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John W. Lee

William & Mary Law School, jwleex@wm.edu

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SECTION 482 AND THE INTEGRATED BUSINESS ENTERPRISE

John W. Lee*

THE classic integrated business enterprise is the full-line manufacturing company that distributes its own products through subsidiaries or related wholesalers and retailers.¹ This business structure is functionally² or vertically integrated,³ since a single entity controls all functions or stages in an industry from top to bottom. Potentially, such a multi-corporate enterprise can split its income among its separately incorporated functions. The ability to split income would allow both domestic and multinational integrated business enterprises to obtain advantageous tax treatment. Domestic enterprises could obtain the advantage of multiple surtax exemptions.⁴ And since domestically owned foreign corporations are ordinarily subject to the lower tax rates of foreign jurisdictions, rather than the substantially higher United States income tax rates, multinational enterprises could obtain a significant tax break through the separate incorporation of its foreign and domestic components. A multinational enterprise may also secure tax advantages through the use of a domestic Western Hemisphere Trade Corporation which is taxed at 14 percentage points below the regular United States corporate rate.⁵

Although the courts, Congress and the Treasury Department have established numerous express barriers to exploiting the potential tax advantage of operating in a multi-corporate form, each of these barriers, because of its definiteness, may be circumvented by careful tax planning. Under section 482 of the Internal Revenue Code, however, the Commissioner has advanced, and the Tax Court has accepted, a flexible restraint on the tax advantages of multiple incorporation that

* John W. Lee, A.B., University of North Carolina 1965; LL.B., University of Virginia 1968; LL.M. (Taxation), Georgetown University 1970; member of the Bar of Virginia; associated with the firm of Hirschler and Fleischer, Richmond, Virginia.

¹ Whitman, *Draining the Serbonian Bog: A New Approach to Corporate Separations under the 1954 Code*, 81 HARV. L. REV. 1194, 1221 (1968) (hereinafter cited as Whitman).

² B. BITTKER & J. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* 462 (2d ed. 1966) (hereinafter cited as BITTKER & EUSTICE).

³ Massee, *Section 355: Disposal of Unwanted Assets in Connection with a Reorganization*, 22 TAX L. REV. 439, 460 (1967) (hereinafter cited as Massee).

⁴ INT. REV. CODE of 1954, § 11(d).

⁵ INT. REV. CODE of 1954, § 922. See generally Note, *Western Hemisphere Trade Corporations: Reconsidered*, 9 WM. & MARY L. REV. 205 (1967). For a definition of a Western Hemisphere Trade Corporation, see notes 30-33 *infra*, and accompanying text.

is subject to none of the limitations of the express barriers. This novel use of section 482 appears to nullify the traditional defense to a section 482 reallocation that the transactions in issue were the equivalent of arm's length negotiations.⁶ In *Marc's Big Boy—Prospect, Inc.*⁷ the Tax Court sustained a reallocation of income under section 482 which effectively denied the benefit of multiple surtax exemptions to an integrated multi-corporate business enterprise. In order to effect such a denial, the Commissioner abandoned the transactional approach prescribed in the regulations for section 482 allocations,⁸ and attributed the entire gross income and deductions (in effect, the entire net income) of sixteen subsidiary retail corporations to a single parent-management corporation on the grounds that the parent had generated the income of the subsidiaries. Although the allocation of net income under section 482 in *Marc's Big Boy* was intended to deny multiple surtax exemptions to a multi-corporate domestic enterprise, the same approach might be used in another context, to deny different tax advantages to affiliated multinational corporations.⁹

Although broad brush reallocations under section 482 effectively eliminate possibilities of tax avoidance, such reallocations and, in particular, the court's implicit approval of the generation of income doctrine¹⁰ create substantial tax problems in both theory and practice. In resorting to broad brush reallocations the Commissioner by-passes several existing Code and regulation sections which provide at least a partial

⁶ Section 482 authorizes the Commissioner to allocate gross income, deductions, credits, or allowances among two or more entities controlled by the same interests in order to prevent tax evasion or to reflect clearly the income of any of the entities. INT. REV. CODE OF 1954, § 482. The purpose of section 482 is to place a controlled taxpayer on a parity with an uncontrolled taxpayer, by determining, according to the standard of an uncontrolled taxpayer, the true taxable income of a controlled taxpayer. The standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer. Treas. Reg. § 1.482-1(b) (1968).

⁷ 52 T.C. 1073 (1969).

⁸ Treas. Reg. § 1.482-2 (1968).

⁹ Although the generation of income doctrine under section 482 has not yet been the vehicle for allocating net income among affiliated multinational corporations, the Commissioner has enjoyed no small degree of success in reallocating the entire income of inert foreign subsidiaries under this section. See, e.g., *Philipp Bros. Chems., Inc. (N. Y.) v. Commissioner*, 435 F.2d 53 (2d Cir. 1970); *aff'g*, *Philipp Bros. Chems., Inc. (Md.)*, 52 T.C. 240 (1969); *United States Gypsum Co. v. United States*, 304 F. Supp. 627 (N.D. Ill. 1969), *rev'd on other grounds*, 71-2 U.S. Tax Cas. ¶ 9706 (1971).

