owns and stock that is attributed to him from entities in which he owns an interest. However, stock may not be attributed to an individual from his partner merely because a member of the individual's family owns such stock. It has been observed above that this precondition, while not common under the various attribution provisions of the Code, has been used by Congress as a device to limit the normal reach of attribution. As a technique of avoiding the arbitrary inclusion or exclusion of a person whose relationship to the taxpayer is marginal, the concept is deserving of additional attention.

The attribution from partnerships rule contained in section 318 is identical to that used in section 267. In addition, section 318 requires back-attribution¹¹⁴ from a partner to his partnership. In neither situation are there threshold requirements. Section 318 does not permit attribution from one partner to another as is permitted under section 267, sidewise attribution having been eliminated from this section in 1964.¹¹⁵

113. The very broad attribution resulting from sidewise attribution has been discussed at note 33 *supra*. It becomes even more pronounced under the reattribution rules.

114. I.R.C. § 318(a)(3)(A).

115. Pub. L. No. 88-554, § 4, 78 Stat. 763 (1964).

As is the case under section 1563 in connection with trust and estate attribution, this section does not employ back-attribution, and it imposes a threshold requirement for entity attribution. Thus, stock is attributed from a partnership proportionately to its partners but not to a partner having less than a five percent interest in the partnership. Neither section 267 nor section 318 undertook to define what was meant by a partner's proportionate interest in a partnership. This area of uncertainty assumed importance with the increased popularity of widely, if not publicly, held investment vehicles cast in partnership form in which the interests of "inside" partners in profits varied over time and was different from their interest in partnership capital. To resolve these doubts, section 1563 adopted the specific rule that a partner's proportionate interest was to be determined with reference to either capital or profits, whichever produced the greater attribution.¹¹⁶ As in the case of section 318, direct partner-to-partner attribution is not permitted.

Section 544, the personal holding company attribution provision, contains the entity attribution rule providing that stock held by a partnership is considered to be owned proportionately by its partners. This provision also retains attribution directly from partners in the form in which it was introduced into the tax laws in 1937.¹¹⁷ Thus, partner-to-partner attribution is required under this section without regard to whether the person to whom the stock is attributable otherwise owns stock in the corporation. Sections 425(d), 447(d)(2), and 613A(d)(3) similarly adopt the standard proportionate attribution rule from partnerships to partners but do not provide for back-attribution or for attribution directly between partners. A special partnership rule, of the aggregation type, is contained in section 1237(a)(2), which attributes to a taxpayer activities by a partnership that includes the taxpayer as a partner.

VI. CORPORATE AFFINITY

A. *Corporate Relationships*

The provisions contained in the Code involving relationships that include corporations are much more extensive and complex

116. I.R.C. § 1563(e)(2).

117. See text accompanying note 30 *supra*.

than the other relationship provisions because of the large number of sections prescribing, for a variety of special purposes, relationships with or among corporations. The welter of provisions may logically be divided into two categories: general relationship provisions that include corporations within their ambit and limited provisions that only describe relationships among corporations. The second form of relationship, usually referred to as "control," is generally outside the scope of this article although it will be useful to describe the more commonly used control sections for purposes of comparison.

Section 267, the original Code relationship provision, established the pattern of corporate relationships that continues to be the one most commonly used. Section 267 encompasses the relationships between (1) a corporation and an individual who owns more than fifty percent in value of the stock of such corporation,¹¹⁸ (2) a corporation and a fiduciary of a trust if either the trust or the grantor of the trust owns more than fifty percent in value of the corporation's stock,¹¹⁹ and (3) two corporations if more than fifty percent in value of the outstanding stock of each is owned by the same individual, provided that one of such corporations is either a domestic personal holding company or a foreign personal holding company.¹²⁰

Section 267 is the only section of the Code that establishes corporate relationship rules that are widely used throughout the Code for a variety of purposes.¹²¹ Other Code sections set forth special relationship rules for corporations that are used solely by that particular section. Section 341, governing the sale or exchange of stock in a collapsible corporation, contains what may be the most confusing use of attribution and relationship rules in the Code. Section 341(e)(8), which defines a related person, prescribes relationships according to whether the stockholder who has sold his interest is an individual or a corporation. If the shareholder is an individual, a corporation in which he owns at least fifty percent of the stock measured by either voting power or

118. I.R.C. § 267(b)(2).

119. I.R.C. § 267(b)(8).

120. I.R.C. § 267(b)(3).

121. Sections 1504 and 1563, described below, are also used by cross-reference but only for defining relationships among corporations. See text accompanying notes 209-11 & 225 *infra*.

value is regarded as related to him. If the shareholder is a corporation, the corporation in question is regarded as related to its parent, its subsidiary, and a sister corporation. However, the definitional tests for these relationships vary slightly. Thus, the same fifty percent ownership test of either voting power or value is employed in defining the parent and subsidiary relationship. A related sister corporation, however, is defined as a corporation more than fifty percent in value of whose stock is owned by the same person who also owns more than fifty percent in value of the corporation in question; voting power is not a part of this test. In defining a sister corporation, the stock interests must be owned by only a single person although the attribution rules of section 267(c), with certain modifications, are applicable to this determination. This attribution approach to related business entities is consistent with section 267 but should be contrasted to the aggregation approach of more recently enacted sections.

Section 954(d)(3) defines a person related to a controlled foreign corporation (CFC) for the purposes of defining "Subpart F income." Generally, the CFC is related to the same persons to whom a corporation having a corporate shareholder under section 341(e) would be related. However, the "parent" of a CFC may be an individual, partnership, trust, or estate. For the purpose of defining the parent and subsidiary relationships, the same fifty percent test is used except that it refers only to voting power of all classes of stock entitled to vote and does not refer to value. Similarly, a sister corporation is defined as a corporation more than fifty percent of the voting power of which is owned by the same person or persons who own fifty percent of the voting power in the CFC. As under section 341(e), attribution rules are applicable, thereby expanding the reach of the section. Section 954(d) cross-references the attribution rules contained in section 958, which adopts, with considerable modification, the rules provided by section 318.

The definition of a related sister corporation in section 954 is far broader than the section 341 definition since the fifty percent control can be found in an unlimited number of persons rather than just a single taxpayer. The section 954 definition is also notably broader than the aggregation approach because no further relationship is required among the controlling stockholders to find the specified relationship between the brother-sister

corporations. By contrast, under the aggregation form of sections 613A(c)(8) and 48(k), two corporations will not be regarded as related, even though over fifty percent of the stock of both is owned by the same person, unless those stockholders are related to each other in the manner specified, that is, within the tests of sections 267, 707(b), and 1563. As noted above, the scope of these more recent sections is also significantly limited by the existence of a *de minimis* rule pursuant to which stock held even by related persons is not counted towards the fifty percent requirement if the related person owns less than five percent of the stock in either corporation in the case of section 613A and ten percent in the case of section 48(k).

These sections also differ with respect to the nature of the stock to be taken into account. The clear reference to voting power in section 954 may be contrasted with the short-hand reference to voting stock in section 48(k), which does not expressly account for stock possessing unequal voting power, and the absence of any definition at all in section 613A.

In contrast to both sections 341(e) and 954, neither section 613A nor section 48(k) employs attribution rules for the purpose of concentrating stock ownership in the corporation in question. Presumably the cross-reference to sections 267, 707(b), and 1563 carry with them references to the attribution rules applicable to those sections. However, such attribution would be only for the purpose of determining which taxpayers would be regarded as related. The effect of attribution at this level is far more difficult to visualize than is the effect of the attribution under sections 341(e) and 954—a difficulty that pervades the approach of sections 613A and 48(k). Nevertheless, the effect of attribution only to expand the list of related parties is generally less extensive than the effect of attribution under the earlier sections and can be illustrated in the following simplified way. Assume that *F* owns all of the stock of corporation *X* and forty percent of the stock of corporation *Y*, his son *S* owns forty percent of the stock of corporation *Z*; and *Z* owns the balance of sixty percent of the stock of *Y*. The issue is whether corporations *X* and *Y* are related for these various sections. Under section 341(e), *S* is regarded as owning twenty-four percent of *Y* through his ownership of *Z*, and this holding is attributed to *F*. Thus, *F* is regarded as owning sixty-four percent of *Y*, and *X* and *Y* are related. Under section

48(k), X and Y will be regarded as related only if F and Z are related within the meaning of section 267. For this purpose, the holdings of S in Z are attributed to F, but since S only owns forty percent of Z, F and Z are not related. Thus X and Y are not related for the purpose of section 48(k).

Two provisions added by the 1976 Act define relationships between corporations and a single family group. Under section 163(d)(7), the relationship exists if the taxpayer together with his spouse and children own fifty percent or more of the value of all classes of stock in the corporation and no attribution is required. On the other hand, section 447 contains an extremely broad definition of family¹²² and requires ownership of at least fifty percent of the combined voting power of all classes of voting stock and at least fifty percent of the number of shares of all other classes by the several members of the family in the aggregate. In addition, section 447(d) prescribes its own unique set of attribution rules.¹²³

The relationships specified in section 1239, as expanded by the 1976 Act, extend to (1) a corporation and an individual owning eighty percent or more in value of the corporation stock and (2) two corporations if the same individual owns eighty percent or more in value of the stock of each corporation. For both purposes, a modified form of the attribution rules of section 318 is applicable.

The stylistic differences between such traditional attribution sections as 341(e), 954, and 1239 and the more recently adopted aggregation provisions in sections 613A, 48(k), 163(d), and 447(d), although considered more fully below, should be noted here. Each of these provisions, at least in part, undertakes to define for tax purposes what is meant by a closely held corporation. The result reached under each section is that all of the stock held by defined members of a family are taken into account in determining whether the stock holdings are sufficiently concentrated. Thus, each of these sections achieves the same substantive result although by two quite different procedures. The need for two paths to the same result under the same Code is dubious.

Section 1237 exemplifies corporate affinity in its most vague form. An improvement to property is deemed made by the tax-

122. See text accompanying notes 51-52 *supra*.

123. See text accompanying notes 95 *supra* & 136-38 *infra*.

payer if it is made "by a corporation controlled by the taxpayer." The Code contains no further elaboration of the meaning of "controlled," but section 1.1237-1(c)(2)(i)(b) of the regulations defines control in terms of ownership of more than fifty percent of the corporation's voting stock. This regulation provides that ownership may be either direct, constructive, "or otherwise." While it is quite clear that the draftsmen of this regulation intended a broad definition of corporate ownership, there is no definition, such as by cross-reference, of either constructive ownership or "otherwise" ownership. It is unclear whether this statement in the regulations indicates the Treasury Department's belief in a common law of constructive ownership or whether the regulations were somewhat casually drafted.¹²⁴

In a similarly vague style section 613(c) includes as a related person a person under common control with the taxpayer. The statutory provision does not contain a definition of control, but the regulations refer to the definition contained in section 482.¹²⁵ Neither section 482 nor the regulations thereto contain a precise definition of control although ownership of fifty percent of the voting stock of a corporation has been found to constitute control.¹²⁶

The two prohibited-transaction provisions also include corporate relationships. Section 4946, pertaining to private foundations, defines a disqualified person as including the owner of more than twenty percent of the voting power of a corporate substantial contributor¹²⁷ and a corporation in which other disqualified persons own more than thirty-five percent of the voting power.¹²⁸ The ERISA provisions contained in section 4975(e)(2) include a corporation more than fifty percent of the voting power or value of which is owned by certain disqualified persons.¹²⁹

The most common of the corporate control provisions are section 368(c) (pertaining to reorganizations), section 1504 (defin-

124. The limited scope of nonstatutory attribution is considered below. See Part IX A *infra*.

125. Treas. Reg. § 1.631-3(e)(5) (1965).

126. See *B. Forman Co., Inc. v. Commissioner*, 453 F.2d 1114, 1153-55 (2d Cir. 1972); *Cayuga Serv., Inc. v. Commissioner*, 34 T.C.M. (CCH) 18 (1975).

127. I.R.C. § 4946(a)(1)(C)(i).

128. I.R.C. § 4946(a)(1)(E).

129. I.R.C. § 4975(e)(2)(G).

ing corporations eligible to file consolidated returns), and sections 1551 and 1563 (disallowing certain multiple tax benefits). The controlled group definitions contained in these sections, except for that contained in section 1563, are not widely employed in the Code.

For the purposes of the corporate reorganization provisions, section 368(c) defines control as the ownership of stock possessing at least eighty percent of the voting power of all classes of stock entitled to vote plus at least eighty percent of the total number of shares of all other classes of stock. However, section 368(c) is not a complete relationship provision by itself since it does not specify in whom control must be found. That element is added by the various substantive provisions that incorporate the stock ownership requirements of section 368(c) and varies from a single shareholder to an unlimited number of shareholders that have another attribute in common (such as having transferred property to the corporation).

Section 1504, in defining an affiliated group, describes a related group of corporations that is quite different from those considered above. The requisite degree of stock ownership, with inconsequential differences in wording, is identical to the section 368(c) requirement. However, a corporation is included in the group if one or more other corporations that are also included own the defined eighty percent of its stock. The common parent is separately defined as owning eighty percent of one of the members of the chain. The group thus described constitutes a vertical chain of related corporations. Under this form of definition, if the chain progresses through several tiers and minority stock is outstanding at each tier, the proportional interest of the common parent in the lowest tier corporation may actually be quite small.

Section 1563 and the similar section 1551¹³⁰ employ a quite different stock ownership requirement in defining control. While under sections 368 and 1504 the two eighty percent requirements are cumulative and designed to restrict the scope of control, under section 1563 control exists by the ownership of either eighty percent of the combined voting power of all classes of voting stock

130. Section 1551 might be described as an unsophisticated version of section 1563. Common ownership must be by individuals only and the section 1563(c) definition of stock is lacking. Otherwise, the controlled groups described are substantially identical.

or eighty percent of the value of all shares (including voting shares). Pursuant to section 1563(c), certain categories of stock, including nonvoting stock that is limited and preferred as to dividends, is entirely excluded from the computation. The definition of a controlled group of corporations contained in section 1563 is the most carefully drafted of such provisions contained in the Code and is the most widely used by cross-reference. The definition distinguishes between vertically and horizontally related groups of corporations and defines such groups separately. With respect to vertical groups, section 1563 adopts the section 1504 chain concept, changing only the definition of stock ownership. However, the definition of a horizontal or brother-sister group was a considerable advance in the art of defining controlled groups. The requisite stock ownership of the potentially related corporations may be held by five or fewer individuals, estates, or trusts rather than by a single individual.¹³¹ To ensure that a mutuality of interest existed among the corporations, it was necessary to specify the extent to which the ownership of each must actually overlap, that is, the extent to which each shareholder must own stock in each of the corporations. Section 1563 adopted a two-pronged approach to this problem. To the extent of fifty percent of the stock of each corporation, the ownership interest of each stockholder must be identical. That is, each shareholder's stock ownership is counted only to the extent that it is identical in each corporation. For example, if *A* owns seventy-eight percent of *X* corporation and twenty-two percent of *Y* corporation and *B* owns the balance of the *X* and *Y* stock, "five or fewer" individuals own over fifty percent of the stock in each corporation, but the test will not be met because, counting only their identical interests in each corporation, they own only forty-four percent (twenty-two percent from each of *A* and *B*).

The second requirement under section 1563 is that at least eighty percent of the stock of each corporation must also be owned by five or fewer individuals, trusts, or estates. Unfortunately, the brevity of the statutory language leaves several questions unanswered. The regulations provide that the five persons

131. The definition of common control contained in such sections as 954(d)(3) is broader than in section 1563 but is too imprecise, and possibly too broad, for general use.

owning eighty percent of the stock must be the same five persons that own the identical fifty percent interest; that is, there can be only one group of five or fewer persons.¹³² Thus, if *X* owns fifty-five percent of both corporations *M* and *N* and *A*, *B*, *C*, and *D* own forty-five percent of *M* and individuals *E*, *F*, *G*, and *H* own forty-five percent of *N*, corporations *M* and *N* are not related. However, the regulations also provide that it is not necessary that each person counted in the eighty percent test own stock in each of the corporations. In other words, the Treasury Department interprets the eighty percent requirement as essentially unrelated to the definition of control and as merely establishing the requirement that to be regarded as related, the corporations must be closely held. Under this construction of section 1563, in the above example, corporations *M* and *N* would be related if *A* and *B* owned forty-five percent of *M* and *E* and *F* owned forty-five percent of *N*—a single group of five persons would own eighty percent of each corporation. It is not at all clear that the draftsmen of section 1563 intended such a limited role for the eighty percent requirement. The Tax Court, with both the majority and dissenting opinions reviewing and relying on the legislative history to section 1563, has twice held this aspect of the regulation invalid.¹³³ In the view of the Tax Court majority, the eighty percent test must be met by counting only stock held by persons whose stock was counted in meeting the fifty percent test. In the above example, only *X*'s stock would qualify, and since he does not own eighty percent of the stock of each corporation, *M* and *N* would not be related. The Tax Court was reversed in both cases on appeal; and thus, for the present, the regulatory construction must be regarded as controlling.¹³⁴ While the technical position of the Tax Court might appear to be the sounder position, the appellate courts evidently agreed with the Treasury Department that a sufficient identity of interest was present among corporations having fifty percent of their stock subject to common control.

132. Treas. Reg. § 1.1563-1(a)(3) (1978).

133. *T.L. Hunt, Inc. v. Commissioner*, 35 T.C.M. (CCH) 966, 972 (1976), *rev'd*, 562 F.2d 532 (8th Cir. 1977); *Fairfax Auto Parts of N. Va., Inc. v. Commissioner*, 65 T.C. 798, 802 (1976), *rev'd*, 548 F.2d 501 (4th Cir. 1977).

134. *T.L. Hunt, Inc. v. Commissioner*, 562 F.2d 532 (8th Cir. 1977); *Fairfax Auto Parts of N. Va., Inc. v. Commissioner*, 548 F.2d 501 (4th Cir. 1977).

B. Corporate Attribution

As we have seen elsewhere, section 267, the oldest of the Code attribution rules, provides for proportionate attribution from entities to their owners. This rule is also applicable to corporations. Thus, stock owned by a corporation is treated as owned proportionately by its shareholders.

The attribution rules added by section 318 in 1954 substantially restricted attribution from corporations by imposing a high threshold requirement that must be met before this provision is triggered. No similar threshold requirement was imposed for attribution from trusts, estates, or partnerships. Section 318(a)(2)(C) provides that stock shall be attributed proportionately from a corporation to its shareholders, but only if the shareholder owns or is considered as owning, after the application of specified attribution rules, fifty percent or more in value of the stock of the corporation from which holdings are to be attributed. Thus, under this provision stock is not attributed to a shareholder whose holdings, together with the holdings of persons economically related to him, do not permit control of the corporation. Similarly, the back-attribution rule adopted by section 318 only attributes to a corporation stock owned by a shareholder who owns or is considered to own fifty percent or more of the stock of the corporation.¹³⁵

The high threshold requirement of section 318 was not followed under section 1563. Rather, this provision adopted the nominal-interest rule for corporations that is applied by this section to other entity attribution provisions. Thus, stock owned by a corporation is attributed to a shareholder, provided that such shareholder owns five percent or more of the value of the stock of the corporation. As in the case of section 318, the attribution rules of section 1563 are first applied in determining whether the shareholder owns five percent of the stock.

The unusual affinity provisions of section 447(d) have previously been noted in connection with its extraordinarily broad definition of the family and its overall character as an aggregation provision.¹³⁶ It has also been observed that, in contrast to the other recently enacted aggregation provisions, section 447 also

135. I.R.C. § 318(a)(3)(C).

136. See text accompanying note 52 *supra*.

employs traditional attribution rules. While the attribution from trusts and partnerships rules are commonplace, patterned exactly on the proportional attribution rule of section 267, the corresponding corporate attribution rule is unique.¹³⁷

As under section 318, stock owned by a corporation is attributed to its shareholders only if the shareholders own (directly or by virtue of attribution from trusts or partnerships) fifty percent or more in value of the stock in the corporation from which attribution is to be made. The computation of the required fifty percent ownership under section 447, however, is quite different from the computation of the section 318 threshold requirement in that the aggregation style generally applicable under section 447 is also employed here in place of the usual attribution rules. That is, the fifty percent ownership is to be found among members of the same family in the aggregate. Again, the substantive result is the same regardless of whether the approach of section 318 or section 447 is used. Section 447(d)(3) is significant because it constitutes a further extension of the substitution in the Code of the aggregation form for the traditional attribution rule.

One striking aspect of the aggregation test for the fifty percent threshold requirement under section 447(d)(3) is that it does not parallel the family aggregation test used in section 447(c)(2) for the purposes of the basic relationship definition. In defining those corporations that are exempt from the substantive application of section 447, the basic relationship provision requires that the family own fifty percent of the voting power and fifty percent of the number of nonvoting shares of the corporation. However, the threshold requirement for attribution is ownership of fifty percent of the value of all stock—obviously, a very different test. Normally the value test will be more easily met, and attribution will be made from corporations that would not be regarded as controlled for the substantive purposes of the section. While that result cannot be criticized, except on the basis of unnecessary complexity, the opposite result may also arise. Thus, it is not difficult to hypothesize situations in which attribution cannot be made from corporations that are regarded as controlled for purposes of the substantive law, and that result does not appear sensible.¹³⁸

137. I.R.C. § 447(d)(3).

138. The most obvious situation in which this could arise is when the

The corporation attribution rules also address for the first time a question that has remained unanswered under other attribution sections: whether voting stock owned by a corporation should be attributed to the holders of its nonvoting stock. Under section 447 it appears clear that such attribution is to be made—a result that might well be criticized. Section 447(d)(3) provides that if the threshold requirement is met, the family is regarded as owning its proportional interest in each class of stock in a second corporation that is owned by the corporation from which attribution is to be made. In the particular case of section 447, with its high threshold requirement, attributing voting stock to the family without regard to whether any member of the family owns voting stock in the attributor corporation does not seem inappropriate since the fifty percent threshold requirement provides a basis for presuming *de facto* domination.

Since section 447 does not contain a general corporate attribution rule but rather attributes stock to the family from a corporation controlled by it, the section as thus far described would not provide for attribution from second-tier corporations. This problem of reattribution, which is very briefly and most unsatisfactorily covered by a parenthetical insertion in section 447(d)(3), is considered below in connection with reattribution.

Sections 544, 425, and 613A(d)(3) contain the same rule applied under section 267: stock owned by a corporation is regarded as owned proportionately by its shareholders. A similar rule is prescribed by section 904(d)(2) but only with respect to stock owned by a foreign corporation.

C. Nature of Stock

The relationships established by section 267(b) require only that the individual or fiduciary own more than fifty percent of the value of the outstanding stock of the corporation; it is unneces-

corporation had outstanding two classes of voting stock having unequal voting power. Assume, for example, the corporation had outstanding 100 shares of Class A Common possessing five votes per share and 400 shares of Class B Common possessing one vote per share, the classes otherwise having equal rights and priorities. If the family owned all of the Class A but none of the Class B, the corporation would be related to the family but attribution could not be made unless the value of the 100 shares of Class A exceeded the value of the 400 shares of Class B.

sary for the shareholder to have any voting interest in the corporation. Very early constructions of the predecessor to section 267 established that the required relationship could exist even though the individual owned only nonvoting preferred stock.¹³⁹ More recent authority has established that the fifty percent ownership requirement can be met, even though the relationship between the shareholder and the corporation has been characterized by the parties as a creditor relationship, if the Internal Revenue Service can persuade the court that the investment in the corporation more nearly resembled equity than debt and that, accordingly, the purported lender should be regarded as an owner of an equity interest in the corporation.¹⁴⁰

The attribution rules contained in section 267(c) do not distinguish between voting and nonvoting stock or between common and preferred stock.¹⁴¹ Where the substantive law purpose for which attribution is being made is geared to value, such as in the case of the relationships defined by section 267(b), this lack of discrimination is immaterial since the application or nonapplication of this section is not altered by the fact that the individual, who owns only nonvoting preferred stock in the parent company, may be regarded as owning a portion of the voting common stock of its subsidiary. Furthermore, most of the provisions throughout the Code that adopt the attribution rules of section 267 are also premised upon ownership of a specified value of outstanding stock. On occasion, however, the attribution rules of section 267(c) are used in a section of the Code that determines substantive relationships based upon the ownership of a percentage of voting stock. This situation exists in the definition of a disqualified person for private foundation purposes under section 4946 and in the similar ERISA provisions in section 4975. For example, under section 4946(a)(1)(C)(i), a "disqualified person" includes an owner of twenty percent of the total combined voting power

139. See Wolf Bergman, 6 T.C.M. (CCH) 1118 (1947).

140. *In re Indian Lake Estates, Inc. v. Stewart*, 448 F.2d 574 (5th Cir. 1971); *Harbour Properties, Inc. v. Commissioner*, 32 T.C.M. (CCH) 580 (1973). See the excellent analysis of the debt-equity problem in Plumb, *The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal*, 26 TAX L. REV. 369 (1971).