¹⁰ Under the generation of income doctrine a taxpayer that designates an entity to perform services and exercises control over that entity is taxable upon income produced by such services. See notes 172-175 *infra*, and accompanying text.

remedy for tax avoidance resulting from multiple incorporation of an integrated business. Where international multi-corporate enterprises are concerned, the Commissioner's tack conflicts with the basic policy underlying taxation of multinational corporations—an allocation of the profits of the enterprise to effect a fair sharing of the tax revenues among the various countries touched by its business activities.¹¹ Therefore, the position of this Article is that the Commissioner should abandon the approach taken in *Marc's Big Boy* and confine his attack on multi-corporate abuse to existing provisions, focusing especially on section 269¹² where domestic enterprises are concerned and on the specific intercompany transactional regulations under section 482 where multinational enterprises are concerned. Should these provisions prove unequal to the task, the Service should seek a legislative or administrative remedy, rather than attempting to create an expansive judicial doctrine of reallocation under section 482.

THE IMPETUS FOR ALLOCATIONS: POTENTIAL TAX ADVANTAGES
OF OPERATING INTEGRATED BUSINESS ENTERPRISES
IN THE MULTI-CORPORATE FORM

Before discussing the various methods for reallocating income among affiliated corporations, it is necessary to consider the potential tax advantages that could accrue to such affiliated corporations if there were no vehicle for reallocating income. In this section, the potential tax advantages of operating an integrated business enterprise in the multi-corporate form are discussed. Since different advantages accrue to integrated domestic enterprises than to integrated multinational enterprises, the two will be discussed separately.

Advantages to Affiliated Domestic Corporations

The potential for multiple surtax exemptions arose in 1950 when Congress substituted for the graduated federal corporate tax rate a flat rate modified by a concession for small businesses.¹³ This concession took the form of a surtax exemption: whereas a normal tax of 22 percent is imposed on a corporation's entire taxable income,¹⁴ a surtax of 26

¹¹ See Surrey, *Treasury's Need to Curb Tax Avoidance in Foreign Business Through Use of 482*, 28 J. TAXATION 75 (1968) (hereinafter cited as Surrey).

¹² For a discussion of section 269, see notes 62-64 *infra*, and accompanying text.

¹³ S. REP. NO. 2375, 81st Cong., 2d Sess. 11 (1950), *reprinted in* 1950-2 CUM. BULL. 483, 492; S. REP. NO. 830, 88th Cong., 2d Sess. 148 (1964), *reprinted in* 1964-1 (Part 2), CUM. BULL. 505, 652; S. REP. NO. 91-552, 91st Cong., 1st Sess. 133 (1969).

¹⁴ INT. REV. CODE OF 1954, § 11(b)(2).

percent is imposed only on its taxable income in excess of \$25,000.¹⁵ At the time it enacted the new law Congress expressed concern that the surtax might be abused by an integrated multi-corporate business enterprise. Congress, however, felt that the predecessors to sections 269 and 482 would prevent such enterprises from fragmenting their functions into multiple corporations and thus avoiding income tax.¹⁶ Significantly, Congress focused on the taxpayer's intent regarding tax avoidance, and not on the size of the corporate structure involved.

The House was not convinced that Congress had dealt properly with the problem of multiple surtax exemptions, and the very next year it proposed to eliminate such exemptions for corporations so closely associated that they constituted a single business.¹⁷ The Senate rejected the House proposal on the grounds that there existed valid business purposes for the multi-corporate structure, primarily in the area of business expansion.¹⁸ Perhaps because section 269 had proven inadequate to prevent abuse of the surtax exemption, the House and Senate compromised their differences by including the predecessor to section 1551 in the Revenue Act of 1951.¹⁹ The Joint Committee, however, did not intend this provision to prohibit or even discourage the formation of additional corporations for the purpose of expanding an existing integrated business or engaging in different businesses; rather, the thrust of the provision was at the fragmentation of an existing business.²⁰

Although Congress, during debate on the Revenue Act of 1964, acknowledged that the intent to engage in the same business in different geographic locales, or in different businesses in the same locale might

¹⁵ *Id.* at §§ 11(c) (3) and 11(d).

¹⁶ S. REP. NO. 2375, 81st Cong., 2d Sess. 70-72 (1950), *reprinted in* 1950-2 CUM. BULL. 483, 533-34.

¹⁷ H. REP. NO. 586, 82d Cong., 1st Sess. 23-24 (1951), *reprinted in* 1951-2 CUM. BULL. 357, 374.

¹⁸ S. REP. NO. 781, 82d Cong., 1st Sess. 67-69 (1951), *reprinted in* 1951-2 CUM. BULL. 458, 506-07.

¹⁹ Section 1551 authorizes the Commissioner to disallow a corporation's surtax exemption if (1) another corporation or five or fewer individuals transfer property to that corporation, (2) the transferee corporation was established for the purpose of acquiring such property or was not actively engaged in business at the time of the acquisition, and (3) the transferors control the transferee corporation following the transfer, unless the transferee corporation can establish by a clear preponderance of the evidence that the securing of the exemption was not a major purpose of the transfer. INT. REV. CODE OF 1954, § 1551.

²⁰ JOINT COMMITTEE STAFF, 82D CONG., 1ST SESS., SUMMARY OF PROVISIONS OF THE REVENUE ACT OF 1951, *reprinted in* 1951-2 CUM. BULL. 287, 303-04.

be a valid business purpose for multiple incorporation,²¹ it ignored this factor in limiting the availability of multiple surtax exemptions to controlled multiple corporations. For such a controlled group of corporations Congress limited the privilege of electing multiple surtax exemptions by imposing a 6 percent penalty on the first \$25,000 of each controlled corporation's income.²² Congress hoped this measure would discourage multiple incorporation.²³ In fact, multi-corporate enterprises²⁴ proliferated. Moreover, the business purposes of expansion and geographic dispersion proved potent defenses to attacks on multiple incorporation under section 269 and 1551.²⁵ Consequently, in 1969, Congress, admitting that large businesses had received considerable tax benefits through the use of the surtax exemption,²⁶ carried the approach first taken in 1964 to its logical conclusion by eliminating all multiple surtax exemptions for controlled corporations whether or not the multi-corporate structure had been chosen for valid business reasons.²⁷ After a transitional period during which the benefits to be derived from such exemptions will decrease steadily²⁸ members of a controlled group of corporations will be entitled to only one \$25,000

²¹ S. REP. NO. 830, 88th Cong., 2d Sess. 149-50 (1964), *reprinted in* 1964-1 CUM. BULL. 505, 653-54.

²² INT. REV. CODE OF 1954, § 1562, repealed effective for taxable years beginning after December 31, 1974, by Pub. L. No. 91-172, § 401 (a) (2). *See* INTERNAL REVENUE CODE OF 1954, § 1563(a) (definition of a controlled group of corporations).

²³ S. REP. NO. 830, 88th Cong., 2d Sess. 150 (1964), *reprinted in* 1964-1 CUM. BULL. 505, 654.

²⁴ *See* JOINT PUBLICATION COMMITTEE ON WAYS AND MEANS AND COMMITTEE ON FINANCE, 91ST CONG., 1ST SESS., TAX REFORM STUDIES AND PROPOSALS (Part 2) 242 (Comm. Print 1969) (hereinafter cited as Johnson Tax Reform Proposals); Tax Reform Proposals contained in the Message From the President of April 21, 1969, and presented by Representatives of the Treasury Department, 91st Cong., 1st Sess. 51 (Comm. Print 1969) (hereinafter cited as Nixon Tax Reform Proposals).

²⁵ *See* note 66 *infra*.

²⁶ S. REP. NO. 91-552, 91st Cong., 1st Sess. 133-34 (1969), *reprinted in* 1969-3 CUM. BULL. 423, 508-09.

²⁷ *Id.* at 134, *reprinted in* 1969-3 CUM. BULL. at 509.

²⁸ The act provides a five-year period during which each extra surtax exemption will be reduced by \$4,167 per year. INT. REV. CODE OF 1954, § 1564 (a) (1) (A). It should be noted that the 6% penalty tax on election of multiple surtax exemptions will apply only to the reduced exemptions. Thus the maximum tax value of such surtax exemptions during this period will be approximately \$4,006 for 1970; \$3,333 for 1971; \$2,500 for 1972; \$1,666 for 1973; and \$833 for 1974. Eustice, *Corporations and Corporate Investors*, 25 TAX L. REV. 509, 561 (1970). After December 31, 1974, of course, the 6% penalty provision of section 1562(b) will be inoperative. *See* note 22 *supra*.

surtax exemption.²⁹ But procedural delay in audit, litigation and appellate review, and the resourcefulness of taxpayers in avoiding classification as a controlled group of corporations will make the issue of multiple surtax exemptions a live issue in the tax law throughout most of this decade.

Advantages to Affiliated Multinational Corporations

The income attributed to a Western Hemisphere Trade Corporation (WHTC) is taxed at 14 percentage points below the normal corporate rate. The WHTC provisions,³⁰ however, contain their own limitations on the allocation of income. In order to qualify as a WHTC for a taxable year, a domestic corporation must carry on all of its business, other than incidental purchases, in the Western Hemisphere;³¹ for the preceding three years it must have derived 95 percent of its gross income from sources without the United States;³² and it must derive at least 90 percent of its gross income from the active conduct of a trade or business.³³ There is, however, no analogue to section 1551 that provides for disallowance of a WHTC's tax preference in certain transactions where tax avoidance was a major purpose. Furthermore, the Service has ruled that creation of a WHTC to obtain the attendant preferential tax treatment does not constitute such tax avoidance that, under section 269, would permit the Commissioner to disallow tax benefits.³⁴ Consequently, section 482, if no more than by default, has come to be the only tool the Service has to prevent abuse of this preference. In the past, however, the Service has been able to eliminate the tax benefits of WHTC's, as contrasted with diluting them through

²⁹ INT. REV. CODE OF 1954, § 1561 (applicable to taxable years beginning after December 31, 1963).

³⁰ INT. REV. CODE OF 1954, §§ 921-922.

³¹ Treas. Reg. § 1.921-1 (a) (1957) (5% safehaven). See *Otis Elevator Co. v. United States*, 301 F.2d 320 (Ct. Cl. 1962); *Topps of Canada, Ltd.*, 36 T.C. 326 (1961).

³² INT. REV. CODE OF 1954, §§ 861-864.

³³ Little guidance is provided in the regulations as to what constitutes the active conduct of a trade or business for the purposes of section 921. There is some question whether the development under identical language in other provisions, such as INT. REV. CODE OF 1954, §§ 274, 346, 355, 761, 864 (c) (4) (B) (i) 931, 954 (c), 1372 (e) (5) (B) (i), and 4914 (a) (6), is relevant. See *Parshelsky's Estate v. Commissioner*, 303 F.2d 14 (2d Cir. 1962). See generally B. BITTKER & L. EBB, *UNITED STATES TAXATION OF FOREIGN INCOME AND FOREIGN PERSONS* 365 (2d ed. 1968) (hereinafter cited as BITTKER & EBB).