141. See Goldstein, *Attribution Rules: Undue Multiplicity, Complexity Can Create Liabilities*, 15 TUL. TAX INST. 384 (1965).

of a corporation that is a substantial contributor to a private foundation. For the purposes of computing this twenty percent interest, the attribution rules of section 267(c) are applicable.¹⁴² Assume that an individual had invested in a class of preferred stock of corporation *A* in which he owned no voting stock and that the value of his preferred stock equaled sixty percent of the value of the outstanding stock of the corporation. Assume further that corporation *A* owned forty percent of the single outstanding class of stock of corporation *B* and that the balance of this voting stock in corporation *B* was controlled by unrelated persons. If those unrelated persons cause corporation *B* to become a substantial contributor to a private foundation, does the individual become a disqualified person with respect to the foundation? If voting stock in corporation *B* is to be attributed to the individual by virtue of his ownership of nonvoting stock in corporation *A*, the individual will be regarded as owning twenty-four percent of the voting power in corporation *B* and thus will be a disqualified person with respect to the private foundation. Although there is no textual basis in the law for avoiding attribution to the individual, that result is so incongruous that it must be erroneous. If corporation *A*, to which the individual is far more closely related, became a substantial contributor to the private foundation, the individual then would not become a disqualified person because he owns no voting power in corporation *A*.

Similarly, section 4946(a)(1)(E) includes as a disqualified person a corporation more than thirty-five percent of the combined voting power of which is owned by certain other defined disqualified persons. Assume that an individual is on the board of trustees of a private foundation, thereby constituting a disqualified person with respect to the foundation, and that the individual has made an investment in nonvoting preferred stock of corporation *C*, which stock constitutes forty percent of the value of the outstanding stock of the corporation. That corporation would not constitute a disqualified person with respect to the private foundation. However, if the corporation had a wholly owned subsidiary, the subsidiary would constitute a disqualified person since the individual would constructively own forty percent of its outstanding voting stock.

142. I.R.C. § 4946(a)(3).

Section 318 also refers only to stock, without elaboration. The problems presented by attribution under section 318 might have been substantially greater than the problems involved in applying section 267 because many of the provisions using section 318 attribution do involve determinations of voting power.¹⁴³ However, the very high fifty percent threshold requirement for the application of the corporate attribution rules of section 318 have tended to eliminate applications of that section that might be regarded as unjustifiably prejudicial to taxpayers since non-voting stock will rarely comprise fifty percent of the value of a viable corporation. While many of the sections that use section 318 attribution rules lower the threshold requirement, such sections tend to employ value rather than voting control tests.

The most egregious absence of legislative or administrative guidance in this area occurs in section 425(d), which contains a set of attribution rules that are expressly for use in determining stock ownership for the purposes of three enumerated sections.¹⁴⁴ Each of the cross-referencing sections requires the computation of voting power, but neither the statute nor the regulations¹⁴⁵ provides any hint of how nonvoting stock is to be handled in the attribution formula.¹⁴⁶ As previously discussed, section 447(d)(3) contains the first express statutory solution to this problem and literally appears to mandate attribution of voting stock to the holders of nonvoting stock in the first-tier corporation.¹⁴⁷ The drafting of that provision is so subject to criticism in other respects that it is not fully clear that Congress actually intended such attribution. Furthermore, section 447 is unusual in that it provides for attribution, not to an individual, but to a class of persons in the aggregate. Perhaps the best analysis of section 447(d)(3) is that it is unique and should not be regarded as a

143. *E.g.*, I.R.C. §§ 302(b)(2)(c), 304(c).

144. Section 425(d) begins: "For the purposes of this part, in applying the percentage limitations of sections 422(b)(7), 423(b)(3), and 424(b)(3) . . ."

145. *Treas. Reg.* § 1.425-1(d) (1966).

146. The definition of a controlled group of corporations contained in section 1563(a) also requires the computation of voting power although the attribution rules to that section similarly do not address this question. However, since section 1563(c)(1)(A) excludes nonvoting preferred stock from the section 1563 computations, the problem is here limited to the much rarer nonvoting common stock.

147. *See* text following note 138 *supra*.

precedent for attributing voting stock to the holders of nonvoting stock under other sections. Section 447, however, contains a fifty percent threshold requirement that tends to eliminate the problem for the purpose of that section. It would seem appropriate, therefore, to examine critically the precedential value of section 447 to a proportional attribution section, such as section 267, that lacks a threshold requirement.

Regardless, of the substantive merits of the stock attribution rules contained in sections 267 and 318, the application of those rules to nonvoting preferred stock is clearly established. A somewhat different situation prevails under section 1563. Section 1563(c)(1) specifies that for the purposes of sections 1561 through 1564, which pertain to multiple tax benefits in the case of controlled corporations, the term "stock" does not include nonvoting stock that is limited and preferred as to dividends. Obviously, for the purpose of applying the attribution rules of section 1563(d) and (e) to the substantive provisions of section 1561 through section 1564, nonvoting preferred stock is disregarded. Such stock is not attributed and does not form the basis for an attribution of other stock. However, several provisions of the Code adopt by cross-reference the attribution rules contained in section 1563. Fortunately, most of these cross-references are to a "controlled group" of corporations within the meaning of section 1563(a), for which purpose the definition of stock contained in section 1563(c) clearly would be applicable. However, a few sections cross-refer solely to the attribution rules contained in section 1563(d) and (e). For example, section 1551 is closely related to section 1561 both in purpose and language. Section 1551(b) provides that for its purposes, the attribution rules of section 1563(e) shall apply. However, neither section 1551 nor the regulations thereto contain a definition of stock; the definition contained in section 1563(c) literally is not applicable since it is not within the cross-reference. Furthermore, the language of section 1551 predates the exclusion of nonvoting preferred stock in section 1563 (the cross-reference was added when section 1563 was enacted). In such circumstances, it is uncertain whether or not the reference in section 1551(b) to section 1563(e) carries the implication that stock is not to be attributed to the holder of nonvoting preferred stock.

Even more difficult is a cross-reference contained in section 993(e), which defines a "related foreign export corporation" for the purpose of defining the qualified export assets of a DISC. Such a corporation is defined in part in section 993(e)(3) as a corporation, less than ten percent of the total combined voting power of which "is owned (within the meaning of section 1563(d) and (e))" by a controlled group of corporations, within the meaning of section 1563, which includes the taxpayer. In defining the controlled group, clearly nonvoting preferred stock is ignored, but it is unclear whether such stock is to be ignored for the purpose of determining the extent of ownership of the foreign export corporation by the controlled group. Certainly it is needlessly complex to include nonvoting stock for one purpose under section 993 and exclude it for another. On the other hand, if a reference to the attribution rules of section 1563(e) is deemed to include a reference to section 1563(c) and its exclusion of nonvoting stock, attribution pursuant to a cross-reference to section 1563 will be quite different in this respect from attribution under the other commonly cross-referenced attribution sections. It seems unlikely that attribution with respect to nonvoting stock is one of the factors taken into account by the draftsmen of tax legislation in selecting the section to be cross-referenced. The choice here is not between consistency and inconsistency but between different forms of inconsistency. Perhaps the better case can be made for consistency among the several attribution provisions, but the stronger case can be made for regulatory clarification.¹⁴⁸

Even where section 1563 is not applicable to nonvoting stock, as when applied to section 1561 and possibly elsewhere, the section may nevertheless be applicable to purported indebtedness found to constitute a form of equity capital. In a case arising under section 1561, the Service argued that an investment in the form of notes, which the court held constituted stock for the purpose of the relationship provisions of section 267(b), should, under the facts of that case, be regarded as stock that was not nonvoting and limited and preferred as to dividends.¹⁴⁹ While the

148. There is some relatively weak analagous authority for ignoring section 1563(c) in the application of section 1563(e) by cross-reference in the construction of the option rule contained in that section. See text accompanying note 163 *infra*.

149. *Harbour Properties, Inc. v. Commissioner*, 32 T.C.M. (CCH) 580 (1973).

court disagreed and did not take the purported debt into account in determining the existence of a section 1561 controlled group, the question may be one of fact. In an appropriate case, the de facto possession of control over the corporate affairs might be sufficient.

VII. OPTIONS AND CONVERTIBLE SECURITIES

It is evident that a taxpayer may easily avoid the impact of a substantive rule of law that is dependent upon his ownership of specified stock in a corporation by permitting others to hold the stock while he owns the right to obtain or regain the stock through the exercise of an option or otherwise. In such circumstances, the taxpayer can maintain his economic interest in the corporation but avoid the tax liability of such ownership. In spite of these realities, section 267(c) has never contained a provision attributing stock to the holder of an option on such stock. In this respect, section 267 is seriously deficient. In light of the omission, it might be anticipated that the Treasury would assert considerable pressure for creative judicial interpretations. However, since either taxpayers have not been inclined to take advantage of this deficiency or the Treasury has not been inclined to challenge them, there has been little case law expanding the concept of ownership under section 267(c) to include options.¹⁵⁰

By contrast, the other early attribution rules, pertaining to the ownership of stock in a personal holding company, adopted the extensive rules governing options that were recommended by the Joint Committee on Tax Evasion and Avoidance.¹⁵¹ The tightening of the tax laws that took place in the Revenue Act of 1937 was largely directed to the elimination of specific abuses that the Joint Committee had discovered. Thus, while the Committee rec-

150. In *Prentiss D. Moore*, 17 T.C. 1030 (1951), *aff'd*, 202 F.2d 45 (5th Cir. 1953), the taxpayers had entered into the agreement to acquire all of the stock of a corporation, and the stock was placed in escrow pending the payment of the purchase price. Thereafter the taxpayers sold property to the corporation at a loss. However, it was stipulated at trial that the transfer of the property was not effective until the closing of the purchase of the stock and the release of the escrow. Accordingly, the court held that, since on the date on which the sale was effective the taxpayers had acquired all of the stock of the corporation, the predecessor to section 267 forbade recognition of the loss.

151. H.R. Doc. No. 337, 75th Cong., 1st Sess., § 3 (1937).

ommended extending the then-existing attribution rules for holding companies to the relationships described in the predecessor to section 267,¹⁵² it did not recommend that its proposed attribution rules in the personal holding company area should also be applied to the disallowance of losses provision. With respect to personal holding companies, the Joint Committee and Congress were persuaded that circumvention of the stock ownership test had occurred through the use of options and convertible securities;¹⁵³ apparently evidence of a similar circumvention of the predecessor to section 267 was lacking.

Under section 544, options and convertible securities are separately and differently treated. Section 544(b) provides that securities convertible into stock, even though the conversion date is deferred, shall be considered as stock but only where the effect of so considering the security is adverse to the taxpayer. This last qualification is entirely appropriate. Otherwise, the present actual owner of over fifty percent of the outstanding stock of a corporation, for example, could avoid personal holding company status by issuing convertible securities to an unrelated person. On the other hand, this section also expressly requires that if any securities are to be treated as stock, then all securities outstanding and having contemporaneous or earlier conversion dates shall also be treated as stock.¹⁵⁴ The requirement that securities other than those owned by the taxpayer also be treated as stock is in recognition of a significant difference between the convertible securities rule and all other attribution rules. For the purpose of determining the existence of a personal holding company, as well as for the purpose of resolving most questions involving attribution, it is necessary to determine not only the number of shares of stock owned by one or more taxpayers, but also to determine the total number of shares of the corporation's stock that are regarded as outstanding. That is, to determine whether the prescribed percentage of ownership has been obtained, it is necessary to know the denominator as well as the numerator of the fraction. The application of all other attribution rules does not change the

152. Revenue Act of 1936, ch. 690, § 24, 49 Stat. 1662.

153. S. REP. NO. 1242, *supra* note 30, at 9.

154. The effect of this requirement, of course, is taken into account in determining whether the application of the option rule will be adverse to the taxpayer.

denominator of this fraction; however, attributing stock to the holder of a convertible security increases the total number of shares considered to be outstanding. If only the stock subject to options held by the taxpayer were considered to be outstanding (in addition to the stock actually outstanding), his proportionate interest in the corporation would be unfairly inflated because the assumption that only the taxpayer would convert his securities is unrealistic. While the assumption of section 544(b) that all securities that could have been converted would have been will also often prove to be inaccurate, the statutory rule is clearly more realistic. It is also probably the fairest possible rule, short of an intolerably burdensome case-by-case financial analysis of each security.

With one exception, the option rule of section 544(a)(3), in contrast, contains none of the operating rules applicable to convertible securities. The exception is that for the specific purposes of the personal holding company provisions, which section 544 accompanies, all of the attribution rules, other than attribution from entities, are applicable only if the effect is adverse to the taxpayer. Thus, the option rule does not provide that an option shall be treated as stock, but rather states that if a person has an option to acquire stock, "such stock" shall be considered as owned by that person. The section is totally silent with respect to stock subject to options held by one other than the taxpayer. The evident explanation for the different treatment is that Congress in 1937 only contemplated that stock would be attributed under the option rule from an actual holder of outstanding stock, in which event the special problems inherent in applying the convertible securities rule to unissued stock do not arise.¹⁵⁵ Regardless of the evils sought to be corrected in 1937, the most common form of option in existence today is the compensatory option issued to employees. Such options are almost exclusively issued by the corporate employer and are options to acquire stock

155. The record ownership of stock may be split up among more than five individuals but less than five individuals may have an option to acquire the stock at any time they desire. In the case of an option to acquire stock such stock may be considered as being owned exclusively by the holder of the option or the owner of the stock . . .

JOINT COMM. ON TAX EVASION AND AVOIDANCE, *supra* note 29, at 11. See also S. REP. NO. 1242, *supra* note 30.

of the employer that is not outstanding and is normally unissued.

Since the option rule of section 544(a)(3) only calls for the attribution of "stock," it is not at all clear that the rule can be applied to attribute stock that is not in existence or at least not outstanding. Thus it is not clear whether stock can be attributed to the holder of a compensatory or investment option issued by the corporation itself. Assuming that the option rule can be so applied, it is also unclear to which holders of options attribution should be made. There is no textual basis for attributing stock to one class of holders but not to others in the manner of the convertible securities rule. Neither of these questions has ever been answered under section 544.

Section 318 contains an option rule that is substantially identical to the rule of section 544. However, because section 318 is a rule of general application, it does not contain the restriction that it only applies if the result is adverse to the taxpayer; nor is such a limitation contained in the sections that use section 318 by cross-reference. Thus, section 318 not only contains the same ambiguities as section 544, with respect to unissued stock, but also adds a troublesome question of its own: is the application of the option rule to persons other than the taxpayer mandatory? With respect to all other rules of attribution, it is of no consequence who, other than the taxpayer or taxpayers in question, owns stock in the corporation. Thus it is irrelevant whether the attribution rules are regarded as applicable to them. However, if the option rule is applied to unissued stock subject to options held by persons other than the taxpayer, the taxpayer's constructive interest in the corporation will be reduced.

Finally, these operational aspects of the option rule assume a greater importance under section 318 than under section 544 because section 318 lacks an express provision governing convertible securities. Therefore, to the extent that attribution can be made to such a security under section 318, it must be made under the general option rule.

The general boundaries of the option rule are not statutory. What little light has been shed on the issue has come from case law development and a single revenue ruling. It is instructive to follow the evolution of these authorities in some detail to see how the courts have dealt with complex ambiguities in the affinity provisions. The application of the option rule of section 318 in

connection with compensatory options has been considered by two courts, but regrettably, resolution of the issue was not material to either decision. Even more regrettably, the courts adopted opposing views. Both cases involved the application of the substantially disproportionate redemption rules of section 302(b)(2) in a situation in which the taxpayer did not hold any options but compensatory options were outstanding in the hands of employees. In *J. Milton Sorem*¹⁵⁶ both the Tax Court and the court of appeals assumed, without discussion, that unissued stock should be attributed to all holders of options and that the entire amount of such attributed stock should be regarded as outstanding. However, in *Bloch v. United States*¹⁵⁷ the court indicated that if the issue were squarely before it, a contrary result might have been reached because attribution with respect to options that might never be exercised would be unduly speculative. The court did not specify on what theory the seemingly mandatory language of section 318 might be ignored.¹⁵⁸

In Revenue Ruling 68-601¹⁵⁹ the Internal Revenue Service announced its agreement with the basic principle of *Sorem* that the option rule of section 318 could be applied to unissued stock. While that ruling dealt with warrants, that is, investment options, there is no basis for distinguishing such options from the compensatory options involved in *Sorem*. While the uncertainty can hardly be regarded as settled by this ruling, a contrary rule would open a wide gap in the scheme of section 318. It is probable, for this reason alone, that most courts would give effect to the ruling.

Revenue Ruling 68-601 actually went beyond merely agreeing that the option rule of section 318 could be applied to unissued stock. It also addressed the long-unsettled question of whether that rule could also be applied to convertible securities.¹⁶⁰ With

156. 40 T.C. 206 (1963), *rev'd on other grounds*, 334 F.2d 275 (10th Cir. 1964).

157. 261 F. Supp. 597 (S.D. Tex. 1966).

158. For such a theory, see *Northwestern Steel & Supply Co. v. Commissioner*, 60 T.C. 356 (1973), involving the option rule of section 1563.

159. 1968-2 C.B. 124.

160. In their early article on attribution under the 1954 Code, Ringel, Surrey, and Warren observed that it could be argued that convertible securities were merely a form of option but noted that the history of separate treatment under section 544 might preclude that interpretation of section 318. Ringel,

little discussion, the ruling asserted that warrants and convertible debentures are not "realistically different" from the options referred to in section 318 and that both such securities would be regarded as options for the purpose of that section.

While the foregoing discussion has suggested that convertible securities are indeed different from the options originally intended to be included in the option rule of the predecessor to section 544,¹⁶¹ it is unquestionably true that convertible securities are not realistically different from other options to acquire unissued stock. If the application of the option rule to compensatory options is sustained, the extension to convertible securities contained in Revenue Ruling 68-601 would almost necessarily follow.

While agreeing that the option rule should be applied to unissued stock, Revenue Ruling 68-601 disagreed with the method by which the rule was applied in *Sorem* although the Service appeared to confine its disapproval to the specific provisions of section 302 rather than to section 318 generally. In *Sorem* stock subject to options had been treated as outstanding for the purpose of computing the disproportionality of a redemption by a nonoptionee. Seemingly, this approach required reading the option rule of section 318 as both mandatory and applicable to all options. The ruling, however, relying on the statement in section 1.302-3(a) of the regulations that the test of section 302(b)(2) shall be applied to each shareholder separately, took the position that the option rule should not be applied to the holders of options whose stock would not be attributed to the shareholder in question.¹⁶² It seems clear, however, that this regulation does not support the position taken in the ruling since the question presented is how many shares are considered to be outstanding for the purpose of applying the test of section 302 separately to each shareholder; the regulations to section 302 clearly do not address that question. To the extent that this limitation on attribution is peculiar to section 302, it is not important here. Subsequent

Surrey, & Warren, *Attribution of Stock Ownership in the Internal Revenue Code*, 72 HARV. L. REV. 209, 223-24 (1958).

161. Int. Rev. Code of 1939, ch. 2, § 503, 53 Stat. 107.

162. See also Treas. Reg. § 1.422-2(h)(1) (1966), which somewhat obscurely indicates that for the purposes of that section, stock subject to options held by the taxpayer should be included in the numerator of the fraction but not in the denominator.

cases, however, have indicated that this limitation may be more broadly applicable.

The conflicting authorities under section 318 were reviewed in *Northwestern Steel & Supply Co. v. Commissioner*¹⁶³ in which the court was required to apply the option rule of section 1563(e) to unissued stock. The Tax Court treated the option rule of section 1563(e) as identical to the rule of section 318 and did not question that the option rule of section 1563 could be applied to unissued stock. With respect to the method of applying that rule, however, the court preferred to follow Revenue Ruling 68-601 rather than its prior suggestion in *Sorem*, which it characterized as dicta. The specific issue presented was whether the petitioner was part of a section 1563(a) controlled group. During the years in question, one corporate stockholder owned over eighty percent of the actual outstanding stock of the petitioner, and the balance was owned by a single individual who also possessed an option to acquire from the corporation an amount of stock that would have given the individual a twenty-five percent ownership interest in the petitioner. The court stated that it was only concerned with determining the ownership interest of the corporate shareholder, not the interest of the individual, whether actual or constructive. Thus, the court held that stock subject to the option should not be taken into account for any purpose. While the court's premise is indisputable, it does not support its conclusion because the question presented is not how many shares the individual owned but how many shares are deemed to be outstanding for the purpose of determining the proportionate interest of the corporate shareholder.¹⁶⁴ Since the constructive ownership rules deal in hypothetical ownership, these two questions are quite distinct.

The court's approach in *Northwestern Steel*, focusing on the taxpayer in question in order to bar attribution to others, is

163. 60 T.C. 356 (1973).

164. That this decision may have resulted in part from a failure by the court to distinguish between options to acquire issued and unissued stock is suggested by a second aspect of the opinion. The court stressed that under the usual operation of the attribution rules, more than one person may be deemed to own the same stock. This aspect of attribution would be relevant if the option had been to acquire outstanding stock but does not appear relevant to the facts of the case. Attribution of unissued stock does not involve multiple ownership but only the number of shares deemed outstanding.

identical to the position of Revenue Ruling 68-601 with respect to the application of section 302. While the ruling relied upon specific language in the regulations to the substantive law section, the approach taken by the Tax Court would appear to apply equally to every application of the option rule of each attribution provision. If this construction prevails with respect to compensatory options, it is difficult to see how a different rule could be applicable to warrants or to convertible securities.

However the option rule of section 318 is applied to convertible securities, it would appear inevitable that the result must be different than that reached under the special convertible securities rule of section 544. That result is unsatisfactory. Certainly the procedure suggested in *Sorem* was far more favorable to the taxpayer than the section 544(b) rule would have been; since the attribution was favorable to the taxpayer, section 544(b) would not have permitted attribution. Conversely, the result in *Northwestern Steel* is consistent with this aspect of section 544(b), but the rationale of that case and Revenue Ruling 68-601 would prevent attribution to persons other than the taxpayer in question regardless of whether the taxpayer also held an option. In that respect, these authorities are more hostile to taxpayers than is section 544(b).

The problem, of course, is that the application of the option rule to unissued stock in the absence of the operating rules contained in section 544(b) with respect to convertible securities will frequently produce unjustifiable results—generally favorable to taxpayers. The need is for corrective legislation.

Regardless of the rigor of the reasoning of the court in *Northwestern Steel*, the case is consistent with the views of the Service and is the first clear judicial determination with respect to the attribution of unissued stock. Unfortunately, in the following year the Tax Court was again presented with the identical issue under section 1563. In *North American Industries, Inc. v. Commissioner*¹⁶⁵ Judge Tannenwald pursued a completely different approach. *North American* also presented the question of whether a section 1563(a) controlled group could be broken through the issuance of options. After first stating that the case was controlled by the prior decision in *Northwestern Steel* and

165. 33 T.C.M. (CCH) 1275 (1974).

that stock could not be attributed to the holder of the option, the court held in the alternative that section 1563(e) applied only to stock that is actually outstanding. It will be recalled that section 1563(c), for the purposes of sections 1561 through 1564, defines the term "stock" to exclude certain categories of stock, one of which is treasury stock. The Service argued, and the court agreed, that if treasury stock were not to be taken into account under section 1563, unissued stock certainly should be excluded. Whether the Service was well advised to present this argument is not clear. If the court's analysis of section 1563(e) is followed, the attribution provisions of section 1563 cannot be applied either for or against the government to unissued stock, including stock subject to compensatory options, warrants, and convertible securities.