³⁴ Rev. Rul. 70-238, 1970-1 CUM. BULL. 61.

partial 482 reallocations,³⁵ only when the WHTC was totally "inert"³⁶ or bore no economic risk at all in the foreign sale.³⁷

The basis for the preferential tax treatment of foreign affiliates is that the United States taxes foreign corporations only on their income from United States sources.³⁸ Until 1962 the United States taxed domestic shareholders on such foreign source income (to the extent the United States rate was above that applicable in the foreign country)³⁹ only when it was repatriated, commonly as dividends or liquidation distributions.⁴⁰ The effect was "tax deferral."⁴¹ In 1962 Congress enacted Subpart F to limit the benefits of tax deferral for multi-corporate integrated production-export business enterprises. The United States now taxes a domestic shareholder⁴² on his undistributed pro rata share of the profits⁴³ of a controlled foreign corporation,⁴⁴ if such corporation is organized in one foreign country—the "base country"⁴⁵—but manufactures, in a second foreign country, goods that are sold to an affiliated foreign corporation in a third country.⁴⁶ Because the provisions were aimed at the elimination of artificial stimulation of foreign investment through segregation of the largest portion of the profit in a "tax haven" country rather than in the countries of origin and destination,⁴⁷ an administrative exception is available if the base coun-

³⁵ See, e.g., *Baldwin-Lima-Hamilton Corp. v. United States*, 435 F.2d 182 (7th Cir. 1970); cf. *Johnson Bronze Co.*, 34 P-H Tax Ct. MEM. 1689 (1965).

³⁶ *Philipp Bros. Chems., Inc. (N.Y.) v. Commissioner*, 435 F.2d 53 (2d Cir. 1970).

³⁷ *United States Gypsum Co. v. United States*, 304 F. Supp. 627, 640 (N.D. Ill. 1969), *rev'd on other grounds*, 71-2 U.S. Tax Cas. ¶ 9706 (1971).

³⁸ INT. REV. CODE of 1954, §§ 881-82.

³⁹ A domestic corporation owning at least 10% of the voting stock of a foreign corporation may elect to be treated as if it paid foreign income taxes in the same proportion as the dividends received from accumulated profits bear to the after-tax accumulated profits of the foreign subsidiary. INT. REV. CODE of 1954, §§ 901 (a), 902 (a).

⁴⁰ A significant exception to this rule occurs when the corporation is a foreign personal holding company. INT. REV. CODE of 1954, §§ 1551-58.

⁴¹ S. REP. No. 1881, 87th Cong., 2d Sess. 84 (1962), *reprinted in* 1962-3 CUM. BULL. 707, 784.

⁴² INT. REV. CODE of 1954, § 951 (a).

⁴³ *Id.* at §§ 953 (a) (2), 954.

⁴⁴ *Id.* at § 957. Control consists of more than 50% ownership of the total combined voting power of all classes of voting stock by United States shareholders.

⁴⁵ *Id.* at § 954 (d); see Pine, *Foreign Base Companies Involved in Selling*, N.Y.U. 21ST INST. ON FED. TAX. 881, 882-83 (1963). The base country is typically a tax haven jurisdiction. See S. REP. No. 1881, 87th Cong., 2d Sess. 84 (1962), *reprinted in* 1962-3 CUM. BULL. 707, 784.

⁴⁶ INT. REV. CODE of 1954, §§ 952(a)(3), 954(a)(2), 954(d).

⁴⁷ See BITTKER & EUSTICE, *supra* note 2, at 265; S. REP. No. 1881, 87th Cong., 2d Sess. (1962), *reprinted in* 1962-3 CUM. BULL. 707, 790.

try's effective tax rate is 90 percent, or within 5 percentage points, of the effective tax rate of the country of destination or of production, whichever is lesser.⁴⁸

Thus, as long as taxes are paid at an effective rate equal to that of country of destination, the United States shareholder can still defer domestic taxation, while paying only foreign taxes which may be minimal. Consequently, regarding many international integrated businesses, there will exist a powerful incentive for the Commissioner to allocate income to the non-preferentially taxed domestic corporation at the expense of the preferentially taxed foreign corporations. Section 482 again would be the primary means for this allocation.⁴⁹ Nevertheless, an allocation of the entire profit of the foreign corporations to the domestic corporation would conflict with the policy underlying the application of section 482 to international business transactions, which is to allocate income to effect a fair sharing of tax revenues among the various countries touched by the activities of the entire business enterprise.⁵⁰

ALLOCATING INCOME AMONG AFFILIATED CORPORATIONS TO PREVENT TAX ABUSE: THE POSSIBLE APPROACHES

Provisions Other Than Section 482

As we have seen, section 482 is the only provision available to the Commissioner to allocate income among the corporate components of a multinational enterprise. There are, however, alternatives to section 482 where multi-corporate domestic enterprises are concerned. What follows is an analysis of these alternative means of preventing tax avoidance through use of affiliated corporations.

Section 1561

The Tax Reform Act of 1969 amended section 1561 of the Internal Revenue Code to limit tax avoidance through the use of multiple surtax exemptions. Focusing on the extent of common control over the

⁴⁸ Treas. Reg. § 1.954-1 (b) (3) (iii) (1964). This "safe haven" is designed to implement section 954 (b) (4), which provides an exception for a controlled foreign corporation not availed of to reduce taxes.

⁴⁹ One of the purposes of section 482 is to prevent shifting of income to foreign entities where it escapes domestic taxation. H. REP. NO. 350, 67th Cong., 1st Sess. 44 (1921), *reprinted in* 1939-1 CUM. BULL. 168.

⁵⁰ Surrey, *supra* note 11, at 76.

various corporate components of an enterprise, Congress decreed that a "controlled group of corporations" would be entitled to only one surtax exemption.

The term "controlled group of corporations" encompasses three categories of affiliation: [1] a parent-subsidary controlled group, [2] a brother-sister controlled group, and [3] a combined group.⁵¹ A parent-subsidary controlled group consists of one or more chains of corporations connected with a common parent corporation which owns 80 percent or more of the stock of the subsidiaries. Ownership is measured by voting power or stock value.⁵² A brother-sister controlled group exists when five or fewer individuals, estates or trusts ("persons"), own at least 80 percent of the voting stock or value of shares of each of two or more corporations, provided that the same five or fewer persons own more than 50 percent of the voting stock or value of shares of each corporation, considering stock owned by a particular person only to the extent that it is owned identically in each of the corporations.⁵³ A combined group exists when three or more corporations are members of a parent-subsidary group or a brother-sister group and one of the three is a common parent corporation.⁵⁴

Although the definition of a controlled group is precise, there are a number of provisions that make the limitations of section 1561 less easy to avoid in the parent-subsidary context than would seem readily apparent. For example, measuring ownership by value, as well as voting power, may cause related corporations to be classed as a parent-subsidary controlled group, even though the parent owns less than eighty percent of the subsidiary's voting stock, since control has a positive effect on the fair market value of each share in controlling block of shares.⁵⁵ Furthermore, if any voting or transfer restrictions are imposed either by the law or by agreement on the minority stock, then its value is depressed.⁵⁶ In addition, the voting rights of the restricted stock may in certain circumstances be attributed to the major-

⁵¹ INT. REV. CODE OF 1954, § 1563(a).

⁵² *Id.* at § 1563(a)(1).

⁵³ *Id.* at § 1563(a)(2).

⁵⁴ *Id.* at § 1563(a)(3).

⁵⁵ See Treas. Reg. §§ 20.2031-2(f) and (2)(e); Rev. Rul. 67-54, 1967-1 CUM. BULL. 269, 270; Rev. Rul. 59-60, § 4.02(g), 1959-1 CUM. BULL. 237, 241-42. But where there is no market for sale of the stock and no good will so that a purchaser would be interested only in the underlying assets, the value may only be a proportionate share of the underlying assets. See *Harry Trotz*, 36 P-H TAX CT. MEM. 687 (1967) (§ 1239 Case).

⁵⁶ Cf. *United States v. Parker*, 376 F.2d 402 (5th Cir. 1967) (Section 1239, 80% in value test).

ity stockholder.⁵⁷ Finally, Congress also defined the term "stock" for the purposes of determining the existence of a controlled group as a word of art in order to limit obvious tax avoidance.⁵⁸

On the other hand, through careful tax planning, brother-sister groups can avoid classification as a controlled group of corporations and thereby enable an enterprise to take advantage of multiple surtax exemptions. The crucial tax planning aspect in brother-sister groups is that the 50-percent test is met only if the same five or fewer persons who own 80 percent of the stock of the corporations in question also own more than 50 percent of the voting stock or value of the shares of each corporation, considering stock owned by a particular person only to the extent that it is owned identically in each corporation.⁵⁹ For example, if a person owns 90 percent of the voting stock of one corporation and 40 percent of another, he would be considered as owning only 40 percent of both corporations for the 50 percent test. The following examples illustrate the tax planning possibilities:

Example 1:

Individuals	Corporations			Identical Ownership
	X	Y	Z	
A	25%	25%	30%	25%
B	30%	25%	25%	25%
C	25%	30%	25%	25%
Total	80%	80%	80%	75%

⁵⁷ Treas. Reg. § 1.1563-1(a)(6) (1965).

⁵⁸ Stock does not include nonvoting preferred stock, INT. REV. CODE of 1954, § 1563(c)(1)(A), which Congress felt more closely approximates debt than an equity interest, S. Rep. No. 830, 88th Cong., 2d Sess. 151 (1964), *reprinted in* 1964-1 CUM. BULL. 505, 565. Neither does stock include treasury stock, which from the standpoint of ownership constitutes unissued stock, INT. REV. CODE of 1954, § 1563(c)(1)(B). Certain other stock is deemed "excluded" stock and is treated as if it were not outstanding in order to prevent neutralization of the controlled group definitions without actual relinquishment of the benefits of corporate control. Treas. Reg. § 1.1563-2(b)(2) (1965). Where a parent corporation owns 50% or more of the voting power or value of the stock of the subsidiary, stock of the subsidiary is deemed "excluded stock" if owned by [1] individuals who are 5% shareholders or officers of the parent corporation; [2] employees of the subsidiary, if the stock is subject to substantial restrictions which favor the parent or subsidiary corporation; [3] trusts which are a part of a plan of deferred compensation for the benefit of the employees of either the parent or subsidiary corporations; or [4] exempt organizations which are controlled directly or indirectly by the parent or subsidiary corporations or any combination thereof. INT. REV. CODE of 1954, § 1563(c)(2)(A)(i) to (iv).

⁵⁹ INT. REV. CODE of 1954, § 1563(a)(2)(B).