This analysis seems wrong, both from the perspective of the proper functioning of the attribution rules in general and the construction of section 1563(c). When it was to its advantage, the Internal Revenue Service rejected a similar analysis.¹⁶⁶ The purpose of the attribution rules is to define stock ownership and thus define what stock is considered to be outstanding. If the option attribution rule is applied to unissued stock, such stock is then deemed to be outstanding in the hands of the optionee; for the purposes of the substantive section involved, it is no longer regarded as unissued. Furthermore, the purpose of the exclusion of treasury stock in the context of defining relationships among corporations is to prevent the artificial inflation of the denominator of the fraction, thus pushing the required ownership below the specified percentage. Clearly, Congress did not intend this exclusion to bar attribution of unissued stock to one who dominated a

166. In the course of its criticism of the suggestion in *Sorem*, the court in *Bloch* indicated that regardless of whether the option rule of section 318 in general could be applied to unissued stock, when applied to section 302(b)(2), § 1.302-3(a) of the regulations might bar such attribution. 261 F. Supp. at 604. In common with section 1563(c), the regulation provides that section 302(b)(2) "shall be applied only with respect to stock which is issued and outstanding in the hands of shareholders." While Revenue Ruling 68-601 did not refer to the *Bloch* case, it undertook to blunt the suggested limitation of the option rule of section 318 by observing that "no mention is made [in the disproportionate redemption regulation] as to what shares, if any, that may be acquired through the exercise of options are to be considered as issued and outstanding stock for this purpose." Rev. Rul. 68-601, 1968-2 C.B. at 125.

corporation through ownership of options or convertible securities.

The result in *North American* does have the merits of not using the existing option rule to attribute unissued stock, for which the rule is not well suited, and of creating a more neutral approach between taxpayers and the Service than did the prior authorities. Nevertheless, attribution should be made to the holders of such options for the same reasons that attribution is made to the holders of options to acquire outstanding stock. The solution to the problems arising under the option rule is not to discard the major application of the rule but to provide appropriate operating rules.

The court in *North American* was not unaware of the impact of its decision and undertook to limit its scope in a somewhat confusing footnote that stated:

In so holding, we deal only with sections 1561 through 1564, noting that a different result may obtain, for the purposes of a section 302 redemption, in respect to increasing the percentage of stock owned by the person whose shares are being redeemed and who has an option to acquire additional shares which are neither issued nor outstanding.¹⁶⁷

Of course, this decision under section 1563 would have no application to section 318, which does not contain a limiting definition of stock. Perhaps the court was suggesting that the section 1563(c) definition of stock constituted a modification of the attribution rules contained in section 1563(e) only when such rules were applicable to sections 1561 through 1564 and that when the attribution rules of that subsection are applied by cross-reference to other sections of the Code, the limiting definition would be inapplicable. Assuming that the option rule of section 1563(e) is not applicable to unissued stock for the purposes of sections 1561 through 1564, it does not necessarily follow that such stock may not be attributed in other contexts. The issue presented is the same as whether the rules of section 1563 are applicable to non-voting preferred stock. In that connection it was suggested that a mere cross-reference to section 1563(d) and (e) should not be deemed to include a cross-reference to section 1563(c).¹⁶⁸ While

167. 33 T.C.M. (CCH) at 1278 n.6. (citing *Northwestern Steel & Supply Co. v. Commissioner*, 60 T.C. 356 (1973)).

168. See text accompanying notes 147-48 *supra*.

the question remains open under both the corporate and the option rules, Judge Tannenwald's footnote is encouraging.

The few authorities that have arisen under the various option attribution rules have not contributed significantly to the definition of an "option" to acquire outstanding stock. Options can assume a wide variety of forms, from an immediately exercisable right to acquire stock at a bargain price, to the deferred and contingent rights held by a party to a "buy-out" agreement permitting the purchase of stock of a deceased shareholder at book value. There is some indication in Revenue Ruling 68-601 that the Internal Revenue Service would be receptive to a definition of options that did not include contingent rights to acquire stock, provided that the contingency is substantial and not within the control of the taxpayer. Thus, in arguing that convertible debentures are not realistically different from options, the ruling stated that in each instance stock may be acquired at the election of the holder of the option and that no contingencies exist with respect to his election. On the other hand, the mere fact that an option is not immediately exercisable should not be sufficient to prevent attribution. Section 544(b) specifically provides that convertible securities will be regarded as stock without regard to whether the conversion date is deferred several years.

It has been ruled under section 318 that when a corporation holds an option to acquire its own stock, the corporation will not be considered the owner of the stock for the purpose of reattributing the stock to another shareholder.¹⁶⁹ The reasoning of this ruling, that a corporation acquiring its own stock did not acquire the rights of a stockholder and therefore such stock holdings should be disregarded, would seem broad enough to prevent attribution to the corporation for any purpose. The language of the ruling, however, suggests that the stock could be regarded as constructively owned by the corporation for other purposes, that is, for treating the corporation as the owner of its own stock. The regulations provide that a corporation will not be considered to own its own stock by virtue of back-attribution but are silent with respect to the option rule.¹⁷⁰

169. Rev. Rul. 69-562, 1969-2 C.B. 47.

170. See Treas. Reg. § 1.318-1(b)(1), T.D. 6969, 1968-2 C.B. 126.

VIII. MISCELLANEOUS RELATIONSHIPS

Despite the differences in detail, nearly all of the relationship provisions include the same entities. However, the Code does contain several unique affinity groupings. A number of sections add entities to the usual set of relationships. For example, section 267(b)(9) relates any person to an organization exempt from tax under section 501 if the organization is controlled by such person or, in the case of an individual, by members of his family. In large part, this provision was rendered obsolete by various sections added to the Code by the Tax Reform Act of 1969, particularly section 4941, which prohibits self-dealing between private foundations and persons related to it. The scope of section 267(b)(9), however, is broader than that of the 1969 Act and thus has some continuing importance.

The policy underlying the various relationship sections discussed above is rarely articulated and frequently unclear. To some extent, it assumes some degree of economic identity of interests and occasionally a concept of domination and control. Certain substantive law sections of the Code, however, turn solely upon considerations of domination and control, and the relationship provisions used by those sections occasionally include relationships involving control without economic mutuality of interest. A principal example is section 672(c), which defines a "related or subordinate party" for various definitional purposes of the grantor trust rules. This provision includes as a related party an employee of the grantor and a subordinate employee of a corporation in which the grantor is an executive. Similarly, the ERISA provisions contain a very broad definition of "disqualified person" that includes the employer, employee organizations, and officers, directors, and highly compensated employees of disqualified persons.¹⁷¹

IX. REATTRIBUTION

While the basic attribution rules described previously are sufficiently complex and quite far-reaching, they only begin the inquiry. When stock (or, less commonly, a partnership or trust interest) is attributed from the actual owner to another, the ques-

171. I.R.C. § 4975(e)(2)(H).

tion arises of whether the constructive owner of the stock should be considered the owner for the purpose of reattributing the stock to a third party who stands in a relationship to the second person that would normally permit attribution but who bears no relationship to the actual owner of the stock. Consistent with the general tenor of the affinity rules, the Code answers this question in various ways, depending upon the section involved and the nature of the initial attribution. These reattribution provisions, which have the effect of substantially widening the relationships prescribed by the substantive law, are generally referred to rather innocently as "operating rules."

A. In General

The operating rule applicable to section 267 attribution¹⁷² provides that stock constructively owned by a person by virtue of the normal entity attribution rule shall be considered actually owned by him for the purpose of reattributing the ownership of such stock to another. On the other hand, when stock is attributed to an individual from members of his family or from his partner, it is not to be reattributed for any other purpose. Thus, stock owned by an entity may be attributed upwards through various tiers of trusts, partnerships, and corporations to an individual and thereafter attributed to the individual's spouse or other family members, but stock attributed to an individual from his spouse or his brother, for example, cannot then be reattributed to another member of the family. Since section 267 does not permit back-attribution from individuals to entities, the more complex reattribution problems presented by such rules do not arise.

Reattribution upward from entities is necessary to prevent taxpayers from too easily avoiding the impact of the attribution rules by separating their ownership of the entity in question by more than one tier of equally dominated entities. Reattribution, of course, is accomplished pursuant to the general attribution rules including the nearly universal proportionality requirement. Thus, if an individual owns only twenty percent of corporation A, which owns thirty percent of corporation B, which owns forty percent of corporation C, the individual is only regarded as own-

172. I.R.C. § 267(c)(5).

ing twenty percent times thirty percent times forty percent or 2.4% of corporation *C*. At this point reattribution becomes essentially meaningless, but it would not be appropriate to limit arbitrarily the number of tiers through which attribution may be made because of those circumstances in which the interest of the ultimate owner is not significantly diluted while passing through several tiers.

On the other hand, there is no need for family reattribution if the initial definition of family is sufficiently broad to describe the full relationship desired. Furthermore, if family reattribution were required, constructive ownership would pass from one family to their relatives by marriage in an endless chain.

Family attribution following entity attribution has generally been thought necessary to prevent dispersion of stock ownership that lacked substance. Presumably the same is to be said for partner-to-partner attribution following entity attribution—assuming that attribution from partners is appropriate at all. In one not at all uncommon circumstance, however, this attribution rule produces a clearly unwarranted result. A partner is treated as the owner of not only his proportionate interest in any stock owned by the partnership, as might appear from a casual reading of section 267(c)(1), but rather he is treated as the owner of the entire amount of such stock by virtue of reattribution from his partners. Such overly broad attribution is the effect of the direct sidewise attribution that is limited to partners and sections 267 and 544.

Section 318, which contains considerably more elaborate attribution rules than does section 267, also employs far more complex reattribution rules. Section 318 adopts the limitation contained in section 267 to the effect that stock attributed under the family attribution rule shall not again be attributed. However, the prohibition is only applicable to reattribution under the same rule, that is, the family rule. Since section 318 does employ back-attribution, stock constructively owned by an individual because it was actually owned by his parents or other family members may be reattributed to a corporation or other entity in which the individual holds the requisite threshold ownership.¹⁷³

Section 318(a)(5)(C) contains a similar limitation on reattri-

173. Rev. Rul. 77-218, 1977-1 C.B. 82.

bution following the application of the back-attribution rules. Thus, stock that is constructively owned by an entity by virtue of the rules attributing stock owned by shareholders, partners, and beneficiaries to entities may not be reattributed under the normal attribution rules to make another shareholder, partner, or beneficiary the constructive owner of the stock. This is the prohibition against so-called "sidewise" attribution.

On the other hand, it is permissible to employ back-attribution downward by reattribution through more than one tier. Thus, stock owned by an individual may be attributed to his corporation and then to a subsidiary of the corporation. Reattribution, particularly involving back-attribution, can produce some rather odd and unpredictable results, some of which are mercifully foreclosed by the regulations. For example, assume that an individual owns all the stock of corporation *A*, which owns all of the stock of corporation *B*. Under section 318(a)(3)(C), corporation *A* is regarded as owning all of the stock owned by the individual, which includes the stock in corporation *A* itself. That is, corporation *A* would be regarded as owning itself. Further, all stock actually and constructively owned by corporation *A* is regarded as owned by corporation *B*. Thus, the subsidiary would be regarded as owning all of the stock of its parent. Section 1.318-1(b)(1) of the regulations prevents both results by providing that a corporation shall not be regarded as owning its own stock by virtue of section 318(a)(3)(C).

There are no reattribution limitations on entity attribution nor on reattribution following the application of the option rule. Moreover, the statute specifically provides that if stock could be attributed to an individual under either the family attribution rule or the option rule, it shall be considered to have been attributed under the option rule in order to permit the reattribution of such stock.

In theory, stock constructively owned may be reattributed under the option rule. It is not entirely clear, however, what stock could ever be so reattributed. The only stock attributed under this rule is the stock subject to the option. In order for an arrangement to constitute a valid option, the stock subject to the arrangement must be described to some extent, and it is difficult to conceive of a description that would encompass stock constructively owned by virtue of an attribution provision. Even an open-

ended option, covering all stock owned or thereafter acquired by the person subject to the option, probably should not be regarded as extending to stock constructively owned.

The reattribution rules of section 1563 approximate the simplicity of section 267 because of the omission of back-attribution from that section. As under sections 267 and 318, attributed ownership is treated as actual ownership for the purposes of reattribution except when specifically prohibited. Section 1563 adopts the same prohibition against the reattribution of stock constructively owned by virtue of the family attribution rule that is contained in section 267. As in the case of the other two provisions, there is no limitation on reattributing stock constructively owned by virtue of the entity attribution rules.

Similarly, there is no prohibition against reattributing stock owned by virtue of the option attribution rule. However, section 1563 expands the dominance of the option attribution rule by providing that if stock is considered owned by virtue of both the option rule and any other attribution rule, it shall be considered as owned under the option rule. The priority of the option rule over the entity attribution rule is not designed to overcome limitations on reattribution, since no limitations exist. Rather, the entity attribution rules of section 1563 contain threshold requirements barring attribution to the owners of a nominal interest in the entity, and it is these restrictions that the priority of the option rule overcomes. Thus, for example, if an individual owns three percent of the stock of a corporation and holds an option issued by the corporation to acquire stock in a subsidiary, he could not be regarded as constructively owning stock in the subsidiary by virtue of the rule attributing stock owned by a corporation to its shareholders because of the five percent threshold requirement. However, he would be regarded as owning all of the stock of the subsidiary subject to the option by virtue of the option attribution rule.

Section 544 contains operating rules similar to those contained in section 267. Thus, stock attributed pursuant to the family attribution rule is not to be reattributed, but stock attributed from an entity to its owner may be reattributed one or more times either under the same attribution rule or under the family rule. As under section 267, partners are treated in the same manner as family members. Thus, stock attributed to an individual from his partner cannot be reattributed to his wife, and vice

versa, while stock attributed to a partner from an entity, including the partnership, may be reattributed to either. The effect of these rules under section 544, treating each partner as owning the entire amount of any stock owned by the partnership, is the same as under section 267.

Section 544 does not contain a back-attribution rule, but unlike section 267, it does contain an option rule. As is consistently the case, section 544 provides that stock attributed under the option rule prevails over the family attribution rule. In contrast to sections 318 and 1563, however, reattribution under the option rule is not permitted.

There is no specific provision in section 544 pertaining to the attribution of stock that an individual is deemed to own by virtue of his ownership of convertible securities. However, it is clear that when the ownership of such securities is deemed to be ownership of stock, such characterization prevails for all purposes. Thus, stock constructively owned by virtue of the convertible securities rule may be attributed and reattributed under the other attribution rules as if the security actually was stock.

B. Nature of Operating Rules

It has never been clearly established whether the operating rules described above constitute specific grants of authority to treat attributed stock as actually owned for the purposes of reattribution, or whether these rules serve to restrict the otherwise unlimited scope of reattribution.¹⁷⁴ Since the operating rules, when they are provided, are complete, that is, they provide for every possible combination of attribution and reattribution, the question only arises under the relatively few attribution provisions, such as sections 425(d) and 447, that do not contain operating rules. Accordingly, little authority exists. However, that authority suggests that the Service, at least, views operating rules as restrictive rather than permissive. The question arose under section 425(d) with respect to double family attribution, a form

174. One explanation for the lack of authority on such a basic question as whether the operating rules are restrictive or permissive is that outside the limited area of double family attribution nonstatutory reattribution has been characterized as a construction of the pervasive word "indirect," thus providing at least a pretense of statutory authorization. See text accompanying note 175 *infra*.

of reattribution not permitted by any operating rule in the Code. The obscure answer given by the Service was in effect that such reattribution was not required—but as a matter of Service policy only. The ruling characterized section 425 as lacking a prohibition on double family attribution and implied that such attribution would be permissible under the statute.¹⁷⁵ If correct, this analysis presumably would not be limited to the family attribution rules or to section 425.

It is not at all clear that the operating rules should be so viewed. Reattribution constitutes a substantial broadening of the scope of attribution and arguably should not be implied in the absence of affirmative congressional approval. Furthermore, at least some of the operating rules plainly read as grants of authority rather than as limitations. Section 544(a)(5), for example, specifically mandates reattribution under paragraphs (1) and (2), the entity and family rules, but is silent with respect to reattribution under paragraph (3), the option rule. It is obvious that this silence constitutes a lack of authority to reattribute and that the approval under paragraphs (1) and (2) is not mere surplusage.

X. NONSTATUTORY AFFINITY GROUPINGS

Given the complexity and variety of the statutory provisions defining relationships, attribution, and reattribution, it might seem only fair that a taxpayer should be entitled to rely on those provisions and not be required to look beyond the statute for further definitional provisions. But as with any other area of the Code, such is not the case. There is a wide variation from section to section in the scope of these provisions. It has frequently occurred that a taxpayer or, more commonly, the Service has concluded that the statutory language was unduly limited and should be given an expansive reading. To a limited extent, courts have been willing to adopt such extensions and have effectively fashioned nonstatutory relationships or rules of attribution. One basis for such an extension is the characterization of the operating rules, discussed above, as restrictive; but the Service has not pursued this line of reasoning. The same result, however, has been sought and on occasion achieved through a liberal construction of the word "indirect."

175. Rev. Rul. 67-262, 1967-2 C.B. 169.

A. "Indirect" Ownership

Throughout the affinity provisions of the Code, stock or other interests in an entity are generally referred to as being owned "directly or indirectly." One of the most difficult questions of statutory construction in this area is the meaning, if any, to be assigned to that phrase in the various contexts in which it appears. When it appears in an attribution provision that is supplemented by operating rules that provide for every possible source of stock ownership, it is difficult to find any meaning in the phrase. For example, section 267(c)(2) states that "[a]n individual shall be considered as owning the stock owned, directly or indirectly, by or for his family." As we have seen, the balance of section 267(c) specifies the circumstances under which the individual family members will be treated as constructively owning stock, and those rules appear to be complete. Thus, it would seem that in such an attribution provision, the use of this language serves only to provide a statutory basis for treating an individual as owning stock that he beneficially owns but that is registered in the name of another (for example, a custodian). Since there clearly is no need for statutory authorization to ignore such technicalities of title, the phrase appears to be meaningless.

On the other hand, when a statutory attribution provision lacks operating rules, the Service has on occasion undertaken to construe the word "indirectly" as authorizing reattribution. Between 1934 and 1937, the definition of a personal holding company included a rule attributing stock from corporations, partnerships, estates, and trusts to the owners thereof but did not contain an operating rule. Presumably as an interpretation of the statutory provisions permitting attribution of stock "directly or indirectly" owned, the regulations during this period required reattribution under this provision, at least in the simple case of direct vertical attribution through various tiers of owners. The regulations suggested that if two individuals were the sole equal beneficiaries of a trust that owned all of the outstanding stock of a corporation, each of the individuals would be regarded as owning fifty percent of the stock of the corporation and of a wholly-owned subsidiary of the corporation.¹⁷⁶ The validity of this regulation has not been tested.

176. Treas. Reg. 94, Art. 351-2, 1937-1 C.B. 123.

The example in the regulations was not changed after the addition of the operating rules to the predecessor of section 544. Even under present regulations, this same example is used to illustrate attribution from entities, referred to in the regulation as indirect ownership.¹⁷⁷ There would appear to be an inconsistency between the elaborate attribution and operating rules contained in section 544 and the ease with which the Treasury Department achieved the same result through an interpretation of the word indirect. In light of this history, however, there may be an arguable basis for an equally broad construction of the language "direct or indirect" contained in those attribution sections, such as section 425(d), lacking operating rules.

A similar question arises in the interpretation of the threshold requirements contained in several of the attribution sections. Thus, under section 318, if fifty percent or more of the stock of a corporation is "owned, directly or indirectly, by or for any person," stock owned by the corporation will be attributed to that shareholder.¹⁷⁸ The statute does not define "ownership" for the purpose of the fifty percent requirement beyond the use of the word "indirectly." The regulations, however, prescribe their own operating rules to the effect that in determining the fifty percent threshold requirement, all of the stock actually and constructively owned by the shareholder shall be aggregated.¹⁷⁹ Thus, the meaning given to the word "indirect" under the threshold requirements of section 318 is far broader than the meaning given the same word under the predecessor to section 544. The example used under the latter section only imported the entity attribution rules, while under section 318 the word is regarded as importing all of the attribution rules of that section.

It is clearly objectionable for Congress to enact attribution rules without accompanying operating rules. However, for the Treasury to prescribe operating rules under such slight authority as the use of the word "indirectly," seems equally objectionable. But in one section added to the Code in 1976, Congress required reattribution solely through the use of the word "indirectly." Section 447(d), while containing the usual rule attributing stock

177. Treas. Reg. § 1.544-2 (1960).

178. I.R.C. § 318(a)(2)(C).

179. Treas. Reg. § 1.318-1(b)(3), T.D. 6969, 1968-2 C.B. 126.

owned by partnerships and trusts to their owners, does not contain a general rule attributing stock owned by corporations. Rather, section 447(d) provides that if fifty percent of the value of a corporation is owned by members of one family "such members shall be considered as owning each class of stock in a second corporation (or a wholly owned subsidiary of such second corporation) owned, directly or indirectly, by or for the first corporation."¹⁸⁰ The family group is thus treated as owning that stock of the third-tier corporation that is owned, directly or indirectly, by the first-tier (controlled) corporation. Because the third-tier corporation must be wholly owned by the second-tier corporation, presumably the first-tier corporation is to be treated as owning "indirectly" the same proportion of the stock of the third-tier corporation that it owns in the second-tier corporation. This casual approach to reattribution created several unsatisfactory results. It is unclear why the first-tier corporation should not be regarded as owning any stock in a ninety-nine percent owned third-tier corporation or in a wholly owned fourth-tier corporation. Most likely, in view of the style of the basic corporate attribution provision of section 447, the limited reattribution may well have been dictated solely by a desire to avoid the drafting complexities of a more complete provision. This section appears to be the only instance of Congress requiring reattribution but providing no more guidance than the word "indirectly."

Outside the realm of reattribution, the Internal Revenue Service has had little success. Nevertheless, when the Service has concluded that a relationship or attribution provision contained in (or omitted from) the Code was inadequate, it has sought a broader scope for the provision in question, generally through an expansive reading of the word "indirectly." While the courts have almost uniformly rejected these efforts, the potential for challenge and litigation remains to complicate efforts by taxpayers to predict the results of their transactions. For many years, a large proportion of the Service's effort in this area was focused on the pre-1976 version of section 1239. This section addressed a relatively common form of transaction that could produce a considerable savings in tax but that employed, prior to its amendment, only limited relationship and attribution. Thus, while section 1239 only specified the relationship between a corporation and an

180. I.R.C. § 447(d)(3).

eighty percent stockholder, in Revenue Ruling 69-109¹⁸¹ the Service stated that the sale of depreciable property between two corporations, each of which was over eighty percent owned by the same individual, was within the section because the sale was indirectly between the shareholder and the transferee corporation. That ruling was consistently rejected in the courts.¹⁸² In 1976 section 1239 was amended to include that relationship.

On occasion a court has opted for an expansive construction of a relationship provision. For example, it has been held under section 267 that a transaction with an individual constitutes an indirect transaction with the individual's spouse¹⁸³ even though that relationship is not included in section 267(b). Other cases, however, have reached a contrary conclusion.¹⁸⁴

The Service has been similarly unsuccessful, even on relatively appealing facts, in attempting to expand the attribution provisions of sections, such as section 1239, that employ only limited attribution or none at all. Thus, when a taxpayer sold depreciable property to a corporation in which he owned seventy-nine percent of the stock and held an option to acquire the balance, the Tenth Circuit refused to manufacture an option attribution rule for section 1239.¹⁸⁵

A similar result was ultimately reached in *Mitchell v.*

181. 1969-1 C.B. 202.

182. *Miller v. Commissioner*, 510 F.2d 230 (9th Cir. 1975), *aff'g* 32 T.C.M. (CCH) 294 (1973); *10-42 Corp. v. Commissioner*, 55 T.C. 593 (1971), *nonacq.*, 1972-2 C.B. 4. Analogous arguments by the Service under other sections of the Code have been similarly rejected. *Fort Walton Square, Inc. v. Commissioner*, 54 T.C. 653 (1970) (arising under section 178, which employs the section 267(b) relationships by cross-reference).