Example 2:

Individuals	Corporations			Identical Ownership
	X	Y	Z	
A	10%	50%	20%	10%
B	50%	20%	10%	10%
C	20%	10%	50%	10%
Total	80%	80%	80%	30%

In Example 1, X, Y, and Z are members of a controlled group, since A, B, and C own eighty percent of each corporation, and the aggregate identity of ownership in each corporation is greater than fifty percent. In Example 2, however, X, Y, and Z are not members of a controlled group. Even though A, B, and C own the same percentage (26.67 percent) of the aggregate enterprise as in Example 1, the aggregate identity of ownership does not exceed fifty percent.

The purpose of the 50-percent test is to confine the brother-sister controlled group classification "to those cases where the five or fewer individuals hold their 80 percent in a way which allows them to operate the corporations as one economic entity."⁶⁰ If, as in Example 2, taxpayers are able to avoid the 50-percent test and still operate a single, integrated business enterprise further legislative changes may be in order. A simple response would be to eliminate the surtax exemption for all corporations. Another solution would provide a more complex statutory definition for a controlled group that would include all functionally integrated enterprises. Meanwhile, where an integrated multi-corporate enterprise manages to avoid classification as a brother-sister controlled group, the Commissioner will be tempted to resort to section 482 to prevent abuse of the multiple surtax exemption.

Sections 269 and 1551

Sections 269 and 1551 provide means for the denial of multiple surtax exemptions in years prior to the effective date of section 1561 and in situations where the taxpayer has avoided the definition of a controlled group. Section 269 grants the Commission the power to disallow tax benefits when tax avoidance is the principal purpose for the acquisition of control of a corporation or for the tax-free acquisition of one

⁶⁰ Johnson Tax Reform Proposals, *supra* note 24, at 245.

corporation's assets by a previously unrelated corporation.⁶¹ Nevertheless, the effectiveness of section 269 as an antedote to abuse of the multiple surtax exemption has evolved slowly and even today is of limited potency.

Before the initial surtax exemption legislation, the Tax Court had interpreted section 269 to deny tax benefits only to persons who attempted to acquire those benefits by acquiring control of the corporation which earned them;⁶² thus section 269 was not originally available to prevent abuse of the surtax exemption by multi-corporate enterprises, since technically it was the acquired corporation which continued to enjoy the exemption. But by the late 1950's, courts, including the Tax Court, had reassessed their position on the applicability of section 269 and uniformly held that it reaches the acquired corporation's tax benefits—including the surtax exemption.⁶³

A second limitation on applying section 269 to prohibit multiple surtax exemptions was in assessing the tax avoidance motive of the acquisition. The courts usually gave decisive weight to any reasonable business excuse posited by the taxpayer; thus multi-corporate enterprises could generally be justified under the principal purpose test of section 269.⁶⁴ This problem was partially ameliorated by the Revenue Act of 1951, which included the predecessor of section 1551, that expressly applied to surtax exemptions and under which the tax avoidance purpose had only to be a major purpose for multiple incorporation.⁶⁵ Nevertheless, the courts continued to accept business reasons for multiple corporations in expanding businesses.⁶⁶ The result was that sections 1551

⁶¹ Control here consists of at least 50% ownership of total combined voting power of all classes of voting power or of the total value of shares of all classes of stock. INT. REV. CODE OF 1954, § 269(a).

⁶² *Alprosa Watch Corp.*, 11 T.C. 240 (1948).

⁶³ *Coastal Oil Storage Co. v. Commissioner*, 242 F.2d 396 (4th Cir. 1957); *accord*, *Joe (Joseph) Dillier*, 41 T.C. 762 (1964), *aff'd sub nom. Made Rite Inv. Co. v. Commissioner*, 357 F.2d 647 (9th Cir. 1966).

⁶⁴ See BITTKER & EUSTICE, *supra* note 2, at 638. D. HERWITZ, BUSINESS PLANNING 170-72 (1966) (hereinafter cited as HERWITZ).

⁶⁵ See notes 19-20 *supra*, and accompanying text.

⁶⁶ See BITTKER & EUSTICE, *supra* note 2, at 677-78; HERWITZ, *supra* note 64, at 180-81. Apart from traditional business purposes for multiple corporations, an integrated business enterprise may avail itself of one of the following business purposes expressly sanctioned by Congress: [1] expansion of business, [2] engaging in the same business in different geographic locales, and [3] conducting different business in the same area.

The leading case on the "expansion of business" purpose is *Tidewater Huls, Inc. v. United States*, 68-1 U.S. Tax Cas. ¶ 9405, 21 Am. Fed. Tax R.2d 1444 (E.D. La. 1968). See also *Delhar, Inc. v. United States*, 71-1 U.S. Tax Cas. ¶ 9107, 26 Am. Fed. Tax R.2d 70-5888 (S.D. Fla. 1970); *Hardin v. United States*, 70-2 U.S. Tax Cas. ¶ 9676, 26 Am.

and 269 became virtually indistinguishable in the area of multiple surtax exemptions.⁶⁷ In sum, under the existing case law most integrated businesses that have expanded a corporation or several corporations at a time will be able to withstand the Commissioner's attack under sections 269 and 1551, despite the fact that the entire integrated business is not a small one.