183. *Barnes v. United States*, 222 F. Supp. 960 (D. Mass. 1963) (a sale of property at a loss from a trust to the spouse of a beneficiary constituted an indirect sale between the trust and a beneficiary of the trust).

184. *Liflans Corp. v. United States*, 390 F.2d 965 (Ct. Cl. 1968) (accrual of interest in favor of a wife of a controlling shareholder did not result in the disallowance of the interest deduction).

185. *Trotz v. Commissioner*, 361 F.2d 927 (10th Cir. 1966). In view of its decision the court did not have occasion to consider whether the option in question constituted the type of option that should permit attribution in any event. The stock subject to option was owned by an employee of the corporation and permitted the acquisition of his stock at book value upon his death or retirement. As indicated above, the better view is that such options should not support an attribution of stock prior to the time when they become immediately exercisable.

*Commissioner*¹⁸⁶ in which the Service argued that the reference to "beneficial" ownership in the regulations¹⁸⁷ to section 1239 should be construed to include attribution from entities. The taxpayer had sold depreciable property to a corporation in which he, together with his wife and minor children, actually owned 79.54% of the outstanding stock, and trusts created by the taxpayer for the benefit of his minor children owned an additional 12.21% (the balance was owned by adult children). The opinion of the Tax Court is of special interest because the court undertook an extensive review of both the variety of attribution rules contained in the Code and the legislative history of section 1239.¹⁸⁸ The court was unable to find order in the bewildering diversity that it discovered. It acknowledged that the omission of any suggestion of attribution in the pre-1976 version of section 1239 most likely represented a deliberate, although mystifying, decision on the part of Congress. Nevertheless, it concluded that the taxpayer had avoided the clear purpose of section 1239 too easily and held that the beneficiaries of the trust were to be regarded as indirectly owning the stock held by the trust, which stock was then attributed from them to the taxpayer. In a subsequent decision,¹⁸⁹ the Tax Court remarked that its decision in *Mitchell* had been reached "reluctantly" and only in view of a longstanding regulation that the court interpreted as requiring a trust beneficiary to be treated as beneficially owning the stock held in trust, an indication that it would not generally endorse efforts to create non-statutory attribution rules. The decision of the Tax Court in *Mitchell* was reversed by the Fourth Circuit on the ground that the deliberate congressional limitation of the scope of section 1239 could not be ignored.¹⁹⁰ The result in *Mitchell* was also changed

186. 300 F.2d 533 (4th Cir. 1962), *rev'g*, 35 T.C. 550 (1960).

187. Treas. Reg. § 1.1239-1 (1957).

188. 300 F.2d at 535-38.

189. 10-42 Corp. v. Commissioner, 55 T.C. 593 (1971), *nonacq.* 1972-2 C.B. 4.

190. *Accord*, United States v. Rothenberg, 350 F.2d 319 (10th Cir. 1965). Efforts have on occasion been made to apply the attribution rules of section 318 to certain of the corporate reorganization provisions. For an outrageous and unsuccessful effort by the government, see *Breech v. United States*, 439 F.2d 409 (9th Cir. 1971). For a successful argument by a taxpayer, see *World Service Life Ins. Co. v. United States*, 471 F.2d 247 (8th Cir. 1973). *But see* Rev. Rul. 76-36, 1976-1 C.B. 105.

by the 1976 expansion of section 1239.

The general lack of success in the Service's efforts to expand the affinity provisions on an ad hoc basis is encouraging from the perspective of restraining the spiraling complexity of these provisions through sound statutory construction. As a matter of substantial justice, however, the Service should have prevailed in each instance. Thus, this history also illustrates the inadequacy of the affinity provisions. The solution to this inadequacy should not be attempted through litigation—such patchwork solutions do little to prevent evasion of the statutory provisions while doing much to enhance the difficulty in understanding and applying those provisions. The proper solution is the one ultimately adopted for the much litigated section 1239: statutory amendment of the basic Code provisions. It is unfortunate, therefore, that corrective legislation in the affinity area has been so rarely achieved.

B. The Special Case of Dividend Equivalence

In one highly significant area it was unclear for many years whether attribution rules were applicable. The ultimate resolution of this question may be regarded as an example of judicially created attribution. Section 302(b) contains a series of tests for distinguishing true redemptions from redemptions having the effect of an ordinary dividend. It is clear from section 302(c) that the attribution rules of section 318 are applicable in determining stock ownership for the purposes of section 302. Paragraphs (2) and (3) of section 302(b) contain safe-harbor rules that turn quite mechanically on changes in stock ownership determined after the application of the attribution rules. Paragraph (1), however, contains a catch-all statement that a redemption will not be treated as a dividend "if the redemption is not essentially equivalent to a dividend." Since this language does not expressly refer to stock ownership, the application of the attribution rules of section 318 to the determination of dividend equivalence was doubtful. But logic required their application, and in *United States v. Davis*¹⁹¹ the Supreme Court so held.

A provision somewhat similar to section 302(b)(1) appears in section 356(a), which governs the distribution of "boot" in a cor-

191. 397 U.S. 301 (1970).

porate reorganization. Paragraph (2) thereof specifies that boot shall be treated as a dividend if it has "the effect of the distribution of a dividend." For many years it was the position of the Internal Revenue Service that the distribution of boot automatically had the effect of the distribution of a dividend, thus rendering such refinements as the attribution rules irrelevant.¹⁹² In 1974, however, the "automatic dividend" rule was formally abandoned by the Service in favor of a flexible test resembling the rules of section 302(b).¹⁹³ While the Service acknowledges that the tests of section 302 are not strictly applicable to the determination of dividend equivalence under section 356(a)(2), the rulings adopting the flexible approach to section 356 specified that those tests would serve as guidelines for decisions under the reorganization section. The rulings further acknowledge, with respect to the attribution rules, that section 318 is not strictly applicable to section 356 but are silent with respect to whether those attribution rules could be used to supplement the guidelines of section 302. In a subsequent ruling, however, the Service cited section 318 in a manner suggesting its application to section 356 although on the facts of that ruling the attribution rules would not have been material to the result.¹⁹⁴ It seems probable that the attribution rules of section 318 will in time be incorporated into section 356(a)(2) to the same extent that the Supreme Court incorporated them into section 302(b)(1).¹⁹⁵

The ripple effect of *United States v. Davis* may not end with section 356. For example, preferred stock distributed in a corporate reorganization will be section 306 stock but only to the extent that "the effect of the transaction was substantially the same as the receipt of a stock dividend."¹⁹⁶ It has long been accepted by both taxpayers and the Internal Revenue Service that under this language the recapitalization of a closely held corporation for the purpose of passing control to the second generation in which all of the common stock held by the older generation was converted into nonvoting preferred stock does not create section 306 stock.¹⁹⁷

192. B. BITTKER & J. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* § 14.34.2 (3d ed. 1971).

193. Rev. Rul. 74-515, 1974-2 C.B. 118; Rev. Rul. 74-516, 1974-2 C.B. 121.

194. Rev. Rul. 75-83, 1975-1 C.B. 112.

195. See *Wright v. United States*, 482 F.2d 600 (8th Cir. 1973).

196. I.R.C. § 306(c)(1)(B).

197. Ehrlich, *Corporate Recapitalization as an Estate Planning Business*

However, the regulations to section 306 provide that the distribution of preferred stock in a reorganization will be regarded as creating section 306 stock if cash received in lieu of such stock would have been treated as a dividend under section 356(a)(2).¹⁹⁸ If the attribution rules of section 318 are applied to section 356, their application to section 306 may soon follow.

The dividend equivalence test of section 302(b)(1) and the related tests of sections 356 and 306 are quite different from other substantive law sections that employ attribution. Under these sections, stock ownership alone is not determinative of the income tax consequences of a transaction but rather constitutes only one of several factors to be taken into account. If stock ownership is not determinative, it might seem to follow that the attribution rules should not be determinative of the amount of stock that the taxpayer should be regarded as owning. That is, for the purposes of these more flexible tests, perhaps the attribution rules should not be mechanically applied, and stock should be attributed to the taxpayer only when the identity of interest presumed by the attribution rules exists in fact. Needless to say, such an approach to attribution would greatly increase the difficulty of applying the substantive provisions in question and predicting the resolution of tax disputes. Nevertheless, prior to the decision in *Davis*, the Tax Court,¹⁹⁹ with some support,²⁰⁰ had adopted such an approach to attribution for the purpose of determining section 302(b)(1) dividend equivalence—at least with respect to family attribution.

These decisions held that when intrafamily hostility existed and the actual owner of stock that otherwise would be attributed to the taxpayer was not in fact subject to his control because of such hostility, such stock would not be attributed to the taxpayer—the so-called “bad blood” exception to attribution. The decision in *Davis* did not refer to such an exception. In view of this silence and because the court stressed the necessity for a meaningful reduction in the shareholder’s proportionate interest in the corporation to avoid dividend equivalence, after *Davis* the

Retention Tool, N.Y.U. 34TH INST. ON FED. TAX. 1661, 1675-76 (1976).

198. Treas. Reg. § 1.306-3(d); see Proposed Treas. Reg. § 1.306-3, 43 Fed. Reg. 10704 (1978).

199. *E.g.*, Estate of Squier, 35 T.C. 950 (1961).

200. *Bradbury v. Commissioner*, 298 F.2d 111 (1st Cir. 1962).

Tax Court approached the application of the attribution rules as a purely mechanical exercise.²⁰¹ However, in *Haft Trust v. Commissioner*²⁰² the First Circuit reversed the decision of the Tax Court and held that the *Davis* opinion did not preclude an examination of all relevant facts and circumstances, including family hostility. Accordingly, the court remanded the case for a determination of the existence of family discord that would have the effect of negating the taxpayer's presumed continuing control over the corporation.

The decision of the First Circuit seems correct. It would appear entirely appropriate to construe the catch-all language of section 302(b)(1) in the most flexible manner possible to counteract the rigidly mechanical approach taken by the balance of the section. However, the extent to which the bad blood exception retains vitality remains to be seen.

XI. USE OF AFFINITY SECTIONS BY CROSS-REFERENCE

From the perspective of the overall complexity of the Code in general and the affinity provisions in particular, the foregoing discussion has only scratched the surface. Many of the affinity provisions thus far described are adopted by cross-reference in many more sections of the Code. In addition, the majority of provisions that cross-refer to the basic relationship and attribution sections also modify the definition being adopted in a variety of ways. Thus, the diversity of definition contained within the Code is multiplied through the use of modifying cross-references. Obviously, space does not permit a detailed analysis of each of the resulting provisions; however, a statistical summary will adequately indicate the extent of diversity within the Code and the corresponding need for legislative attention.

A. Cross-References to Basic Sections

The relationship or attribution rules provided by section 267 are employed in at least twenty-one distinct subsections of the Code. Of these, ten subsections incorporate by cross-reference the full range of relationships established by section 267(c). Only five

201. See *Niedermeyer v. Commissioner*, 62 T.C. 280 (1974); *Haft Trust v. Commissioner*, 61 T.C. 398 (1973).

202. 510 F.2d 43 (1st Cir. 1975), *vacating* 61 T.C. 398 (1973).

adopt the section 267(b) relationships without modification: sections 103(b)(6)(C), 170(a)(3), 178(b)(2), 465(b)(3)(B), and 631(c). Each of the five sections modifying the 267(b) relationships do so by initially restricting the definition of family. Three of the sections eliminate brothers and sisters from the relationship; and in two of those sections, sections 44(c)(3) and 179(d)(2)(A), that is the only modification in the cross-reference. The two final sections, sections 613A(c)(8) and 48(k)(5), greatly modify the definition of family to include only an individual's spouse and minor children, but they otherwise adopt the section 267 relationships and employ the cross-reference to these relationships in an aggregation form of attribution.²⁰³ The one remaining section that eliminates brothers and sisters from the family definition, together with the one section that does not modify the section 267 relationships, also alters the threshold percentage of ownership of corporate stock that an individual must possess in order to create the corporation-shareholder relationship. Section 178(b)(2) increases the percentage from fifty to eighty percent while section 1235(d) reduces the required ownership to twenty-five percent.

Of these ten sections that cross-refer to section 267, eight appear to adopt the attribution rules of section 267(c) along with the cross-reference to the relationship provisions of section 267(b). Sections 170(a)(3) and 465(b)(3)(B), however, cross-refer to section 267(b) only. The regulations to section 170(a) provide no hint of whether this cross-reference should be regarded as including the constructive ownership rules of section 267(b), and there are as yet no regulations to the newly added section 465.

Section 178 has been somewhat arbitrarily classified as cross-referring to the section 267 relationships without modification of the definition of family. Actually, the cross-reference is more complex. As in the case of section 170(a)(3), the initial cross-reference deviates from the usual language and refers instead to the relationships described in subsection (b) of section 267.²⁰⁴ Sec-

203. Both sections severely restrict the use of a Code benefit that previously was available—percentage depletion on oil and gas in the case of section 613A and the investment tax credit on motion pictures in the case of section 48(k)—and the limited family definition appears to be Congress' way of mildly reducing the impact of the new limitations. One might suppose that whatever justification exists for attribution at all would equally support a somewhat broader family definition.

204. I.R.C. § 178(b)(2)(B).

tion 178, however, provides that for the purpose of determining the existence of the section 267(b) relationships, the attribution rules of section 267(c) shall be applied except that brothers and sisters are deleted from the family definition.²⁰⁵ Thus, while an individual would be regarded as related to his brother and to a corporation wholly owned by his child, he is not related to a corporation wholly owned by his brother. Section 178 appears to be the only instance of separate cross-references to sections 267(b) and 267(c) and thus is the only instance in which the Code uses two different family definitions for the single purpose of defining one set of relationships.²⁰⁶

Six of the ten sections that cross-refer to section 267 supplement the cross-reference by also cross-referring to the similar provision in section 707(b) relating to partners and partnerships. Of these six sections, two cross-refer to section 267 without modification (sections 103(c)(6)(C) and 631(c)), two modify 267(b) only by eliminating attribution from brothers and sisters (sections 44(c)(3) and 179(d)(2)(A)), and two employ the sharply limited definition of the family (sections 48(k)(3)(D) and 613A(c)(8)).

Accordingly, while there are ten sections of the Code that employ the relationship and attribution provisions contained in section 267 for the purpose of expanding the substantive law provision using the cross-reference, there are seven distinct subcategories of relationships:

1. unmodified adoption without attribution,
2. unmodified adoption with attribution,
3. unmodified adoption adding partnership relationships,
4. unmodified adoption with modified attribution and increased stock-ownership threshold,
5. elimination of brother-sister attribution and addition of partnership relationships,
6. elimination of brother-sister attribution and reduction of stock ownership threshold, and

205. I.R.C. § 178(b)(2) (flush language).

206. Section 178, however, is not the only instance in which a single section of the Code uses two variations of the section 267 definition of family for quite similar purposes. See note 228 *infra*.

7. sharply narrowed family definition but added partnership relationships.

Obviously, there is no consistency among the numerous modifications of section 267.

Of the remaining eleven sections that cross-refer to section 267, six refer only to the definition of family and are discussed below. The remaining five sections cross-refer only to the attribution rules contained in section 267(c) while prescribing their own relationships. Of these five sections, only section 50B(c)(5)(A) uses the section 267(c) attribution rule without modification. Section 707(b), which prescribes its own partnership relationship rules, essentially adopts section 267(c) attribution without modification although it excludes the application of section 267(c)(3), which attributes stock from one partner to another. Section 341(e), discussed in somewhat greater detail below, modifies the definition of family for section 267(c) purposes by eliminating brothers and sisters. The final two sections using these attribution rules are the prohibited-transaction provisions in sections 4946(a) and 4975(e) pertaining to private foundations and pension plans, respectively. In each instance, the cross-reference to section 267(c) is modified by eliminating brother-sister attribution and by including spouses of lineal descendants as members of the family.

Section 318 is used in eighteen distinct ways in fourteen sections of the Code. While section 318 is exclusively an attribution-of-stock-ownership section that does not purport to establish relationships in the manner of section 267(b), four of the cross-references to section 318 are for the purpose of defining relationships rather than prescribing attribution. Three of these four cross-references do not modify the provisions of section 318. Thus, section 306(b)(1)(A) sets forth an exception to the normal treatment of the disposition of section 306 stock, provided, among other things, that the disposition is not to a person the ownership of whose stock would (under section 318(a)) be attributable to the stockholder. Section 302(c)(2)(B)(i) requires full attribution in a "termination of interest" redemption if any stock redeemed was acquired within ten years from a person whose stock would be attributed at the time of the redemption to the shareholder under section 318(a). Section 334(b)(2)(B) also uses section 318 with respect to the acquisition of stock but with the added complexity

that it may be necessary to determine the date upon which the corporate parent "is first considered under section 318(a) as owning stock owned by the corporation [which must stand in the section 318 relationship] from which such acquisition was made." The final use of section 318 as a relationship section occurs in section 382(a)(5), which modifies section 318 by eliminating the fifty percent threshold requirement for the ownership of stock in a corporation.

Twelve of the eighteen cross-references to section 318 are adoptions of the full attribution rules provided by that section. Of those twelve, only five sections adopt the attribution rules without modification: sections 302(c)(1), 306(b)(1)(A), 367(c)(2), 545(c)(3)(B),²⁰⁷ and 995(e)(10).

The remaining cross-references to section 318 all prescribe reductions in the fifty percent threshold requirement for ownership of a corporation before attribution may be made. Two of these references, sections 856(d) and 6038(d), reduce the threshold requirement to ten percent. Sections 304(b), 304(c), 382(a)(3), and 1239(c) completely eliminate the fifty percent threshold. The final cross-reference to the attribution rules of section 318 is contained in section 958, discussed below, which modifies the application of that section considerably. The set of attribution rules resulting in section 958 is used by cross-reference in four sections: 679(c)(2), 1246(b)(2), 1248(a) and (c), and 1249(b). In each instance, these rules are used to establish ownership of a foreign corporation for which section 958 is specifically adapted. Thus, these four sections may be added to the list of uses of section 318 by cross-reference.

Two of the cross-references to section 318 are solely to the definition of family contained in that section and are discussed below.

The final basic affinity rule contained in the Code is section 1563. This section, although it constitutes a relatively recent addition to the Code, is referenced twenty-two times in eighteen sections. Of these, sections 243(b)(6) and 404(a)(1)(C) are special

207. The cross-reference to section 318 in section 545 is curious. Section 545 defines undistributed personal holding company income, and it might have been anticipated that any attribution rules used by that section would be adopted from section 544, which prescribes the attribution rules that are generally used with respect to personal holding companies, rather than section 318.

rules that will not be further considered. Of the remaining twenty cross-references, sixteen involve cross-references to the corporate relationships established by section 1563(a). Of those, eight do not modify the provisions of section 1563(a): sections 46(a)(6), 50A(a)(5), 58(b), 250(d), 368(a)(2)(F), 414(b), 861(e)(1), and 99(e)(3)(A). An equal number modify that definition by reducing the eighty percent ownership requirement to fifty percent: sections 48(c)(3)(C), 48(k)(3)(D), 52(a), 103(b)(6)(C), 179(d)(7), 415(h), 613A(c)(8)(D), and 993(a)(3).

The cross-reference to section 1563 in section 993(a)(3) is in the context of defining a controlled group of corporations for the purpose of the DISC sections of the Code. This definition is in turn used by cross-reference throughout the DISC provisions. In 1976, when the international boycott provisions were adopted and the need arose to define a controlled group of corporations, the definitional cross-reference was made to section 993(a)(3) rather than to section 1563, as had previously been done throughout the Code. Thus, sections 908(a) and 999(a) and (b) also in effect cross-refer to section 1563.²⁰⁸

One additional section may cross-refer to section 1563. Section 48(c)(1), in defining relationships, uniquely cross-refers to the relationships established by section 179(d)(2)(A) and (B). While subparagraph (A) of that provision cross-refers in turn to sections 267 and 707, subparagraph (B) merely refers to a controlled group of corporations. For the purposes of section 179, section 179(d)(7) defines such a controlled group by a modified cross-reference to section 1563. While section 48(c)(1) does not cross-refer to paragraph (7), it would seem reasonable to assume that such a reference should be implied by the reference to paragraph (2)(B). This imprecision in draftsmanship is the direct result of defining relationships by means of double cross-references through apparently randomly selected and wholly unrelated substantive provisions such as section 179. Such a drafting technique is totally without merit and needlessly complicates the task of decoding the relationship intended.²⁰⁹

208. At one point in the international boycott provisions it was necessary to refer to a person in control of a corporation; and, for that purpose, section 999(e) contains a unique cross-reference to section 304(c). For the purpose of defining the relationship established by section 304(c), section 304(c)(2) requires the use of the attribution rules of section 318, with modifications.

209. The cross-reference to section 304, for example, is for the purpose of

While the attribution rules prescribed by section 1563 are the most refined and sophisticated in the Code, they are employed by cross-reference in only four sections that do not also adopt a cross-reference to the 1563(a) relationship provision. These sections are 993(e)(3)(A),²¹⁰ 1551(b),²¹¹ 120(d)(6), and 415(c)(6)(B). Within the relatively sophisticated attribution rules of section 1563(e), the definition of family is the most refined. That definition, however, is not employed in any other section of the Code. Presumably, the restrictions on such attribution, particularly from a spouse, are regarded as too great for general use.

The cross-references to section 1563 contained in sections 414 and 52 form the basis for the all-inclusive relationship provisions created by these sections. In the earlier of these two sections, section 414(b) routinely cross-refers to the section 1563(a) definition of a controlled group of corporations for the purpose of treating all related employers as one employer in the context of the ERISA provisions. Section 414(c) provides that all businesses, whether or not incorporated, shall be treated as a single employer for those specified purposes if they are under common control as determined under regulations based upon the principles applicable to section 414(b)—presumably the definitions of section 1563 and the attribution rules applicable thereto. The temporary²¹² and proposed final²¹³ regulations that have been issued under section 414 have faithfully undertaken the required adaptation, and there is no present indication that the resulting relationship pro-

defining control over a corporation. Section 304 does provide such a definition—in fact an unusual one that could not be incorporated by reference to any of the commonly cross-referenced provisions. Assuming the control definition in section 304(c) exactly met the objectives of the draftsmen of section 999(e), the economy of words achieved by the cross-reference seems a rather modest success in view of the present length of the Internal Revenue Code. Of far greater importance is the rationality and simplicity of the draftsmanship of the Code, and that cannot be obtained when the construction of a provision pertaining to international boycotts requires referring back some two hundred pages to two sections relating to an entirely different subject matter.

210. Section 993(e)(3)(A) separately does cross-refer to the section 1563 definition of a controlled group.

211. This section contains a definition of a controlled group that is similar to the section 1563 definition.

212. Treas. Reg. § 11.414(c), T.D. 7388, 1975-2 C.B. 180.

213. Proposed Treas. Reg. § 1.414(b), .414(c), 40 Fed. Reg. 51467-68 (1975).

vision is unsatisfactory in either form or scope. Indeed, it was copied with only a minor revision in 1977.²¹⁴ While these regulations and the resulting relationship cannot be described as uncomplicated, they are far easier to understand than the alternative aggregation form used in sections 613A and 48(k) in the 1969 and 1975 Acts.

The regulations to section 414 supply traditional answers to the problems posed in adapting the principles of section 1563 to unincorporated entities. Since the Treasury Department had considerable flexibility in fashioning these regulations, it is somewhat disappointing that the opportunity was not taken to improve various aspects of the relationship and attribution rules. Section 1563 distinguishes between voting and nonvoting stock in defining the corporate relationship but not in defining its attribution rules.²¹⁵ While the proposed regulations to section 414 restate the voting power or value test for corporations,²¹⁶ ownership of a partnership is measured by interest in profits or capital with no reference to voting power.²¹⁷ The absence of the voting power alternative means that in a limited partnership in which the general partners own less than fifty percent of the profits or capital interest, the partnership will not be regarded as controlled by those persons who in fact have exclusive control over its daily activities. This regulatory focus on the traditional formula may not be consistent with the principles of section 1563.

With respect to trusts and estates, the determination of control is based solely upon the actuarial interest in the entire trust or estate.²¹⁸ This would seem to be the only appropriate test. Consistent with section 1563, however, attribution from a trust or estate is made in accordance with the beneficiaries' actuarial interest in the stock or other ownership interest being attributed.²¹⁹ While again this basis for attribution seems to be appropriate, it must be observed that in the context of section 414, the

214. I.R.C. § 52; see text accompanying note 222 *infra*.

215. Nonvoting preferred stock is ignored entirely. See text accompanying note 130 *supra*.

216. Proposed Treas. Reg. § 1.414(c)-2(b)(2)(A), -2(c)(2)(i), 40 Fed. Reg. 51469 (1975).

217. *Id.* § 1.414(c)-2(b)(2)(C), -2(c)(2)(iii).

218. *Id.* § 1.414(c)-2(b)(2)(B), -2(c)(2)(ii).

219. *Id.* § 1.414(c)-4(b)(3)(i), 40 Fed. Reg. 51471-72 (1975).

application of these two different rules can produce unexpected results. For example, assume that an individual holds an actuarially computed forty percent interest in a trust and thus is not regarded as controlling the trust. He may nevertheless be regarded as controlling a corporation wholly owned by the trust if other beneficiaries are excluded under the trust agreement from obtaining any interest in the stock.

While the regulations prescribe an option attribution rule, they contain no explanation at all concerning the operation of that rule.²²⁰ In view of the rather confused case law under the option rule of section 1563,²²¹ it is probable that the omission was deliberate and that the Treasury Department was either unable or unwilling to prescribe a coherent set of rules governing this area. One can have sympathy with the Treasury Department's difficulties, but it seems clear that nothing is to be gained by leaving the resolution of the doubts under the option rule to further case development. It would be preferable for the Treasury to take the opportunity presented by section 414 to rationalize this area.

After developing the aggregation form of all-inclusive relationships in 1976, Congress returned in 1977 to the section 414 approach of modifying a cross-reference to section 1563. Congress may have reverted to the section 414 approach because of the similar need in the new section 52 to define a related group of entities in order to treat the group as a single employer.²²² However, while the cross-reference to section 1563 was not modified by section 414, the cross-reference in section 52 eliminates the eighty percent requirement,²²³ thus creating dissimilar definitions. The regulations to section 414 entirely restate the principles of section 1563 while the regulations that have been proposed under section 52 largely cross-refer to the temporary regulations under section 414.²²⁴

Eleven sections cross-refer to the definition of a controlled

220. See *id.* § 1.414(c)-4(b)(1), 40 Fed. Reg. 51471 (1975).

221. See text accompanying notes 165-67 *supra*.

222. Section 52 imposes a limitation on the "new jobs" credit allowed by section 44B and is unrelated to the ERISA provisions of which section 414 is a part.

223. I.R.C. § 52(a)(1).

224. Proposed Treas. Reg. § 1.52-1, 42 Fed. Reg. 62932 (1977).

group of corporations contained in section 1504,²²⁵ which limits the relationship to parent-subsidary chains. Of these cross-references, five do not modify the section 1504 definition: sections 178(b), 542(d)(3), 904(d), 1313(c)(7), and 1371(a). Section 1504(b) excludes from the definition of an affiliated group certain types of corporations, and five of the cross-references delete these exclusions, thus broadening the definition: sections 48(h)(10), 49(b)(8), 279(g), 337(c), and 593(e). Section 593(e), in addition, reduces from eighty percent to fifty percent the quantity of stock in the subsidiary that must be owned to establish the relationship. Section 47(a)(7)(B) also reduces the required stock ownership to fifty percent but retains all of the exclusions except foreign corporations.

B. Multiple Cross-References

Several of the Code sections that employ cross-references to section 267, and perhaps to section 707(b), supplement the basically individual orientation of those sections with a cross-reference to one of the sections focusing on relationships among controlled groups of corporations. Thus, sections 48(k)(3)(D), 103(b)(6), 179(d)(2), and 613A(c)(8)(D), in addition to referring to both sections 267 and 707(b), cross-refer to section 1563(a), in each case reducing the ownership test to fifty percent. Section 178(b)(2) supplements its reference to section 267 by reference to an affiliated group of corporations within the meaning of section 1504 but does not include a reference to section 707(b). Other sections, such as section 631(c), supplement their reference to section 267 with their own definition of controlled corporations.

C. Cross-References to the Family Definition

Numerous sections of the Code define the family, generally to deny a benefit otherwise granted by the Code to transactions occurring between members of the family or to impute to an individual activities detrimental to his tax position even if such activities were actually undertaken by members of the defined family. Most sections of the Code that define the family do so in

225. This tally does not include those sections that refer to groups of corporations filing consolidated income tax returns, eligibility for which is defined by section 1504.

the course of adopting complete relationship rules by cross-reference to either section 267 or section 318. As we have seen, these cross-references are subject to numerous modifications. A few additional sections cross-refer solely to the family definition contained in section 267 or section 318 and either do not use nonfamily relationships at all or supply their own.

Six sections of the Code²²⁶ adopt the definition of family contained in section 267, which includes an individual's spouse, ancestors, lineal descendants, and brothers and sisters. As noted above, the regulations may intend that the terms "ancestors" and "lineal descendants" be limited to two generations.²²⁷ None of the sections cross-referencing to these rules modify the section 267 definition of family except section 464(c)(2)(E). The other sections are 274(e)(5) (which is atypical because a benefit granted by the Code is extended to family members under this provision), 280A(d)(2)(A), 1237(a)(2), and two prohibited-transaction sections, 503(b) and 4975(d).²²⁸

The Tax Reform Bill of 1975, as originally passed by the House of Representatives, contained a provision identical in substance to the present section 464 that adopted by cross-reference the family definition of section 267.²²⁹ In the Senate, this cross-reference was broadened into its present form, which includes the members of the family, as defined in section 267(c)(4), of "a grandparent" of the taxpayer.²³⁰ It seems clear that the purpose

226. An unmodified cross-reference to the family definition in section 267(c)(4) is also contained in sections 613A(c)(9)(B)(iii) and 613A(d)(1)(D), but these are special provisions applicable only to one taxpayer and are not further considered herein.

227. See text accompanying note 41 *supra*.

228. The unmodified adoption of the family definition by section 4975(d) is not for the purpose of defining a so-called disqualified person with respect to a qualified trust. As we have seen above, the definition of family for such purpose was modified by deleting brothers and sisters and adding any spouse of a lineal descendant. Section 4975(d), however, contains a series of exceptions from the definition of a prohibited transaction, and to these exceptions there is in turn an exception for a qualified plan benefiting owner-employees that engage in certain activities. In the course of describing those activities, section 4975(d) employs the unmodified family definition of section 267(c)(4). Thus, the same section of the Code uses two different definitions of family for essentially identical purposes.

229. H.R. 10612, 94th Cong., 1st Sess., § 101(a), 121 CONG. REC. 38598-601 (1975).

230. Tax Reform Act of 1976, Pub. L. No. 94-455, § 204(a), 90 Stat. 1531.

of this change was to expand the family definition along the lines of the broad definition contained in section 447. The report of the Committee on Finance states that "[f]or the purpose of this provision, the family of an individual includes not only his brothers and sisters (whether by whole or half-blood), his spouse, ancestors, and lineal descendants but also other lineal descendants of the individual's parents and grandparents."²³¹ The first portion of this statement recites the family definition of section 267 exactly, while the balance includes descendants of the individual's grandparents. The simplistic cross-reference to the section 267 family of "a grandparent" does not accomplish that objective.

The initial interpretation question under section 464 is whether the reference to "a grandparent" should be construed as meaning "any grandparent." The plurals used in the committee report would support this construction as would a comparison with section 447 (although consistency among such similar uses of the family definition has not been an earmark of the affinity provisions). Obviously the defined family will be far broader if the descendants of all four grandparents are to be included, but the important difference between these two interpretations is not in their overall breadth. The descendants of a single grandparent would only include one of the taxpayer's parents so that under a literal reading of section 464(c)(2)(E), the taxpayer's family would include either his father or his mother, but not both.

Of even greater importance, under the present statutory language, is the fact that the taxpayer's spouse is clearly excluded from the definition of family since a spouse is not commonly a descendant of any of the taxpayer's grandparents. The Technical Corrections Bill of 1977²³² proposed adding spouses of each family member to the definition of family. While this proposal would have remedied the clearly unintentional omission of the taxpayer's spouse, the addition of all spouses of family members seems to go beyond the family description contained in the above-quoted committee report. The proposal, however, would be in conformity with the related section 447 family definition. Pend-

231. S. REP. NO. 94-938, 94th Cong., 2d Sess., 59, reprinted in [1976] U.S. CODE CONG. & AD. NEWS 3439, 3495.

232. H.R. 6715 95th Cong., 1st Sess., § 2(k)(3), 123 CONG. REC. H 11096 (1977).

ing the adoption of this or similar corrective legislation, the section 464 definition of family only includes the spouse of the taxpayer's grandparent.

There may even be a question concerning whether the family of the taxpayer, as so defined, includes his children. It will be recalled that while section 267(c)(4) refers to an individual's lineal descendants, the regulations thereto define those terms as including children and grandchildren.²³³ If this statement in the regulations is construed as a limitation rather than as a relatively pointless illustration, the limitation presumably would be applicable to all uses of section 267(c)(4) by cross-reference. In the context of section 464, the taxpayer in question is the grandchild of the "grandparent." If the relationship extends no further, the children of the taxpayer are not included. This question could be resolved appropriately by regulation in favor of including all descendants of the taxpayer. It might be hoped, however, that clarification would come by removing the limitation suggested by the regulations to section 267 rather than by a regulation to section 464. Clarification by a regulation to section 464 would necessarily suggest that the term "lineal descendants" in section 267 has a different meaning when applied to section 464 than when applied elsewhere.

The form and substance of the family definition of section 464 should be compared to the family definition contained in section 447, discussed above.²³⁴ Both sections 447 and 464 were added to the Code in 1976 to reduce the attractiveness of farming as a tax shelter by altering the tax accounting rules that previously had been applicable to all farming operations. Both sections exempt from their application family-owned farms, and both sections define family quite broadly for this purpose. It is interesting to compare the different approaches taken to define the family in section 464 (by way of a modified cross-reference) and in section 447 (through its own definition). It is also instructive to note the different, although perhaps unintentional, results reached by these approaches.²³⁵

233. Treas. Reg. § 1.267(c)-1(a)(4) (1958).

234. See text accompanying note 52 *supra*.

235. In light of the difficulties encountered in modifying an existing definition to arrive at the desired breadth, it might be concluded that when such a dramatic deviation from the established definition is sought, a better approach

Two sections of the Code adopt the definition of family contained in section 318: sections 103(c)(3) and 1379(d). Neither of these sections modify the definition so adopted.²³⁶

D. Cross-References to Miscellaneous Sections

In addition to the double cross-references referred to above,²³⁷ a few sections of the Code cross-refer, with or without modification, to the affinity provisions defined in sections other than sec-

would be to draft a new provision as in section 447.

The 1976 Act generally receives very low marks for its approach to attribution. The Act defined family for stock attribution purposes eleven times in the course of eight different newly added or amended sections. Of these eleven sections, two cross-refer to the section 267 definition of family, and both then modify the definition so adopted, one in a unique and extreme way. One section incorporates the section 318 definition by reference without modification and another cross-refers to section 958 that itself cross-refers to section 318. One section cross-refers to section 1563 without modification of its family definition and three sections cross-refer to section 993(a)(3) that in turn cross-refers to section 1563—thereby adding a new double cross-reference to the Code. One section adds a unique cross-reference to section 304 that cross-refers to section 318 for a second new double cross-reference. Finally, two sections contribute their own family definition, one of which is very narrow and the other very broad. Of the eleven provisions, seven employ the traditional approach and four use the aggregation form of attribution.

236. Section 103(c) contains an exception to the general exemption under section 103 from tax for interest on municipal bonds when such bonds constitute arbitrage bonds as defined in section 103(c). Section 103(c)(3) contains an exception to the arbitrage bond definition but that exception is in turn subject to an exception for bonds held by a person who is a substantial user of the property being financed or a member of his family. For this purpose, the unmodified definition of family contained in section 318 is employed. Section 103(b) contains a second exception to section 103 for industrial development bonds, but that exception is in turn subject to a variety of exceptions for particular types of industrial development bonds, the interest on which remains exempt from tax. These exceptions are themselves subject to certain exceptions including the provision subjecting the interest on such a bond to tax during any period of time in which the bond is held by a substantial user of the facilities being financed or a person related to the substantial user. For this purpose, a related person is defined very broadly and includes all of the relationships prescribed by sections 267 and 707(b) as well as an expanded reference to section 1563(a). The cross-reference in section 103(b) to section 267 is unmodified. Accordingly, this section also employs two different definitions of family for substantially identical purposes.

237. See notes 208-09 *supra* and accompanying text.

tions 267, 318, 1504, and 1563.²³⁸ Of these, the most significant is the unique²³⁹ cross-reference in section 341(d) to the "rules prescribed in paragraphs (1), (2), (3), (5), and (6) of section 544(a)."²⁴⁰ Section 341(d) is the de minimis exception to collapsible corporation treatment, reserving ordinary-income treatment for shareholders owning more than five percent of the value of the outstanding stock of the corporation (subparagraph (A)) or for a shareholder whose stock is attributable to such a five percent shareholder (subparagraph (B)). Thus, section 341(d) not only uses the rules of section 544(a) for attribution purposes, but also in section 341(d)(1)(B) establishes a relationship among shareholders of a collapsible corporation based upon those attribution rules. The complexity of the resulting provision has caused understandable confusion.

The cross-reference to section 544(a) specifically includes a cross-reference to the operating rules contained in paragraph (5). However, at least one court has concluded that the limitations upon reattribution contained in the section 544 operating rules may not be applicable, at least in part, to section 341(d). This construction, of course, could have the effect of widening the scope of that provision beyond all reasonable bounds. In that case, *Lewis S. Jacobson*,²⁴¹ the Tax Court was faced with the question of whether stock owned by a partner of the husband could be attributed to the wife. At this time, the predecessor to section 341(d)(1)²⁴² prescribed a ten percent threshold. The wife held seven and one-half percent of the value of the outstanding

238. For example, section 704(e)(3) defines family to include only the spouse, ancestors, and lineal descendants and thus is identical to the definition contained in section 267 except for the deletion of the reference to brothers and sisters (although the regulations to this provision do not suggest that the reference to ancestors and lineal descendants is limited to grandparents and grandchildren only) and section 704(e) is used by cross-reference in section 1375(c). See text accompanying note 41 *supra*.

239. Prior to 1964, section 1551 also used the attribution rules of section 544 but that cross-reference was changed to the more closely related attribution rules contained in section 1563(e) when that section was enacted.

240. See also I.R.C. § 704(e) (used by a cross-reference from section 1375(c)).

241. 32 T.C. 893 (1959), *rev'd on other grounds*, 281 F.2d 703 (3d Cir. 1960).

242. Int. Rev. Code of 1939, § 117 (m), as amended by Revenue Act of 1950, ch. 994, § 211(a), 64 Stat. 933.

stock of the collapsible corporation, the husband owned no stock, and his partner owned in excess of ten percent. The taxpayer argued that the wife could not be regarded as owning the stock owned by the partner because of the operating rule in the predecessor to section 544 prohibiting double family and partner attribution. However, the court concluded that the predecessor to section 341(d)(1)(B) overruled the prohibition against such reattribution and held that the wife was subject to tax on her sale of the stock at ordinary income rates. This statement by the Tax Court seems to be based upon a misreading of the section and is clearly wrong. In fact, the wife was subject to tax under the predecessor to section 341(d)(1)(B), not because she was constructively a ten percent shareholder (which would require an impermissible attribution of the partner's stock to her) but rather because her stock was attributable to another (her husband) who was constructively a ten percent shareholder. This case illustrates the logic of the proposition that attribution rules should never be used to establish relationships, not only because the resulting statutory language is unduly confusing but also because of the extreme breadth of the relationship so created. In any event, the erroneous suggestion that the operating rules of section 544 are not applicable to section 341(d) presumably will not be followed.

It may be recalled that section 544 is unique among attribution rules in that it provides a specific and detailed provision treating convertible securities as stock. However, the cross-reference in section 341(d) is only to section 544(a) and therefore excludes the convertible securities rule contained in subsection (b). This exclusion raises an interesting question with respect to the scope of the option rule contained in section 544(a) as applied to section 341(d). It may also be recalled that the Service has interpreted the option rule contained in section 318 as being applicable to convertible securities on the ground that such securities were not realistically different from options. Presumably, a similar construction of the identical option rule contained in section 544 could not be made because of the superseding specific rule contained in subsection (b). Cases like *Jacobson*,²⁴³ however, have suggested that attribution rules adopted by an unrelated

243. 32 T.C. 893 (1959), *rev'd on other grounds*, 281 F.2d 703 (3d Cir. 1960). See also *North Am. Indus., Inc., v. Commissioner*, 33 T.C.M. (CCH) 1275 (1974).

substantive law section of the Code become in effect a part of that substantive law and may be subjected to varying interpretations depending upon the substantive section to which they are being applied. Thus, a court might regard itself as free to interpret the option rule of section 544, as applied to section 341(d), entirely differently from the manner in which that option rule would be applied for the purpose of the personal holding company provisions. In spite of the specificity of the cross-reference to section 544(a), the question cannot be regarded as free from doubt. If a court were presented with what it regarded as a clear case of tax avoidance under section 341(d) through the use of convertible securities, the pressure for an expansive reading of the option rule would be considerable.

The cross-reference to the family definition contained in section 544(a) is specifically modified for the purposes of section 341(d) to create the broadest family attribution (and relationship) rules existing in the Code—except for the farm-family definitions of sections 447 and 464. The definition in section 544(a) is an older, relatively broad definition that includes an individual's spouse, ancestors, lineal descendants, and siblings. Section 341(d) adds the spouses of the individual's brothers and sisters and the spouses of his lineal descendants.

The rules of section 544 are also used, for the purposes of section 341(e), by means of a cross-reference in section 341(e)(10) to section 341(d). Unfortunately, section 341(e) also cross-refers to the rules of section 267(c) and blends these cross-references into a most confusing pattern. With extensive elaboration and refinement, section 341(e) excludes from ordinary-income treatment any gain on the sale of stock of a collapsible corporation if the unrealized appreciation inherent in the assets of the corporation is below a specified amount. Under paragraph (1), however, this treatment is not available to a twenty percent shareholder if his stock is redeemed or sold to a person "related" to him within the meaning of paragraph (8). Paragraph (10) prescribes that for the purposes of section 341(e), including the twenty percent computation, stock ownership shall be determined under section 341(d), that is, under the rules of section 544(a). However, this provision is expressly inapplicable to the definition of a related person under paragraph (8). Paragraph (8) establishes its own, relatively narrow, relationship provisions pursuant to which an

individual shareholder is regarded as related only to his spouse, ancestors, lineal descendants, and a corporation in which he owns fifty percent of the stock based either upon voting power or value.²⁴⁴ To determine ownership of stock for these purposes, paragraph (8) cross-refers, not to section 544(a), but to section 267(c) and modifies the cross-reference to the section 267(c) definition of family by eliminating brothers and sisters.²⁴⁵

The application of these very different rules of section 341(e) to the same transaction can produce somewhat surprising results. For example, if an individual and his brother each owns fifteen percent of the stock of a collapsible corporation that otherwise satisfies the requirements for exemption from collapsible treatment provided by section 341(e)(1), the individual will be regarded as a more than twenty percent shareholder of the corporation because of the attribution of the stock owned by his brother to him as required by sections 341(e)(10), 341(d), and 544(a). Nevertheless, he is free to sell stock to his brother, avoiding ordinary income treatment, since his brother is not regarded as related to him under sections 341(e)(8) and 267(c) as modified.

E. Defining Relationships by Cross-References to Attribution Rules

On a few occasions the Code has defined relationships among taxpayers by a cross-reference to attribution rules. Since, in general, attribution may be made from a considerably broader circle of entities than would normally be regarded as related to the taxpayer, the effect of this use of attribution rules is to describe an unusually broad set of relationships. The impropriety of this

244. If the shareholder is a corporation, it is regarded as related to its parent and its subsidiary, which relationship is established by the same 50% of voting power or value test, and to a sister corporation if more than 50% of the value only of the stock of the shareholder is owned by a person who also owns 50% in value of the stock of the sister corporation.

245. It is not at all clear why the draftsmen of section 341(e), which post-dates section 341(d), adopted the attribution rules of section 267(c). These rules differ from the rules contained in section 544 in only two respects. First, both permit attribution directly from a partner, although section 267(c) requires as a condition to such attribution that the individual to whom stock is being attributed otherwise owns stock in the corporation. Second, section 267 lacks the option rule contained in section 544 and all other principal attribution sections of the Code.

device has long been recognized,²⁴⁶ and the regulations attempt to remedy its worst defects. Unfortunately, different regulations attack different problems, leaving behind a pattern that is more confused than the statute alone.

Sections 334(b)(2) and 382(a) both prescribe certain consequences to the purchase of corporate stock under the conditions specified in those sections, and both exclude from the definition of purchase the acquisition of stock "from a person the ownership of whose stock would, under section 318(a), be attributed to the person acquiring such stock."²⁴⁷ In common with most attribution rules, section 318 contains an option attribution rule. Taken literally; therefore, if the purchaser of stock first obtains a short-term option to purchase the stock, the later exercise of the option would not constitute a "purchase" under these sections since the stock would be acquired from a person whose stock would be attributed to the purchaser. Such a rule would not only eliminate from the definition of "purchase" a large number of arm's length sales between unrelated persons that clearly should be included within the substantive provisions of sections 334(b)(2) and 382(a) but would also permit taxpayers to avoid "purchase" characterization at their election by arranging their acquisitions. In recognition of these objections, the regulations to section 334 in effect ignore the existence of the option.²⁴⁸ Unfortunately, a parallel provision is absent from the regulations to section 382.

The use of section 318 to define the relationships used in these two sections eliminates what would be the most serious source of excessive breadth because atypically, under section 318, attribution is only made from a corporation to a fifty percent shareholder. Accordingly, the relationship so described conforms to the usual threshold requirement for relationship purposes. However, attribution is made to a partner with no threshold requirement, which is inconsistent with the usual cross-reference to the fifty percent partner definition of section 707(b)(1). The regulations to the pre-1976 version of section 382(a) attacked this

246. See, e.g., Reilly, *An Approach to the Simplification and Standardization of the Concepts "The Family," "Related Parties," "Control," and "Attribution of Ownership,"* 15 *Tax L. Rev.* 253, 278 (1960).

247. I.R.C. § 334(b)(3)(C). The pre-1976 version of section 382(a) contained a substantially identical provision in the prior section 382(a)(4).

248. See *Treas. Reg.* § 1.334-1(c)(6)(iii), T.D. 7231, 1973-1 C.B. 176.

problem by ignoring the statutory language and excluding from the definition of purchase only the shares of stock that would be attributed to the purchaser immediately before the transaction in question.²⁴⁹ Under the regulations, therefore, if a partnership owns sixty shares of stock, all of which are purchased by a fifty percent partner, only the acquisition of thirty shares is excluded from the definition of purchase since only fifty percent of the partnership holdings would be attributable to the purchasing partner.

Section 382(a) was considerably modified in the 1976 Act. While the basic structure of this relationship provision was not changed, the law was conformed to the proportional approach of the regulation.²⁵⁰ The unsatisfactory effect of the cross-reference to section 318 cannot be remedied so easily. While the result now reached under section 382(a) may be superior to the prior approach, it is nevertheless totally unsound and inconsistent with the very concept of the relationship provisions. Taxpayers are either so closely related that their transactions should not be accorded the same treatment as transactions between unrelated taxpayers or they are not so related; it is illogical to assert that they are sufficiently related with respect to a portion of their holdings.