Section 61

Under the aegis of section 61⁶⁸ courts have fashioned the "sham doctrine," under which a corporation is recognized for tax purposes only if it is a viable business entity. Courts have ruled that to meet this criterion a corporation must be formed for a substantial business purpose, or engage in substantive business activities.⁶⁹ If a corporation is not a viable business entity, it is a sham and its income is taxed to the enterprise that actually earned it or otherwise created the right to receive it.⁷⁰

Although courts once held that the business activity test was satisfied if a corporation transacted a single item of business,⁷¹ the Tax

Fed. Tax R.2d 70-5852 (S.D. Miss. 1970); *Interior Sec. Corp.*, 38 T.C. 330, 339 (1962). Where expansion is not available as a business purpose for multiple incorporation of an integrated enterprise, courts have been reluctant to find that the principal purpose was not tax evasion. See, e.g., *Joe (Joseph) Dillier*, 51 T.C. 762 (1964), *aff'd sub nom. Made Rite Inv. Co.*, 357 F.2d 647 (9th Cir. 1966). For examples of cases in which the courts have approved of the multi-corporate form for operating the same type of business in different geographic locales, see *Louisville Store of Liberty, Ky., Inc. v. United States*, 376 F.2d 314 (Ct. Cl. 1967), and *Southern Canteen Co. v. Commissioner*, 410 F.2d 615 (6th Cir.), *cert. denied*, 396 U.S. 833 (1969). Moreover, even in a case in which the court found that the taxpayer's principal reason for multiple incorporation was tax evasion, it allowed an integrated enterprise, composed of eighteen corporations, three surtax exemptions on the grounds that by operating in three separate geographic areas it constituted three separate taxable entities. *Atlas Storage Co. v. United States*, 306 F. Supp. 570 (S.D.W.Va. 1969), *aff'd per curiam*, 437 F.2d 1319 (4th Cir. 1971).

⁶⁷ See Eustice, *Tax Problems Arising From Transactions Between Affiliated or Controlled Corporations*, 23 TAX L. REV. 451, 457 (1968); BITTKER & EUSTICE, *supra* note 2, at 679. However, each of these sections does cover situations the other does not: Section 269 has a 50% control test as contrasted with the 80% test under section 1551.

⁶⁸ INT. REV. CODE OF 1954, § 61.

⁶⁹ See *Perry Bass*, 50 T.C. 595, 600 (1968), and cases cited therein.

⁷⁰ HERWITZ, *supra* note 64, at 181; BITTKER & EUSTICE, *supra* note 2, at 16, 17.

⁷¹ *Herbert v. Riddell*, 103 F. Supp. 369 (S.D. Cal. 1952). See generally Note, *Multiple Incorporation to Obtain Additional Accumulated Earnings Credits and Surtax Exemptions*, 44 MINN. L. REV. 485, 490 n. 24 (1960) (hereinafter cited as Note, *Multiple Incorporation*).

Court in *Aldon Homes*⁷² ruled that the corporation's activity must substantially produce the income in question. There, the shareholders of a real estate management corporation formed sixteen additional corporations (commonly referred to as alphabet corporations because the initial letters of their names formed an acronym) to acquire residential lots from the management corporation. The Tax Court disregarded the sixteen title holding corporations as shams, and allocated the net profits that they had reported to the management corporation.

In several subsequent decisions involving real estate multiple corporations, or alphabet corporations, the courts relied on the presence of an "integrated business" in applying the sham doctrine. In these cases, however, the courts used the term to refer to an enterprise in which only one of the related corporations carried on substantial business activities, rather than as a reference to a functionally divided business.⁷³ In other words, the existence of a single integrated business connoted a single taxpayer only because the other entities were shams. Therefore, if in a functionally integrated enterprise each corporation carries on substantive business activities, the sham doctrine in its classic form would not authorize the Commissioner to disregard the component corporations and tax their reported income to the management corporation.

* * * *

As we have seen in this part, neither sections 1561, 1551, or 269, nor the sham doctrine under section 61 provides a dependable means for reallocating income among the corporate components of a multi-corporate business enterprise. Thus, whether the enterprise involved is domestic or multi-national, the Commissioner may be forced to resort to section 482 if he wishes to reallocate income.

Allocating Income Under Section 482

The Prelude to Marc's Big Boy: Allocation of Net Income

Section 482 authorizes the Commissioner to allocate gross income, deductions, credits and allowances among businesses controlled by the same interests⁷⁴ to prevent tax evasion or to reflect income correctly.

⁷² *Aldon Homes, Inc.*, 33 T.C. 582 (1959).

⁷³ See *Kessmar Constr. Co.*, 39 T.C. 778 (1963) *aff'd on other grounds*, 336 F.2d 865 (9th Cir. 1964); *Henry S. Alper*, 31 P-H TAX CT. MEM. 215 (1962).

⁷⁴ Control under section 482 differs from the mechanical test of control for the purpose of controlled foreign corporations (see note 44 *supra*), sections 1551 and 1561 (see notes 52 and 53 *supra*) and 269 (see note 61 *supra*). It is "any kind of control,

In order to utilize section 482 as a device to eliminate the advantages of multiple surtax exemptions, the Commissioner must allocate effectively the *entire net income* of one corporation to another.⁷⁵ Since the purpose of section 482 is to keep transactions between controlled enterprises the equivalent of arm's length dealings between uncontrolled taxpayers,⁷⁶ it presupposes recognition of separate entities.⁷⁷ Indeed, the regulations under section 482 provide that the section is not intended to "produce a result equivalent to a computation of consolidated taxable income" ⁷⁸ Yet to invoke section 482 to deny the benefit of a surtax exemption through the reallocation of net income, the Commissioner, in effect, must ignore the existence of the corporation that reported the income or consolidate the income of the corporations in question.⁷⁹ Because of the theoretical inconsistency involved in net income allocations under section 482, the Tax Court, in a long line of cases exemplified by *Chelsea Products, Inc.*,⁸⁰ refused to sustain such allocations of the net income of a group of corporations to a single member.

direct or indirect, whether legally enforceable, and however exercisable or exercised." Treas. Reg. § 1.482-1(a)(3) (1968); See generally Seieroe & Gerber, *Section 482—Still Growing at the Age of 50*, 46 TAXES 893, 897-98 (1968) (hereinafter cited as Seieroe & Gerber).