The third example of this technique, the cross-reference to section 544 in section 341(d), has been described above.²⁵¹ Typically, under section 544, there are no threshold requirements for attribution from corporations to their stockholders, and thus under this provision a corporation is regarded as related to each owner of a single share of its stock—a patently absurd result. Unfortunately, the regulations to this section do not address any of the problems posed by the inordinate breadth of the described relationships.²⁵²

The opposite problem, the use of relationship provisions for attribution purposes, is more than just a question of improper cross-referencing; it is the substance of the device referred to herein as the aggregation form of attribution. The weaknesses in this drafting style are considered below.²⁵³

249. *Id.* § 1.382(a)-1(e)(1), T.D. 6616, 1962-2 C.B. 106.

250. Tax Reform Act of 1976, Pub. L. No. 94-455, § 806(e), 90 Stat. 1583.

251. See text accompanying notes 231-32 *supra*.

252. See Treas. Reg. § 1.341-4, T.D. 6738, 1964-2 C.B. 95.

253. See Part XII *infra*.

XII. THE ULTIMATE IN ATTRIBUTION: SECTION 958

One section of the Code that in part employs attribution by a modified cross-reference to section 318 and in part prescribes its own rules is deserving of more individualized attention than that given to other uses of attribution by cross-reference. Several of the particular rules either contained in section 958 itself or in the regulations thereto are unique although they are not uniquely required by the substantive law supplemented by these rules. If the approach of section 958 is meritorious, it should be applied elsewhere; if it is not, it should be eliminated from the Code altogether. In any event, from the perspective of sheer complexity, section 958 is the ultimate in attribution.

Sections 951 through 964, collectively referred to as Subpart F of the Code,²⁵⁴ set forth a complex series of rules designed to impose a current tax on certain classes of income earned abroad by foreign corporations that are controlled by "United States persons." The "controlled foreign corporations" subject to Subpart F are foreign corporations of which more than fifty percent of the total combined voting power of all classes of stock is owned by United States shareholders. The effect of the application of Subpart F is to include a portion of the income actually earned by a controlled foreign corporation in the tax return of its United States shareholders. For these purposes, a United States shareholder is a citizen or resident of the United States or a domestic corporation or other entity that owns ten percent or more of the combined voting power of the controlled foreign corporation. Subpart F requires a careful definition of stock ownership, and that definition is supplied by section 958. In addition, for the purposes of the substantive provisions of Subpart F, a distinction is drawn between United States persons and nonresident aliens or foreign corporations. This distinction is also reflected in the stock ownership rules provided by section 958.

Section 958 essentially prescribes two sets of attribution rules, one of general and one of limited scope, that overlap considerably. Section 958(a)(2) prescribes a rule for attributing stock from entities to their owners that is similar in operation to the rule prescribed by section 267. Thus, the shareholders, partners, or beneficiaries are treated as owning proportionately the stock

254. Actually, Subtitle A, Chapter 1, Subchapter N, Part III, Subpart F.

held by the respective entities and there are no threshold requirements. Constructive ownership of stock under this rule is treated as actual ownership so that stock may be vertically reattributed indefinitely. However, the provision is only applicable when the entity from which stock is attributed is a foreign corporation, partnership, trust, or estate. Accordingly, once stock is attributed to a United States person pursuant to this provision, attribution ceases. For example, assume that domestic corporation *A* owns twenty percent of domestic corporation *B*, which owns sixty percent of foreign corporation *C*, which owns twenty percent of foreign corporation *D*. Under this provision, domestic corporation *B* is regarded as owning twelve percent of foreign corporation *D* (sixty percent times twenty percent), but domestic corporation *A* is not regarded as owning any stock in either foreign corporation *C* or foreign corporation *D*.

Section 958(b) adopts by cross-reference all of the attribution rules contained in section 318 but imposes a number of modifications. The fifty percent threshold requirement for the normal attribution of stock from a corporation to its shareholders is reduced to ten percent although the fifty percent threshold for back-attribution is not changed. Second, if an entity owns, directly or indirectly, more than fifty percent of the voting power of all outstanding stock in a corporation, it is regarded as owning all voting stock in the corporation for the purpose of the rules attributing stock owned by that entity to its owner. Thus, in the illustration used above, domestic corporation *B*, by virtue of its sixty percent ownership of foreign corporation *C*, would be regarded as owning one hundred percent of foreign corporation *C* and, therefore, would also be regarded as owning twenty percent (one hundred percent times twenty percent) of foreign corporation *D*. Domestic corporation *A* would be regarded as owning twenty percent (twenty percent times one hundred percent) of foreign corporation *C* and four percent (twenty percent times one hundred percent times twenty percent) of foreign corporation *D*.

The family definition of section 318 is not modified for the purposes of section 958 except that in applying the family attribution rules, stock owned by a nonresident alien is not to be attributed to a citizen or resident even though the nonresident alien otherwise constitutes a member of the family of the United States individual. Thus, if United States citizen *A* has two brothers, *B* and *C*, and *B* is a resident alien but *C* is a nonresident alien, stock

owned by *B* may be attributed to *A*, but stock owned by *C* cannot be attributed to either *A* or *B*. Furthermore, the back-attribution rules of section 318(a)(3) may not be applied to treat a United States person as owning stock that is actually owned by an individual or entity who is not a United States person. Thus, stock owned by nonresident aliens or foreign corporations or other foreign entities that are shareholders, partners, beneficiaries, or grantors of grantor trusts may not be attributed to the United States corporation, partnership, trust, or estate in which they have an interest. Stock owned by a non-United States family member or shareholder can, however, in some instances be attributed to a United States person. For example, the prohibition against attribution is not applicable to the option rule. Thus, if individual *A* held an option on stock owned by his nonresident alien brother *C*, such stock would be attributable to *A*. Of course, there is no limitation on the attribution of stock held by foreign entities to United States shareholders, partners, beneficiaries, and the grantors of grantor trusts.

In contrast to the relatively brief and mechanical regulations appearing under other attribution sections of the Code, the regulations to section 958 add considerably to the statutory provision. This elaboration is particularly extensive under the limited attribution rule prescribed by section 958(a)(2) governing indirect ownership through foreign entities. Section 1.958-1(c)(2) of the regulations asserts that attribution under this rule is not a mere mechanical exercise but rather is to be made in light of "all of the facts and circumstances in each case" and, in particular, the purpose for which attribution is being made. It will be recalled that all of the attribution rules discussed above attribute stock from entities to their owners in accordance with the value of such owner's interest in the entity (or in the stock being attributed). Accordingly, a proportionate share of voting stock owned, for example, by a corporation or partnership will be attributed to the holder of nonvoting preferred stock or to a limited partner. The regulations to section 958, interpreting substantially identical statutory language, take a different tack.

Section 951(a), to which the attribution rules of section 958 are applicable, prescribes the amount of income of a controlled foreign corporation includable in the income of a United States shareholder. The regulations provide that in applying section 958(a)(2), for the purpose of this provision, a person's proportion-

ate interest in a foreign corporation will be his proportionate interest in the income of the corporation and not his proportionate interest in value of all outstanding stock or voting power.²⁵⁵ On the other hand, the definitions of a United States shareholder and of a controlled foreign corporation are in terms of the ownership of a proportion of the voting power of the controlled foreign corporation. The regulations to section 958 provide that when section 958(a)(2) is applied, for the purpose of these sections, an individual's proportionate interest is to be determined by reference to his interest in the voting power of the corporation.²⁵⁶ It would appear to follow that an individual's interest in a controlled foreign corporation for the purposes of determining whether he is a United States shareholder may be different from his interest in the corporation for the purpose of determining the amount of its income to be included on his tax return.²⁵⁷

With respect to trusts and estates, the regulations adopt the more refined rule of attribution employed by section 1563: stock is attributed to a beneficiary with respect to the beneficiary's interest in the *stock*, not with respect to his interest in the trust or estate. Thus, example (4) of section 1.958-1(d) provides that if pursuant to the terms of a will governing a foreign estate, stock in a foreign corporation is specifically bequeathed to a United States individual, he will be considered the owner of the entire amount of such stock, and the other beneficiaries of the estate will not be regarded as owning any of such stock.

255. Treas. Reg. § 1.958-1(c)(2) (1966).

256. *Id.*

257. For example, assume that foreign corporation *F* has two classes of stock with an equal number of shares of each class outstanding. The classes are identical in all respects except that one class possesses all of the voting power in the corporation. Assume further that foreign corporation *F* owns 60% of the single class of stock of foreign corporation *S*. If domestic corporation *D* owns 30% of the outstanding voting stock of foreign corporation *F*, it will be regarded under the interpretation of section 958(a)(2) contained in the regulations as owning 18% (30% x 60%) of foreign corporation *F* for the purpose of determining whether domestic corporation *D* constitutes a United States shareholder of foreign corporation *S* by virtue of its ownership of over 10 percent of the voting control of foreign corporation *S*. On the other hand, domestic corporation *D* will be regarded as owning only 9% (30% x 50% x 60%) of the income of foreign corporation *S* for the purpose of determining the amount of Subpart F income of foreign corporation *S* upon which domestic corporation *D* will be taxable (assuming that foreign corporation *S* constitutes a controlled foreign corporation because of other United States ownership of its stock).

The tax avoidance possibilities in the regulatory interpretation to section 958(a)(2) are obvious and were not overlooked by the Treasury. The regulations indicate that the "facts and circumstances" test may be a one-way street in favor of the collection of tax since they specifically state that an arrangement that "artificially" decreases a United States person's proportionate interest in the foreign entity will not be recognized. For example, assume that United States corporation *A* is the sole limited partner of foreign partnership *P*, which in turn owns one hundred percent of the only class of stock outstanding of foreign corporation *B*. Assume further that ninety percent of the income of the partnership was attributable to the limited partner and that pursuant to the partnership agreement, the partnership could be dissolved at any time without delay by the limited partner. Applying the regulatory interpretation of section 958(a)(2) literally, while ninety percent of the Subpart F income of foreign corporation *B* would be attributable to domestic corporation *A*, domestic corporation *A* would not constitute a United States shareholder nor would foreign corporation *B* constitute a controlled foreign corporation because of the absence of voting control. Accordingly, Subpart F would be inapplicable and domestic corporation *A* would not be subject to taxation with respect to the income of foreign corporation *B*. Nevertheless, in such circumstances, it may be assumed that the Internal Revenue Service would seek to invoke the qualification in the regulations and treat domestic corporation *A* as constructively owning over fifty percent of the voting stock of foreign corporation *B*.²⁵⁸

The regulatory refinement of the attribution rules contained in section 958(a)(2) is not applicable to the adaptation of section 318 incorporated in subsection 958(b). Presumably, therefore, stock is attributed in accordance with the regulations to section 318 subject to the statutory modifications of section 958(b)(1) through (4). Thus, attribution from a corporation to its shareholders under section 958(b) is strictly in proportion to the value of the stock owned by the stockholder, and attribution from trusts is solely in proportion to the beneficiary's actuarial interest in the trust.²⁵⁹ Accordingly, the process of determining stock ownership

258. See also *Kraus v. Commissioner*, 490 F.2d 898 (2d Cir. 1974); *Garlock, Inc. v. Commissioner*, 489 F.2d 197 (2d Cir. 1973).

259. Treas. Reg. § 1.958-2(c)(1)(ii) (1966).

under section 958 requires the computation of constructive ownership pursuant to two entirely different sets of rules. As might be expected, the regulations provide that the Service will apply whichever of the two attribution rules, section 958(a) or section 958(b), that would result in the attribution of the largest amount of stock to United States shareholders.²⁶⁰ Generally, the adaptation of section 318 used in section 958(b) will result in the greatest attribution unless such attribution is prohibited by a failure to meet the threshold requirements of those provisions.²⁶¹

While the cross-reference to section 318 naturally includes the operating rules of that section for the purposes of reattribution, there are no operating rules in section 958(b) itself with respect to its modifications of section 318. The two provisions barring the attribution of stock owned by a non-United States person to a United States person pose few questions because if stock actually owned by the foreigner cannot be so attributed, obviously stock constructively owned by the foreigner cannot be so attributed. However, a question could arise with respect to stock actually owned by a United States person that might be attributed to another United States person through a foreign individual or entity.

A more difficult question arises under the provision deeming a stockholder that "owns, directly or indirectly" more than fifty percent of the voting power of the stock of a corporation to be the owner of all of such voting stock.²⁶² The regulations, perhaps deliberately, do not indicate whether stock attributed to the stockholder may be aggregated with stock actually owned by him for the purpose of determining whether the fifty percent threshold requirement has been met.²⁶³ The regulations to section 318, in interpreting the fifty percent threshold requirement of that section, require that stock constructively owned by the shareholder be taken into account for the purpose of determining whether the threshold requirement has been met.²⁶⁴ It is unfortunate that the regulations to section 958 do not disclose the views of the Treas-

260. *Id.* § 1.958-2(f)(2) (1966).

261. The "facts and circumstances" test of section 958(a) can produce a different result when two classes of ownership are involved.

262. I.R.C. § 958(b)(2).

263. *See* Treas. Reg. § 1.958-2(c)(2) (1966).

264. *Id.* § 1.318-1(b)(3), T.D. 6969, 1968-2 C.B. 131.

ury with respect to this fifty percent threshold requirement since it is not clear that the same rule should be applied. The effect of this special rule in section 958(b), which is not mirrored by any other section of the Code, is severe. The provision can only be justified by the analysis that fifty percent voting control of a corporation in practice permits complete domination of its affairs. Thus, in the context of attributing stock in a subsidiary of such a corporation to the stockholder, the analysis must be that such attribution should not be diluted by the existence of ineffectual minority ownership. It is not clear that stock of the parent corporation attributed to the stockholder, the voting of which he does not in fact control, should be taken into account in determining that there is such a complete domination of the parent by the stockholder that the stockholder should be regarded as owning all of the subsidiary's stock. Nevertheless, it is probable that the Internal Revenue Service, should the question arise, would seek to interpret the word "indirectly" in section 958(b)(2) in the same manner as it interprets the same language used for a similar purpose in section 318.²⁶⁵

XIII. THE AGGREGATION FORM OF ATTRIBUTION

It has been repeatedly observed that the Code employs two distinct forms of attribution, the traditional form and what has been referred to herein as aggregation, and that the aggregation form is becoming increasingly popular with the draftsmen of tax legislation. Conceptually, the aggregation form is appealing; but as thus far reduced to statutory expression, it is not. Traditional attribution is authoritarian: it assumes a single source of wealth and the diffusion of that wealth, presumably for tax avoidance purposes, throughout the members of a family and into various entities dominated by them. The traditional attribution rules constructively reverse the process and treat that wealth as again concentrated in its source. The aggregation form is more democratic and perhaps more contemporary in outlook. It discards the concept of a single dominant figure and assumes instead a community of interest among a number of economically related taxpayers. Rather than focusing on the largely artificial relationship between the reconstructed dominant figure and a business entity,

265. See text accompanying note 173 *supra*.

the substantive law is addressed to the relationship between the entity and the economic group as a whole.

The flaw in the seemingly more realistic aggregation approach lies in the assumption that an economic community of interest among a diversity of entities can clearly be defined. For the purposes of the traditional relationship provisions, such a community of interest is defined because it must be defined; taxpayers are either so closely related that their transactions should be accorded exceptional treatment or they are not so related.²⁶⁶ There is an obvious arbitrariness in the definition of family and in the establishment of the threshold ownership requirements, but the arbitrariness is tolerated because of the necessity of definition.

On the other hand, when the focus shifts from the definition of the primary relationship to the determination of whether that relationship exists, that is, to the definition of the secondary relationship, the traditional attribution rules have permitted far greater flexibility. A partner, for example, need not be treated as the owner of either all or none of the stock owned by his partnership. Instead, the partner may be treated as the owner of only the proportion of its holdings that corresponds to his interest in the partnership. It is this flexibility that the aggregation form of attribution eliminates. As a result, this newer form of attribution produces a less realistic result than the traditional approach.

A second difficulty with the aggregation approach as it has been drafted lies in the definition of the aggregate—those taxpayers having the requisite community of interest. Not surprisingly, the draftsmen of both sections 613A and 48(k) turned to the traditional relationship provisions for this definition. The inadequacies of those provisions become aggravated when they are used for attribution purposes.

The operation of the aggregation form can best be understood by examining section 48(k). The section itself is of only minor interest since it constitutes an elective alternative for the compu-

266. Such has been the virtually uniform treatment of relationship provisions under the Code, including the aggregation provisions. A proportional approach to the relationship provisions is not logically impossible, but it presents a variety of problems that have not to date been given thoughtful attention. For one such relationship provision under the Code and some of the problems it raises, see text accompanying notes 99-103 *supra*.

tation of the useful life of motion picture films and video tapes for investment tax credit purposes. However, the aggregation form of attribution used in the section is an expanded version of the form first used in section 613A, and it seems probable that any future use of this form will be patterned on section 48(k).

The objective of section 48(k) is to define a controlled group of business entities for the purpose of requiring a uniform election by all such entities. The traditional approach to this objective is represented by the cross-reference to section 1563(a) in sections 414 and 52.²⁶⁷ Section 48(k), however, defines the primary relationship as the ownership of a fifty percent or greater interest in each potentially related entity by the "same or related persons." Persons are related if they are within the relationships described in sections 267(b) or 707(b)(1) or if they are members of a section 1563(a) controlled group.²⁶⁸ Finally, the holdings of a related person are not counted towards the required fifty percent unless the person owns at least ten percent of the interest in the business entity.

When the cross-referenced relationship provision does not contain a threshold limitation, as in the case of a trust and its beneficiaries under section 267(b)(6), the section 48(k) aggregation approach will cause far more tangentially related entities to be regarded as under common control than would the traditional approach. Thus, under section 48(k) the entire stock holdings of a trust in a business corporation will be aggregated with the stockholdings of a beneficiary of the trust even though the beneficiary's interest in the trust may be less than one percent. If the beneficiary and the trust each owned thirty percent of the outstanding stock of the corporation, the corporation would be regarded as controlled under the aggregation approach since related persons own over fifty percent of its stock. Under the traditional proportional attribution approach, the beneficiary would be regarded as owning only one percent of the trust's thirty percent interest, and therefore the beneficiary would not be regarded as controlling the corporation.

On the other hand, when the cross-referenced relationship provision contains threshold requirements, the "all or nothing"

267. See text preceding note 212 *supra*.

268. I.R.C. § 48(k)(3)(D). Both cross-references are slightly modified.

aspect of the aggregation approach will produce results that are either more or less restrictive than those produced by traditional attribution. Thus, while under section 48(k) the holdings of a trust are aggregated with the holdings of any beneficiary, none of the holdings of a corporation are aggregated with the holdings of an owner of forty-nine percent of its stock. All of its holdings, of course, are aggregated with the holdings of an owner of fifty-one percent of its stock.²⁶⁹

These rather dubious results are inherent in the use of relationship concepts for attribution purposes and would not be altered by changes in the definition of a related person (although the thresholds used in the definition might be changed). In addition, the cross-references in both section 48(k) and section 613A to the existing Code relationship provisions have created further irrationalities. Most prominently, the list of types of taxpayers included in the cross-referenced relationship provisions is less complete than are the lists of taxpayers from whom traditional attribution is made. Thus, section 267(b) does not include any reference to estates or to partnerships although attribution is made from both such entities under section 267(c). With respect to partnerships, this omission is partially corrected by the further cross-reference in section 48(k) to section 707(b), which defines

269. As a further illustration, assume that an individual owns over 50% of corporation *A* and the question is whether corporation *B* is related to corporation *A*. The corporations will be related if 50% of the stock in *B* is owned by the individual or a corporation 50% owned by the individual (because under section 267(b)(2) such a corporation would be related to the individual). Assume that the individual owns 40% of corporation *B* and 40% of corporation *X* and that corporation *X* owns the remaining 60% of *B*. Since the individual is not related to corporation *X*, corporations *A* and *B* are not related. If the normal attribution rules applied and the individual were regarded as owning a proportionate share of the stock owned by corporation *X*, he would be regarded as constructively owning 24% of corporation *B* by attribution from corporation *X*, which when added to his actual 40% results in a deemed 64% ownership of corporation *B* and thus corporations *A* and *B* would be regarded as related. Now assume that the individual owns 60% of corporation *X*, which owns 20% of corporation *B*. Since the individual is now related to corporation *X*, their 40% and 20% is combined to cause corporation *B* to be under common control with corporation *A*. Under proportional attribution, however, the individual would now only be regarded as constructively owning 18% of corporation *B* in addition to this actual 40%, or 6% less than in the first example. The problem, of course, is that the threshold requirements used in the relationship provisions make those provisions inappropriate for use as attribution provisions.

relationships between a partner and a partnership. But the separate references to sections 267 and 707 do not result in defining a relationship between a partnership and any other entity. Nothing, however, rectifies the omission of estates. Thus, for example, if two business entities subject to section 48(k) were owned, one by a husband and one by a wife, they would be regarded as related, but upon the death of the husband they would no longer be related since estates are not included in the section 267(b) list of related taxpayers—even if the wife were the sole beneficiary of the estate.²⁷⁰ Under the traditional attribution rules, of course, the wife would be regarded as owning the interest held by the estate and the businesses would continue to be regarded as related. It is unclear why this omission has been tolerated in section 267, but it should not be tolerated under 48(k).²⁷¹

There is a question as to the purpose served by excluding from the category of related persons the owners of less than ten percent of the interests in a business enterprise. In fact, it is not altogether clear how the exclusion is to be applied. For example, if an individual owns a twelve percent interest in business *A* and a seven percent interest in business *B*, it is questionable whether his ownership in business *A* is to be counted or whether he must own a ten percent interest in both entities. If his interest in business *A* is counted, it is also unclear whether he then qualifies as a related person for all purposes so that his interest in business *B* can also be counted.

Aside from these ambiguities, the ten percent exclusion superficially resembles the threshold requirements for attribution that the traditional provisions employ to restrict the otherwise excessive breadth of attribution—such as the condition for attribution from trusts under section 1563(e) that the beneficiary own a five percent interest in the trust. These provisions, however,

270. See text accompanying note 54 *supra*.

271. A further difficulty with the aggregation form is that it only describes horizontal or brother-sister relationships among business entities and does not specifically describe vertical or parent-subsidiary relationships. Rather, the application of these provisions to such relationships must be determined indirectly. For example, assume that an individual owns 100% of trust *A*, which in turn owns 100% of trust *B*. Trust *A* and trust *B* are related business entities, not because trust *A* owns all of trust *B*, but because the individual and trust *A* are related within the meaning of section 267 and the individual owns in excess of 50% of trust *A* and trust *A* owns in excess of 50% of trust *B*.

serve an entirely different purpose. Under the section 1563 type restriction, regardless of the extent of the interest of the trust in a corporation, its holdings will not be attributed to a beneficiary unless the relationship between the trust and the beneficiary is large enough (in excess of five percent) to warrant that result. Under section 48(k), regardless of how closely related the trust is to the beneficiary, the trust's holdings are disregarded if they fall below ten percent. Indeed, it appears that under the section 48(k) approach, a business entity will never be regarded as controlled if the ownership of the business is spread equally among eleven or more persons, regardless of how closely related those persons may be—which is exactly the tax avoidance technique that the attribution rules were created to prevent. A *de minimis* rule might be sensible but only if the ten percent computation were made after the application of appropriate attribution rules. Such traditional rules, however, are not applied by section 48(k) for this purpose. Unless the regulations can construe this ten percent limitation differently, it opens an easy path to avoiding the related business entity provision of section 48(k).

If, on balance, the aggregation form possesses any advantages over traditional attribution, they are not evident. Even worse than the use of aggregation alone, however, is the possibility of combining the two approaches and creating a hybrid form of attribution. Presently, only section 447 employs such a provision. The aggregation is limited to members of the family, and stock is traditionally attributed to the family from entities in which they have an interest.²⁷² The resulting inadequacies of that section have been detailed elsewhere.²⁷³ Here it is sufficient to observe that once the established form is abandoned, the possible alternatives, and the ensuing complexity of the Code, are virtually without limit.

272. I.R.C. § 447(d)(1)-(3). As noted above, it vastly oversimplifies section 447 to characterize it as using traditional attribution rules. Estates of deceased family members are treated as members of the family rather than as entities, and estates of nonfamily members are ignored even if a family member is a beneficiary. While attribution from trusts and partnerships is in the traditional mold, attribution from corporations is unique in that stock is attributed to the members of the family as a group if they own in the aggregate 50% or more in value of the stock of the corporation from which attribution is to be made.

273. See text accompanying notes 147 & 180 *supra*.

XIV. TOWARD UNIFORM RULES

By this point, it should be obvious that the relationship and attribution rules used throughout the Code are badly in need of repair. The rules range from the grossly inadequate to the excessive, and at all times are inconsistent and frequently imprecise. It is not difficult to see how the Code reached such a state. The earliest relationship and attribution rules were incorporated into the Code during a simpler era and at a time when social and business relationships differed from those prevailing today. These early rules were primitive in design and were expanded on an ad hoc basis through efforts to eliminate specific abuses. At no time were these early rules the subject of a rational investigation designed to produce comprehensive rules appropriate in scope. Occasionally, these initial rules were adopted for use in other sections, again with modifications that seemed appropriate at the time.

The decision to add attribution rules applicable to the corporate adjustment provisions in 1954 occasioned the adoption of an entirely new set of attribution rules that corrected many of the faults of the earlier provisions. However, no attempt was made to revise the earlier provisions. In turn, several of the decisions contained in section 318 proved to be unsatisfactory and were extensively criticized, principally by an American Law Institute (ALI) study.²⁷⁴ While section 318 was thereafter modified to eliminate sidewise attribution, perhaps the most serious defect, the provision has never been comprehensively modified. However, section 1563, enacted several years later, substantially adopted the ALI recommendations. Thus, the Code attribution and relationship rules have been subject to a generation of fine tuning, but almost without exception the result has been the addition of new improved models without a revision of prior efforts; and in some instances, the new models were far from improved.

In addition to the inconsistency inherent in the statute, the Treasury regulations, rulings, and judicial decisions in this area all have injected further inconsistency and confusion as efforts were made to fill perceived gaps in the statutory scheme. Thus, identical statutory wording in different attribution rules may

274. ALI REPORT ON INCOME TAX PROBLEMS OF CORPORATIONS AND SHAREHOLDERS 548 (Oct. 31, 1958) [hereinafter referred to as ALI REPORT].

have different meanings, and in some instances the same language in the same attribution rule may have different meanings depending upon the substantive section applying the rules.

It is clear that, in spite of the considerable diversity among these provisions that presently exists, a substantial uniformity could be achieved with little sacrifice of the individual policies contained in the affected substantive provisions. Twenty years ago the American Law Institute determined that substantial uniformity could be achieved, although the task becomes more difficult each year as additional relationship and attribution rules are adopted, modified, and referred to throughout the Code.²⁷⁵ Nevertheless, it does not appear that uniformity has not been achieved because of the inherent impossibility of the task but rather because of the natural disinclination of the legislative process to replot old ground.

Given the sheer number and diversity of the affinity provisions and the variety of ways that they are used throughout the Code, the task of drafting acceptable uniform rules is considerable. Clearly, it would be presumptuous to attempt such a draft here. It is possible, however, to distill some general notions or principles that would be of assistance should Congress wish to undertake such an effort.

If the goal were to achieve a perfectly drafted Internal Revenue Code, theoretically it would be necessary to identify the purpose underlying each of the relationship provisions established by the various sections of the Code. Then each relationship provision and its accompanying attribution rules could be tailored precisely to that policy. Quite likely, the enormity of such a task would discourage any general revision of these provisions. However, practical obstacles to such a complete overhaul do not mean that substantial improvement could not be achieved by undertaking a far more modest investigation.

The relationship provisions generally may be classified into a comparatively small number of categories. Several sections of the Code that grant a specific benefit require that one such benefit be shared by two or more taxpayers. Examples of such sections include the ceiling on the investment tax credit for used property in section 48(c), the floor on taxable items of tax preference in

275. *Id.* at 487.

section 58, and the independent producers allowance for percentage depletion in section 613A(c)(8). Because these provisions directly conflict with the individualistic orientation of our tax laws, the relationship provisions established by these sections have always been highly limited. With one exception, these relationships extend only to husbands and wives and to controlled groups of corporations within the meaning of section 1563. The one exception is the recently adopted section 613A in which the draftsmen, encouraged by the successful attack on oil depletion, required that a husband and wife share their allowable production with their minor children. It is doubtful that minor children should be deprived of their own entitlement to percentage depletion any more than they should be deprived, for example, of their own untaxed items of tax preference. In both instances, it is equally likely that their ownership of the property in question is derived from their parents and subject to their control. Regardless of whether it is now the view of Congress that such tax benefits should be shared by the entire family unit or only by the parents, there would not appear to be any valid reasons for distinguishing among these situations.

With respect to controlled corporations subject to such single benefit provisions, there is similarly a difference between adopting the section 1563(a) definition intact and modifying it by reducing the ownership requirement from eighty percent to fifty percent. Thus, a fifty percent controlled group must share the maximum investment tax credit on used property, but each member is entitled to his own floor on items of tax preference unless the eighty percent test is met. Similarly, the eighty percent test is applicable to the sharing of the work incentive program credit provided by section 50A, but the fifty percent limitation is applicable to the percentage depletion allowance. There appears to be no rationality behind these varying treatments, and with no loss of equity, Congress could adopt a uniform single benefit relationship definition. It does appear, however, that the sections using these relatively narrow relationships are in a separate category and should not be broadened by a cross-reference to a general relationship provision.

A second category of relationships that would appear to warrant special treatment are relationships that are not established in connection with a revenue producing or protecting provision of the Code but rather stem from essentially regulatory provisions,

particularly the supervisory functions recently imposed upon the Internal Revenue Service. These sections include the several prohibited-transaction provisions, such as those applicable to private foundations and qualified pension trusts.²⁷⁶ Such sections are designed to control conduct that may be beneficial to all parties concerned (except the charity or pension trust). Thus, it would appear appropriate to adopt an expanded definition of relationships for the purposes of these sections.

The balance of the relationship provisions fall in two principal categories. While quite different in their operation, both categories generally reflect similar policy limitations and thus could appropriately be of similar scope.²⁷⁷ These provisions either impute a status or activity of one taxpayer to another or treat transactions between related taxpayers differently from the manner in which such transactions are treated for tax purposes when they occur between wholly unrelated taxpayers, typically either by ignoring the transaction or by imposing a higher tax burden on its consummation. The imputation sections may be illustrated by section 103(b), which in effect taxes what would otherwise be exempt interest attributable to an industrial revenue bond if the holder of the bond is either a user of the facilities financed through the issuance of the bond or a person related to the holder—thus imputing the use of the facilities to the holder of the bond. In the absence of such a provision, the user of the facility would be entitled to a full income tax deduction for amounts paid in the nature of interest with respect to the bonds, which interest (upon receipt by him) would be free of tax.²⁷⁸

276. I.R.C. §§ 503(b), 4946(a), 4975(e).

277. Excluded from consideration here are (1) the 80% control requirement specified by section 368(c) for a variety of corporate adjustment purposes, which constitutes a problem distinct from that considered herein, and (2) a small number of special purpose sections that only involve particular categories of relationships and thus must be considered separately on their individual merits. An example of the latter is contained in section 4942, which restricts the ability of a private foundation to make grants to a public charity that is "controlled (directly or indirectly)" by the private foundation or by disqualified persons with respect to the private foundation.

278. Similarly, section 1237 was designed to allow limited sales of real property to be eligible for capital gains taxation without regard to the case law definition of a dealer, a definition that had developed along somewhat vague but quite restrictive lines. Among other requirements, the property subject to this

The provisions affecting transactions among related taxpayers are the most common form of relationship provisions and do not require extended illustration. Several sections exclude acquisitions from related persons from the definition of purchase, either for the purpose of barring a credit with respect to the purchase (the residence credit provided by section 44), barring a depreciation advantage (first-year depreciation under section 179), or permitting a step-up in tax basis (the step-up received in a liquidation subject to section 334(b)(2)). Section 1235 prohibits capital gain taxation on the sale of certain patents to a related person, and section 1239 taxes gain on the sale of depreciable property between related taxpayers as ordinary income.

All of these sections assume that the taxpayers within the prescribed relationship have a sufficient identity of economic interest, and perhaps also a measure of mutual control, that transactions between them could be manufactured or modified in an unbusinesslike manner in order to obtain or increase tax benefits. Even absent deliberate tax avoidance, such parties are so related that a transfer of property from one to another does not amount to a sufficiently complete disposition to occasion the imposition of the normal tax consequences. A rational approach to unifying the affinity rules could quite properly begin with the presumption that the identity of economic interest and control required for each of these sections is the same or at least so nearly the same that each such section could be revised to cross-refer to the same relationship definition. If upon close scrutiny of each substantive provision it appeared to Congress that the tax reduction device being attacked was relatively easier or more difficult to accomplish or would have more serious consequences if accomplished, modifications of the cross-reference could be made within the substantive section—a practice too common under the existing Code. However, the presumption should be to the contrary, and each section should at least begin with the same cross-reference.

Certainly, there does not appear to be any obvious reason that a taxpayer would trust his brother with depreciated stock over which he did not wish to lose control any more than he would

provision may not have been substantially improved by either the taxpayer or a person related to him within the special definition of related person provided by that section.

be willing to trust him with his patents, although section 267 would deny a loss on the stock while section 1235 permits capital gain treatment on the patent sale. On the other hand, if the taxpayer sold these properties to a thirty-five percent owned corporation, for some reason the loss would be allowed but capital gain treatment denied. It is unclear why borrowing from one's brother is treated as a sham for purposes of section 465 while the purchase of property for purposes of section 179 is not. Nor is it clear why provisions designed to prevent the conversion of ordinary income into capital gain should be highly limited when sales of depreciable property under section 1239 are involved, subject to unique rules when iron ore is involved under section 631(c) or subject to unusually broad rules under sections 306 and 341(e).

Although the primary relationships that involve entities are subject to enlargement through the attribution rules to ensure a proper scope of the substantive law, the relationship provisions should be drafted wholly without regard to this effect. The relationship provisions establish the minimum connection appropriate for substantive law purposes and therefore must be given a sufficiently broad reach to ensure that in the absence of any attribution all appropriate relationships among entities will become subject to the substantive law. Presumably, the starting point for a uniform relationship rule would be section 267, which contains the most comprehensive list of relationships in the Code.

Section 267(b), however, is seriously defective in a number of respects. The definition of family contained in that provision should be modified to conform to the more recent Congressional decisions with respect to the scope of an individual's family for relationship purposes. Most of the recent cross-references to the section 267 family definition, as well as most special definitions, have excluded brothers and sisters, presumably on the premise that an individual's economic relationship with his siblings is not sufficiently close to justify inclusion of the relationship. Naturally, there are individual circumstances inconsistent with that assumption, and there may be cases in which Congress would seek to employ a broader family definition in order to achieve a greater assurance that a particular tax reduction device cannot be used. However, for general purposes, it is believed that the definition of family should exclude brothers and sisters.

Perhaps more as a matter of style than substance, a revised

section 267 should refer to children and grandchildren and parents and grandparents²⁷⁹ rather than to lineal descendants and ancestors. In the relatively rare circumstances in which more remote generations are in existence, it is unreasonable to conclusively presume a sufficiently close identity of interest to justify inclusion in the relationship. While there has been considerable diversity in treatment in the more recent attribution provisions of the grandparent-grandchild relationship, and even of the parent-adult child relationship, the identity of interest among such persons is sufficiently close to be included in a general relationship section.

Naturally, an individual's spouse should be included within the relationship. However, the exception contained in section 1563 for spouses under an interlocutory or final decree of divorce or separate maintenance does seem appropriate. With the apparently increasing popularity of cohabitation by unmarried couples, precision might require an extension of the concept of common-law marriage, but the difficulties of definition and the relatively small number of financial transactions involving such relationships would militate against such a revision.

A second defect in section 267 is its omission of estates. Without question, an estate should be treated in exactly the same manner as a trust under the relationship provisions.

The relationship between persons and exempt organizations established under section 267 is largely obsolete and since 1969

279. The ALI criticism of section 318 concluded that grandparents should be returned to the family, and that was done in section 1563. The premise for this decision was that a grandchild had a reasonable expectation through inheritance of obtaining an interest in stock owned by the grandparent and that accordingly this relationship should be included. ALI REPORT, *supra* note 274, at 471. There may, however, be an inconsistency in this decision with the exclusion of brothers and sisters for it is probable that holdings of a grandparent will be divided between two generations, and it may more properly be said that an individual may reasonably expect to acquire an actual interest in only a minor fraction of such stock, perhaps less than 20% of such stock in a normal family. Since an individual is not deemed to have a sufficiently close relationship to his brothers and sisters and, a fortiori to his cousins, the factual basis for attributing all of such holdings to the grandchild is weak. It would certainly be unduly complex to attribute only a fraction of such stock computed on the basis of the number of grandchildren who may be presumed to have an expectation of inheritance from the grandparent, and thus the choice is between full attribution or none at all. Given this choice, the ALI conclusion seems to be better.

has had little effect except with respect to noncharitable exempt organizations. Rather than suggest the creation of a complex set of rules applicable to all exempt organizations, similar to those currently applicable to private foundations, it would seem appropriate to retain this relationship in substantially its present form. However, to the extent that this provision is currently applicable to private foundations, it is redundant, and such charities should be removed from its scope.

Trusts have been treated in section 267(b) in the same manner as members of a family rather than as separate entities, as corporations are treated. Thus, any quantum of interest in a trust is assumed to be sufficient to justify including the trust-beneficiary relationship, while a shareholder is only regarded as related to a corporation in which he owns, actually or constructively, a certain threshold interest. Frequently, however, a beneficiary does not own even a significant portion of the assets of a trust, and the identity of interest of a minor beneficiary with a trust cannot be assumed. The absence of a threshold requirement can only be justified if it is assumed that other individuals related to the beneficiary own the major portion of the assets of a trust. The factual basis of this assumption would be significantly eroded if brothers and sisters are deleted from the definition of family for relationship purposes. Even in the absence of such a deletion, there is no justification for making such an assumption rather than referring to the actual factual circumstances, as is done with corporations and, under section 707(b), with partnerships. In fact, the more recent efforts toward an all-inclusive relationship provision in sections 414 and 52 have treated trusts in the same manner as other entities.

It seems preferable to treat all entities that may have more than one beneficial owner in the same manner. Thus, the prescribed relationship should not exist unless, after the application of appropriate attribution rules, an individual is regarded as owning at least fifty percent of the trust. The added complexity of this approach is slight and well justified by the greater precision it achieves. For example, under present section 267, if an individual only owns one percent of a trust and the balance is owned by individuals outside the section 267 family (for example, aunts and uncles), the individual's transactions with the trust are proscribed. However, since transactions directly between the individual and the other trust beneficiaries would not be proscribed,

his transactions with such a trust should also be permissible. Under the rule here suggested, a taxpayer may to some extent avoid the proscription against dealing with members of his family. However, since unrelated persons must by definition possess at least fifty percent of the value of the trust, in most instances the trust would be sufficiently independent of the individual to bar manipulative transactions. Furthermore, the situation presented is no different from that now generally prevailing for closely held corporations.

The problem of defining the extent of a beneficiary's relationship to a trust or estate does not presently arise under section 267. However, the problem would arise if the modification suggested here is adopted. Since it is necessary to quantify a beneficiary's interest in trusts and estates for the purpose of the attribution rules, no additional complexity is presented by the need to quantify such interests for relationship purposes—provided, of course, that the same computation is employed. As has been seen, the *Steuben Securities* rule is probably no longer applicable to trusts under any provision but seems to be applicable to estates under section 318. The consensus in favor of the all-encompassing actuarial approach is clear, and that measure should be used in determining the extent of a beneficiary's interest for relationship purposes.

For attribution purposes, section 958 and 1563 require that the actuarial interest be computed, not with reference to the entire assets of the trust or estate, but only with reference to the interests of the beneficiaries in the stock subject to attribution. This basis for attribution is in recognition of the fact that it is not uncommon for the interests of beneficiaries to extend to such assets unequally. The greater precision of this rule has much to recommend it when the inquiry concerns a specific identifiable trust asset, which is always the case when attribution is involved. However, the relationship provisions are used for a wide variety of purposes—some, as when conduct of one person is imputed to a related entity, not directly involving specific assets at all. Any attempt to be more precise than determining a beneficiary's interest in the entire trust or estate for relationship purposes would require an intolerably difficult section-by-section analysis of the uses of the relationship provision without corresponding equitable benefit. Thus, for relationship purposes, the actuarial interest

should always be computed with respect to the entire trust or estate.²⁸⁰

For the suggested revision of the trust rules to operate effectively, it is necessary to establish a device attributing the ownership of an interest in a trust from one beneficiary to another in a manner similar to the attribution rules presently employed by section 267 with respect to corporations and adopted by section 707(b) with respect to partnerships. This problem is considered below.

The primarily personal orientation of section 267(b) is reflected both by its failure to include partnerships in its enumeration of relationships and by the very limited inclusion of corporate relationships. While there is no important reason for the partnership relationships provision to be contained in subchapter K, there is a very sound reason for the creation of a universal relationship provision. Section 707(b)(1), the partnership provision corresponding to section 267(b), specifies the relationship of a partnership and a partner owning more than fifty percent of the profits or capital interest in the partnership, whichever is the greater. This definition is consistent with the general tenor of the relationship provisions and evidently has proven satisfactory in practice since the definition has never been modified by a cross-referencing provision. As discussed below in connection with corporations, however, it is doubtful that a general relationship provision should be based solely on value. If the corporate relationship definition were to be based on an alternative voting power or value test, it follows that the partnership provision should be similarly based. The voting power test would be met if as a matter of state law or the partnership agreement, a partner is entitled to cast more than fifty percent of the votes on questions of partnership business. Thus, in a partnership in which each partner has one vote, the test will not be met with respect to any partner—in the absence of attribution. Limited partners, under a law conforming to the Uniform Limited Partnership Act, should not be regarded as possessing voting power even though they are entitled to vote on certain extraordinary questions or in case of certain contingencies.²⁸¹

280. The proposed regulations to section 414 adopt this approach. See Proposed Treas. Reg. § 1.414(c)-(2)(b)(2)(i)(B), 40 Fed. Reg. 51469 (1975).

281. Such contingent rights are analogous to the rights typically granted holders of "nonvoting" stock when, for example, dividends are in arrears.

The relationship established by section 267 between a corporation and an individual owning fifty percent of its stock should be retained, but its single test based upon value of stock owned should be reexamined. The several sections of the Code addressed to corporate relationships vary widely on whether votes or value, or both, are to be taken into account.²⁸² Expansion of the section 267 test to include the greater of voting power or value would affect a relatively small number of taxpayers. The only shareholder-corporation relationships that would be added would be when the requisite shareholder group had retained voting control of the corporation but had permitted nonvoting stock to be held by others. It would seem that the possession of control over corporate transactions would establish a sufficient identity of economic interest between the shareholders and the corporation to justify the inclusion of the relationship.

There would seem to be good reason to exclude from consideration, under either test, stock that is both nonvoting and limited and preferred as to dividends. The holder of such stock not only does not possess any measure of control over the corporation but also does not stand to be benefited materially by transactions entered into by the corporation since his interest in the income of the corporation is limited.²⁸³ Both the alternative reference to voting power and value and the exclusion of nonvoting preferred stock are consistent with section 1563, the most recent comprehensive statement by Congress of the basis for measuring corporate relationships.

By far the most serious defect in the existing scheme of the affinity provisions is the absence of a generally applicable provision defining relationships among different types of entities. Section 267, with its personal orientation, is extremely weak in this respect; the section does not refer to partnerships at all. When the draftsmen of a particular substantive provision wish to include

282. In some cases the differences are related to the substantive law using the relationships.

283. The holder of a preferred stock, of course, has some interest in the economic health of the corporation, particularly if earnings are sufficiently depressed that the payment of dividends is in arrears. Nevertheless, it is not believed that this interest is sufficient to bring the shareholder within the proscribed relationship. The ALI recommendations were to the same effect. See ALI REPORT, *supra* note 274, at 467.

partnership relationships, the standard approach has been to cross-refer to section 707(b). That section, however, is addressed solely to partnerships, and thus a cross-reference to it does not include relationships between a partnership and a trust or corporation. Corporations are related under the present section 267 only to other corporations that are personal holding companies and to trusts that own fifty percent of the stock of the corporation (or the grantor of such a trust). After section 1563 was added, a cross-reference to that section could accompany the cross-reference to section 267 and 707(b); but, as in the case of partnerships, that addition would solve only the problem of corporation-to-corporation relationships. A growing number of sections have addressed this problem on an ad hoc basis. While the overall relationships established under these sections are vastly improved over the pre-1969 provisions, the piecemeal approach to all-inclusive relationships has greatly increased the pointless diversity within the Code. As part of a comprehensive scheme of revision, these ad hoc solutions should be repealed and replaced with a single, uniform, all-inclusive relationship provision.

When defining the relationship between an individual and an entity, it is necessary that the individual, after attribution, own fifty percent of the interests in the entity; otherwise, a sufficient identity of interest will be lacking. In relating entities, however, it is only necessary that fifty percent of the interests in each entity be commonly owned for the entities to have the same degree of identity of interest. Such common ownership need not be in one person; indeed, in theory, the number of common owners could be unlimited. Thus, if the same one hundred persons each owned a one percent interest in each of two corporations, it might fairly be presumed that the interests of the corporations were identical and that they should be regarded as related. As a practical matter, however, when ownership is so diffused, the likelihood that the corporations will be acting in concert is too remote to justify the complexity and difficulty of application that such a sweeping relationship provision would entail. Thus, it is desirable to limit the number of owners that can be taken into account for the purpose of this fifty percent test. Section 1563 limits this number of owners to five, thus permitting the relationship to be found if the degree of overlap exceeds five ten percent shareholders. This degree of ownership concentration finds support in other

sections of the Code.²⁸⁴ Unless experience under section 1563(a) indicates that this test is too narrow, it should be adopted in a uniform relationship rule.

In addition to being closely held, of course, the ownership of the entities must actually overlap to the extent of fifty percent of the interests in the entities. The section 1563(a)(2)(B) definition of this requirement seems appropriate: the common owners must own fifty percent of each entity taking into account only that degree of ownership that is identical in each entity.

The ALI proposals were both broader and more flexible. The ALI relationship provision would have found entities to be under common control if the entities were owned by up to twenty persons, after attribution, and their interests in each entity were "in approximately the same proportion."²⁸⁵ The twenty-person test seems far too broad. After giving effect to the attribution rules, the test would include entities having a very large number of shareholders. The benefits from such a broad definition simply do not justify requiring all entities in the quasi-public range—entities having up to one hundred shareholders before attribution—to keep track of the relationships among their shareholders and the shareholders of entities with which they have dealings in order to ensure that they do not fall within the scope of this provision. The administrative cost is too great a price to pay to reach the very few entities that have such highly diffused ownership and are in fact being operated in concert to obtain an undue tax advantage.²⁸⁶

The section 1563 definition of horizontally related entities adds one further requirement that would not be appropriate for general application. Not only must fifty percent of the stock be commonly owned, but eighty percent of the stock in each corporation must be owned by the same five persons, although not necessarily in the same proportion. There does not appear to be any reason that entities must be so closely held before they can be regarded as related to other entities. In fact, about one-half of

284. *E.g.*, I.R.C. § 542(a)(2) (defining a personal holding company); I.R.C. § 957(a) (defining a controlled foreign corporation).

285. ALI REPORT, *supra* note 274, at 469.

286. Furthermore, the "approximately proportional" requirement is unacceptably vague for use in a relationship provision, even assuming that some degree of mechanical content to the phrase were provided by regulation.

the provisions that cross-refer to section 1563 drop this requirement. It should not be included in a uniform relationship provision.

Similarly, section 1563 imposes an eighty percent ownership requirement for vertical relationships among entities. Such a requirement is too high for use in a uniform provision. An eighty percent ownership requirement is employed in the reorganization and consolidated return provisions as indicating such a substantial identity of interest that the two corporations may properly be regarded as one. This degree of identity is far too stringent a requirement for a general relationship provision; a substantial identity of interest is sufficient. The vertical relationship between entities should be subject to the same fifty percent test as that used for the relationship between an individual owner and the entity.

The present section 1563 uses the concept of a parent-subsidary chain in defining vertical relationships, a definitional style that would seem too broad for a uniform relationship provision, particularly if the ownership requirement were reduced to fifty percent. Thus, under 1563 (a)(1), all corporations are regarded as related if eighty percent of their stock is owned by one or more other members of the chain (except the common parent). Thus, if corporation *A* owns eighty percent of corporation *B*, which owns eighty percent of corporation *C*, which owns eighty percent of corporation *D*; all four corporations are related even though corporation *A* only owns, actually and constructively, fifty-one percent of corporation *C* and forty-one percent of corporation *D*. The premise for this result is that the twenty percent minority should be disregarded and that through its ownership, corporation *A* effectively dominates each tier and thus possesses substantial economic identity of interest with each corporation in the chain. Even with the required ownership at the eighty percent level, this result may be too extreme for use with all of the substantive provisions that employ relationship definitions. For example, in connection with transaction provisions such as section 267(a)(1), when the underlying issue is whether there has been a meaningful change in ownership, a transfer of property from corporation *A* to corporation *D* would result in a reduction of interest in the property transferred of fifty-nine percent. Under other branches of the relationship definition, this would be sufficient to avoid relationship status.

If the required ownership percentage is reduced to fifty percent, the assumptions of the chain concept become more doubtful and the reach of the relationship definition clearly too broad. If the ownership in the above example were reduced to fifty-one percent, corporation *A* would constructively own twenty-six percent of corporation *C* and only thirteen percent of corporation *D*—clearly not a sufficient interest to justify inclusion in a general relationship provision. Thus, it would seem appropriate to abandon the chain concept and require that an entity own, actually or constructively, over fifty percent of a second entity before they would be regarded as related. Thus, assuming a chain of eighty percent ownership, corporation *A* would be related to corporation *B* and *C* but not to corporation *D* although corporations *B* and *C* would be related to corporation *D*.

The resulting definition of related entities would generally provide that an entity of any type would be regarded as related to another entity if it controlled or was controlled by such other entity or if the two entities were under common control—in each instance with reference to both actual and constructive ownership.

There is a far greater consensus with respect to the broad outlines of the attribution provisions than there is with respect to the relationship provisions. The considerable diversity that does exist among these provisions goes generally to their detail—for example, the use of varying threshold requirements. The one exception to this relative uniformity is in the family, for which, as with the family relationship, there is a total absence of uniformity.

Initially, it may be observed that there is no inherent reason that the definition of family for the purpose of the attribution rules should be identical to the definition of family for relationship purposes although almost uniformly that has been the case. Previously, it was suggested that brothers and sisters be excluded from the family for relationship purposes because their identity of economic interest was not sufficient to justify disregarding transactions among brothers and sisters. However, it may not follow that an ownership interest in an entity, such as stock, should never be attributed to a taxpayer from his brother. It might be thought, for example, that when a taxpayer owns, actually or constructively, forty-five percent of the stock of a corporation and his sister owns an additional six percent, there is a

strong factual basis for concluding that the economic interest of the taxpayer in the corporation is just as strong as when the additional six percent interest is owned by the taxpayer's daughter. On the other hand, if the taxpayer owned only six percent of the corporation, it would appear that his relationship to the corporation would be substantially less if his sister owned forty-five percent of the stock than if his son owned the forty-five percent. Section 1563 introduced the appealing concept of a threshold for attribution among family members in appropriate circumstances.²⁸⁷ It would seem proper, therefore, to require attribution to an individual from brothers and sisters if the individual otherwise held a dominant interest in the entity. However, the fifty percent threshold established by section 1563 is excessively high in the context of defining section 267 relationships, which themselves only require a fifty percent ownership interest. Perhaps a thirty percent threshold for brother-sister attribution would be more appropriate.

Section 1563 provides a complicated pattern for family attribution involving threshold requirements depending on whether or not an individual is a minor. That pattern is too complex, as well as too restrictive, for use in a generally applicable attribution rule. The well-thought-out limitations on family attribution contained in section 1563 are designed to ensure a substantial likelihood of both identity of economic interest and control. However, an adequate factual basis exists for attributing stock among parents and adult children, and, therefore, the older rules of sections 267 and 318 should be retained. If these rules are found to be overly broad, the use of a threshold requirement would be preferable to deleting entirely a family member (as in the section 318 deletion of grandparents).

With respect to attribution from entities, the rules contained in section 1563(e), which are substantially similar to the ALI recommendations, do not require any considerable modification. Attribution from all such entities—corporations, partnerships, trusts, and estates—should be proportional to the ownership interest of the shareholder, partner, or beneficiary. The five percent *de minimis* rule contained in 1563 should be retained to elimi-

287. Prior to section 1563, section 267 required that an individual own some stock before stock owned by his partner was attributed to him but did not establish a threshold requirement.

nate attribution of insignificant holdings that would generally be irrelevant to the relationship definition. Of course, for the purpose of determining the existence of a five percent or greater interest, the attribution rules should be applied.

The reference to proportionality, however, conceals some quite difficult questions. With respect to stock, attribution rules have invariably attributed stock in proportion to the value of the outstanding stock of the corporation held by the taxpayer. However, if the corporation from which stock is being attributed has outstanding more than one class of stock and the purpose of the attribution is to determine voting control of the corporation whose stock is being attributed, sole reliance upon a value test can produce inappropriate results.

Relatively few relationship provisions in the Code that employ attribution rules are based upon ownership of a specified percentage of voting power; value is far more commonly used. Accordingly, in the past, the problem of attributing voting stock through an entity to an individual who only held a nonvoting interest (such as nonvoting stock or a limited partnership interest) in the entity from which attribution was being made has not commonly arisen. However, if the suggestion herein—that the relationships for section 267 purposes between individuals and entities be defined, in the alternative, with reference to voting power—were adopted, the problem would achieve far more significant dimensions.

To a substantial degree, the anomalies produced in this area can be eliminated by excluding from consideration nonvoting stock that is preferred and limited as to dividends. This exclusion has been suggested with respect to the definition of relationships and would be equally applicable for attribution purposes. However, such an exclusion does not solve the problem of nonvoting common stock. For example, assume that an individual owned stock in corporation *P* that possessed over fifty percent of the voting power but, because of an outstanding issue of nonvoting class A stock having dividend rights equal to the common stock, represented only forty percent of the value of corporation *P*. Further assume that corporation *P* owned all of the outstanding stock in corporation *S*. The relationship between the individual and corporation *P* would meet the fifty percent of voting power test. However, corporation *S* would only fall within the defined relationship with the individual if fifty percent of the stock of corpo-

ration *S* were attributed to him. If the attribution rules were based upon value alone, only forty percent of the stock of corporation *S* would be so attributed, and the required relationship would not exist. Clearly, such a result is untenable.

The only provision focusing on this problem is contained in the regulations to section 958, which attribute ownership based upon voting power or interest in income, depending upon the purpose for which attribution is being made. If attribution is being made for the purpose of a relationship provision that employs an alternative definition based upon voting power or value, then under the rule of section 958 attribution from entities should be computed twice, once for each branch of the relationship test. For example, assume that an individual held both voting and nonvoting stock in corporation *A* and possessed ten percent of the voting power but thirty percent of the value of corporation *A*. Further, assume that corporation *A* held fifty percent of the voting power of the stock in corporation *B* but that such stock represented only twenty percent of the value of *B*. The issue is the extent of the individual's constructive ownership of corporation *B*'s wholly owned subsidiary, corporation *X*. With respect to voting power, the individual would own five percent (fifty percent times ten percent) of the voting power of *X*; with respect to value, he would constructively own six percent (twenty percent times thirty percent) of the value of the outstanding stock of corporation *X*. Thus, for relationship purposes, the individual would be regarded as owning six percent—the greater of the two computations—of corporation *X*. Of course, attribution with respect to voting power and value must be entirely separate. It would be clearly inappropriate to combine the individual's thirty percent by value interest in corporation *A* with corporation *A*'s fifty percent voting power in corporation *B* to conclude that the individual held a fifteen percent interest in corporation *X*.

Attribution from partnerships should follow substantially the same format with one modest increase in complexity: the value branch of the test applicable to corporations should be replaced by the partner's proportionate interest in profits or capital, whichever is greater, as under the current section 707(b). There is no technical reason that the partnership provision could not be conformed fully to the corporate provision and be based upon valuation of the entire partnership interest—a weighing of the profits and capital interest. The objection to this approach is

purely practical: an accurate valuation of the partnership interest will rarely be readily available while the proportionate interest in profits and capital will be apparent from the partnership agreement. If in the preceding example corporation *A* was a ten-man partnership in which the individual held a thirty percent interest in profits and a twenty percent interest in capital but was only entitled to one vote along with each of his partners, the same attribution of the stock of corporation *X* would be made.

The addition of the alternative voting power test admittedly adds to the complexity of the affinity provisions and may thus seem out of place in an argument for greater mechanical simplicity. However, if the variety of affinity provisions presently in the Code were replaced with a single uniform provision, substantial simplification would be achieved regardless of the complexity of that provision. Furthermore, it is expected that the alternative test will not often be used. If nonvoting preferred stock is eliminated from the value computation, the alternative test will be necessary only for corporations having particularly complex capital structures. Similarly, in most partnerships, voting power corresponds to the partner's interest in profits and capital. Perhaps most importantly, however, it is believed that the added complexity is amply justified by the greater consistency of the alternative approach with the realities of mutual interest and control.

With respect to trusts and estates, attribution should generally be made in accordance with the same actuarial formula used in determining relationships with such entities. These entities, however, pose a special problem since, more commonly than in the case of corporations and partnerships, the interests of the several beneficiaries may not constitute an undivided interest in the entire corpus. Rather, either the income from or the ultimate entitlement to certain assets of the trust or the estate may be greater with respect to a particular beneficiary. In this situation, attribution under a single mechanical formula will not produce a proper result. For example, the trust instrument may provide that upon the death of the life beneficiary, all of the stock that would be the subject of attribution is to be distributed to *A* while the balance of the assets are to be distributed to *B*. In this situation, the life beneficiary has an interest in the stock being attributed equal to his actuarial interest in the entire trust. *A*'s interest in the stock is equal to the actuarial interest of the entire remainder interest. *B* has no interest in the stock, and it would be inap-

propriate to attribute any of such stock to him, either for the purpose of treating him as the owner thereof or for the purpose of diluting the ownership interest therein of A or the life beneficiary.

Although this problem has long been recognized, no statutory provision has yet attempted to provide special attribution rules for such trusts. The regulations to section 958 appear to require a special allocation but do so by way of an example, not by attempting to state a specific allocation rule.²⁸⁸ The ALI draft proposal suggested statutory language requiring a special allocation, but the proposal was vague and its operation unclear.²⁸⁹ Because of the considerable flexibility that exists in the drafting of wills and trust instruments, it may not be feasible to provide a definitive statutory provision that will not require ad hoc development. However, it would appear that the statute generally should provide that stock (or the partnership or other interest that is the subject of attribution) shall not be attributed to a beneficiary who, under the express terms of the will or agreement establishing the estate or trust or pursuant to the law governing the distribution of income or assets held by the entity, cannot under any circumstance obtain by virtue of his interest in the trust or estate any interest in the stock (or other interest) including the income therefrom or the proceeds of any distribution thereof. Rather, such stock (or other interest) shall be attributed to those beneficiaries who may obtain an interest therein in proportion to their actuarial interests in the stock (or other interest) that is the subject of attribution.

288. Treas. Reg. § 1.958-1(d), ex.(4) (1966).

289. ALI REPORT, *supra* note 274, at 461. The ALI provision specified that stock would not be attributed to a beneficiary who could not obtain any interest therein and continued to provide that the stock would be considered owned by the other beneficiaries "in proportion to their relative actuarial interests in the balance of the estate or trusts." By balance of the trusts, the draft presumably is referring to the actuarially computed portions of the trust determined after subtracting the actuarial interest of the beneficiaries who could not obtain any interest in the stock. This formulation appears defective when the trust creates income and remainder interests in different persons as would normally be the case. Referring to the example in the text, it would not be appropriate to treat the income beneficiary as having a greater interest in the stock than would be his actuarial interest in the trust. Rather, only the interest of A should be enlarged by the inability of B to obtain any interest in the stock.

Back-attribution, that is, attribution from owners to entities, presents the most complex problems of attribution. There is a strong factual basis for treating closely held entities as mere creatures of their owners and treating the owners as directly owning their proportional interest of the assets of the entity. The reverse, however, is not necessarily the case. The economic interest of, for example, a shareholder—even a substantial shareholder—may not be identical to the interest of the corporation, and clearly the shareholder is not controlled by the corporation. Thus, back-attribution is never appropriate except in the case of a controlling owner. Furthermore, the field of attribution should not, and generally does not, include widely held corporations and partnerships; rather, it is a concept applicable to closely held entities. However, unrestrained back-attribution may easily result in such overly broad relationship provisions that widely held entities become affected. Thus, corporation *A*, which does not actually own any stock in corporation *B*, may be regarded as owning stock in corporation *B* that is actually owned not only by a stockholder in corporation *A*, but also by members of his family or by other entities in which the shareholder or the members of his family hold an interest. Thus, in the absence of appropriately high threshold requirements, General Motors would be regarded as controlling IBM if shareholders of General Motors and their families, trusts, and personal holding companies in the aggregate controlled IBM.

Even when such results of back-attribution are eliminated by high threshold requirements, such as the fifty percent requirement employed by section 318, back-attribution is generally unnecessary.²⁹⁰ The function of back-attribution is to enhance the

290. The ALI study, which recommended a considerably broader scope of relationships for section 267(b) than is here recommended, concluded that the list of relationships so described did not require back-attribution.

Congress has accepted the proposition that back-attribution is not required if the relationships described are sufficiently complete since such attribution was deliberately omitted from section 1563(d) and (e). The relationships established in this section constitute an extension of the definition of controlled corporations contained in section 1551. Section 1551 requires ownership of a second corporation by only a single corporation but employs a limited form of back-attribution for this purpose, specifying that the ownership must be by "the transferor corporation, its shareholders or both." Section 1563 eliminates back-attribution and relies upon a complete definition of controlled groups.

ownership interest in one entity by another for the purposes of establishing a relationship among such entities. If the relationship provision to which attribution is applicable is complete, specifying all of the relationships between various entities to which the substantive law is to be applicable, back-attribution is unnecessary and, if applied, would result in an overly broad relationship.²⁹¹

291. For example, assume that an individual holds an actuarially determined 80% interest in a trust, that the individual owns a 20% interest in a corporation, that the trust owns a 40% interest in the same corporation, and that the balance of both the trust and the corporation was owned by unrelated persons. Under a relationship provision such as recommended here (including entities if one owned a 50% interest in the other or if 50% of each is owned by an individual or a third entity), the individual and the trust would be related as would the individual and the corporation since the individual directly owned 20% and indirectly 32% of the corporation, producing a 52% constructive ownership. However, the trust and the corporation would not be related based solely upon direct ownership of the corporation by the trust. However, since the relationship provision includes a 50% common ownership provision, the trust and the corporation would be related because the individual actually or constructively owned 50% of each and back-attribution is not required to reach that result. If the relationship provision lacked a common control feature, the use of back-attribution would be required in order to find the trust and the corporation related: the trust would be regarded as owning the 20% of the corporation owned by the individual in addition to the 40% it owned directly.

Assume now that the individual's beneficial interest in the trust was only a 60% interest. The individual and the trust are still related, but the individual and the corporation are not because the individual would constructively own only 24% of the corporation that, when added to his actual 20% interest, would fall below the required 50%. In addition, the trust and the corporation would not fall within the relationship provision because 50% of the corporation was not owned by the individual. This result seems clearly correct. By itself, the interest of the trust in the corporation is not sufficient to cause the entities to be regarded as related: were property sold from the trust to the corporation, for example, the retained indirect ownership in the property by the trust would be over 50% less than its interest prior to the transfer. The fact that a related beneficiary of the trust held an additional interest in the corporation should not change this result. Prior to the transfer, the individual together with the other beneficiaries of the trust indirectly owned the entire property; after the transfer only the individual retained an indirect interest and that interest is only a 44% interest. Thus, the trust and the corporation should not be regarded as related.

If we were to assume in addition that a second individual owned a 10% interest in both the trust and the corporation, these two entities would be related because the relationship provision takes into account overlapping ownership by up to five persons. In other words, if the relationship provision is of proper breadth, back-attribution is not necessary.

There are, however, certain substantive provisions of the Code that employ attribution but do not use general relationship provisions. Certain of these provisions, principally those governing corporate distribution and adjustments, require back-attribution in order to reach a proper result. For example, for the purpose of section 302, which establishes the distinction between redemptions and dividends, it is not relevant whether the corporation is related to the redeeming shareholder. Rather, the inquiry focuses on the precise number of shares of stock that the shareholder is deemed to own after the application of the attribution rules.²⁹² For the purposes of these sections, back-attribution must be retained—but only for the purposes of these sections.²⁹³ The back-attribution provision, presumably in substantially the form now contained in section 318, must be separated from the balance of the attribution rules so as to be included in a casual cross-reference.

The possession of an option presents a clear basis for attribution, and there should be relatively little controversy concerning either the need for such a rule or its preferred scope. The holder

On the other hand, if back-attribution were applicable to this example, ignoring the second individual, the trust would be regarded as owning the 20% of the corporation's stock actually owned by the individual, which, when added to the 40% actually owned by the trust, would exceed the required 50%. Thus, these entities would be regarded as related, which would give the relationship provisions excessive breadth.

292. If both an individual and a trust of which the individual was the primary beneficiary owned stock in a corporation and stock held by the individual were redeemed, the stock held by the trust would nevertheless be attributed to the individual under the normal entity attribution rule for the purpose of determining whether the redemption should be taxable as a dividend. This result is entirely proper, and it is clear that the reverse should also be true. That is, a redemption of stock held by the trust should be tested for dividend equivalence by taking into account the stock owned by the individual. Back-attribution is required in order to achieve that result.

293. It would be considerably beyond any proper scope of this review to examine all of the substantive provisions of the Code to which attribution is applicable to determine whether back-attribution would be appropriate. Such a study, undertaken by the ALI, concluded with respect to sections of the Code existing in 1958 that back-attribution was only required in sections 302, 306, 341 (assuming certain other revisions were made in that section), and might be necessary in sections 334 and 382 unless the definition of purchase contained in those sections were revised by employing a reference to general relationship provisions—a change that would seem eminently proper.

of an option should be regarded as owning the stock subject to the option, and it should make no difference whether the stock subject to the option is treasury stock, unissued stock, or stock presently outstanding in the hands of shareholders. Nor should it matter whether the option is held against the issuer of the stock subject to the option or against another or whether the option is a separate security or a part of a larger security (as in the case of a convertible debenture).

On the other hand, options that do not represent a significant present economic interest in the corporation should not form the basis for attribution of stock. In particular, when there are substantial conditions on the exercise of the option that are not certain to occur, the factual premise for attribution—that the option is the substantial equivalent of stock—does not exist, and attribution would be improper.

What constitutes a substantial condition for this purpose would best be left to case law development; nevertheless, some principles seem clear. Consistent with section 544(b), time alone (which is certain to pass) should not be regarded as a substantial contingency. Thus, that the option is not immediately exercisable should not itself prevent attribution. One who has a right to increase his interest in a corporation at a future date possesses, by virtue of that right, a substantial economic interest in the corporation. However, if an individual has an option to acquire stock held by another only if the holder of the option survives the stockholder, there should be no attribution to the holder of the option until the death of the stockholder. While the holder of such an option may have an economic interest in the corporation by virtue of his option, the interest is speculative. Thus, the relationship between the holder and the corporate issuer of the stock subject to the option is not sufficient to justify treating the holder of the option as a present stockholder. The adoption of such a limitation on the option rule would make it clear that stock that may be acquired by a shareholder of a corporation pursuant to a standard "buy-out" agreement would not be attributed to the shareholder during the lifetime of other shareholders.²⁹⁴ On the other hand, when the contingency is

294. Such agreements normally provide that upon the death of a shareholder, his stock must be sold, or at least offered, to the corporation or other shareholders. If such an agreement formed the basis for attribution, it would

within the control of the holder of the option, such as the payment of a certain price in connection with the exercise of the option, the contingency should not be a bar to attribution.²⁹⁵

In the case of an option to acquire unissued stock, it is obvious that the shareholder's proportionate interest in the corporation, determined after attribution, should be computed by assuming that the stock subject to option was outstanding in the same manner as computations under section 544(b) are presently made.

The more difficult question is whether options held by persons other than the person to whom stock is being attributed should be regarded as also having been exercised for the purpose of enlarging the denominator of the fraction representing that person's proportionate interest in the corporation, generally to the benefit of the taxpayer. This question only arises when the option is to acquire unissued stock and ultimately involves a prediction concerning a question of fact. Since the prediction cannot be made with certainty, it would be appropriate to provide assistance in the form of conclusive presumptions contained in operating rules, similar to those applicable to section 544(b). For example, it might be provided that attribution should be made only with respect to options that would increase the stock ownership of the individual in question, regardless of whether such

cause wholly inappropriate results. For example, it might be impossible for any shareholder of the corporation to cause his stock to be redeemed at capital gains rates under the substantially disproportionate test of section 302(b)(2).

Attribution under such agreements would pose the further problem of determining the number of shares to be attributed to the holder of the option if the corporation had more than two shareholders. Such agreements typically permit the surviving shareholders to purchase the stock of the deceased shareholder in proportion to the survivors' interests in the corporation. However, if some survivors do not exercise their rights, the stock is reoffered to those stockholders that do. Thus, each shareholder has an option (albeit doubly contingent) to acquire all of the stock of each of the other shareholders.

295. There are certain situations in which the mere requirement that a price be paid for the stock under option might be regarded as sufficient to prevent attribution. If at the time attribution is to be made the option is worthless in that the exercise price is so high that it would be economically irrational to exercise the option, the option might be ignored. Also, where an option may only be exercised upon the payment of a price for the stock subject to option equal to the fair market value of the stock determined at the time the option is exercised, the holder of the option does not have a present economic interest in the corporation.

options are held by him or by another whose stock would be attributed to him—subject to specified exceptions. Those exceptions might include a rule attributing stock to all options held by other persons if stock is attributed to the individual in question by virtue of the option rule and the options held by others are substantially identical to such option with respect to their terms and conditions. Further, an option held by another should be regarded as exercised if the option in question may not be exercised unless such other option is also exercised. Clearly the rule should be sufficiently flexible to permit case law development of the exceptions.

XV. CONCLUSION

The process of producing tax legislation has always been complex and frequently subject to intense pressure. Perhaps, it is not surprising that supplementary material like the affinity provisions is inserted in an arbitrary, inconsistent, and sometimes clearly erroneous fashion. However, the substantive provisions of the Code are sufficiently complex, and it can no longer be acceptable for such secondary material to contribute its own needless confusion.

By the time of the adoption of the 1976 Act, complexity was no longer just the object of complaints by practitioners unable to charge for their time. It had become publicly acknowledged as a serious problem. Nevertheless, the draftsmen of that Act seemed particularly prone to use the worst techniques of drafting that had appeared in the pre-1976 Code. There is no question that the attribution provisions added in 1976 are less consistent, more difficult to use, and contain more drafting errors than the pre-1976 provisions. The trend alone is disturbing; in light of the acknowledged necessity for simplification, it is no less than outrageous.

Under the current priorities, each piece of tax reform legislation pushes the Code further from human comprehension. Unless Congress is willing to devote a greater portion of its reform energies to mechanical simplification—and the affinity provisions are merely illustrative of the need—the time will soon arise (if it has not already) when experienced tax specialists can no longer have confidence in their ability to understand and apply the tax law. And, if these practitioners cannot perform confidently, surely nei-

ther they nor the public at large will have confidence that the Internal Revenue agent in the field, or his superiors in Washington, can understand or fairly apply the law. At that point, our voluntary compliance system collapses. It has been suggested here that such a crisis of complexity can be avoided without foregoing the equitable fine tuning that necessarily complicates the substance of the Code. But the need to rationalize legislatively the affinity provisions is urgent for the task becomes progressively more difficult each year.