⁷⁵ Although 482, unlike sections 269 and 1551, does not authorize the disallowance of surtax exemptions, a reallocation of all the net income from one profitable corporation to another under section 482 may accomplish the same monetary result as a disallowance of surtax exemptions under sections 269 or 1551. *Challenger, Inc.*, 33 P-H Tax Ct. Mem. 2315 (1964). Note that an allocation of entire gross income and deductions effectively constitutes an allocation of entire net income.

⁷⁶ Treas. Reg. § 1.482-2(b) (1968). See generally Pomeroy, *Allocation of Income, Deductions, Credits, and Allowances Among Related Taxpayers*, 15 CASE W. RES. L. REV. 250, 252 (1964) (hereinafter cited as Pomeroy). It has been held that this is not the sole standard under section 482. See *Eli Lilly Co. v. United States*, 372 F.2d 999 (Ct. Cl. 1967).

⁷⁷ See, e.g., *Advance Mach. Exch., Inc. v. Commissioner*, 196 F.2d 1006, 1008 (2d Cir.), cert. denied, 344 U.S. 835 (1952); *Challenger, Inc.*, 33 P-H Tax Ct. Mem. 2315 (1964).

⁷⁸ Treas. Reg. § 1.482-1(b)(3) (1962). This provision resulted from § 482's original express authorization for the "consolidation of accounts," but when the consolidated returns provisions were deleted in 1928, section 482 was amended accordingly and the express power to consolidate the accounts was never brought back into the provision. See Mortenson, *The Multiple Attack on Multiple Corporations*, 35 TAXES 647, 651 (1957) (hereinafter cited as Mortenson).

⁷⁹ See Eustice, *supra* note 67, at 484; Hoefs, *Intercompany Operations: Joint Use of Employees, Services, Plant, Equipment and Intangibles*, N.Y.U. 28TH INST. ON FED. TAX. 603, 613-14 (1970) (hereinafter cited as Hoefs).

⁸⁰ 16 T.C. 840 (1951), *aff'd*, 197 F.2d 620 (3d Cir. 1952); *accord*, *T.V.D. Co.*, 27 T.C. 879 (1957).

The first crack in the dike of the Tax Court's prohibition against allocation of net income was made in *Ballentine Motor Co.*⁸¹ There two corporations transferred valuable inventories at fair value to a related corporation having accumulated losses. Then, after the transferee sold sufficient inventory to utilize the losses,⁸² it transferred the remaining inventory back to the transferor corporations. The court asserted that the allocation of net income was a proper method to accomplish the purposes of section 482:

[N]et income may in certain instances be properly allocated under . . . section 482. If net profits are shifted (one device at which the statute was specifically directed), it would be a logical short cut to allocate them instead of allocating 'gross income, deductions, credits, [etc.].' * * * * The statute allows allocation of gross income and deductions, and to the extent this is permitted we believe it may be done as "net income."⁸³

The court distinguished cases such as *Chelsea* principally on the ground that they rested on findings that a tax avoidance scheme was not the primary motive of the transactions. According to the *Ballentine* court the taxpayer would have prevailed had the sales been bona fide. The court, however, found that the *primary* object of the transfer was to evade taxes by shifting anticipated profits from the corporation to which they should be allocated; thus section 482 was available to allocate the net profits to the transferor corporation. Significantly, in *Ballentine* the facilities and employees of the profitable corporations were transferred without consideration to the loss corporation.⁸⁴ These facts coupled with the round-robin exchange of checks through which the sale of inventory was accomplished led commentators to the conclusion that the loss corporation did no more than procure title to the inventory. Therefore, the sale was in actuality a sham.⁸⁵

The dike cracked in *Ballentine* was utterly breached in *Hamburgers*

⁸¹ 39 T.C. 348, *aff'd*, 321 F.2d 796 (4th Cir. 1963).

⁸² Transfer of income producing inventory to a controlled corporation in order to match pre-acquisition losses with income is indicative that the principal purpose for acquiring control was evasion or avoidance of Federal income tax. Treas. Reg. § 1.269-3(h) (1) (1962).

⁸³ 39 T.C. at 358.

⁸⁴ *Id.* at 359.

⁸⁵ Plumb & Kapp, *Reallocation of Income and Deductions Under Section 482*, 41 TAXES 809, 819 (1963) (hereinafter cited as Plumb & Kapp); see Pomeroy, *supra* note 76, at 264 n. 69.

*York Road, Inc.*⁸⁶ The shareholders of a highly successful, long established men's store (brother corporation) organized a separate sister corporation to operate a suburban store. The brother corporation did not make a formal transfer of assets to its sister corporation as in *Ballentine*, but the operation of the sister corporation was substantially the function of the brother corporation. The same directors and officers managed both corporations. Although the suburban store had its own sales personnel and buyer for men's clothing, the brother's employees conducted the sister's advertising, purchased most of the sister's general merchandise, supervised the sister's display and sales, maintained the sister's telephone service, and made the sister's bank deposits. In addition, the brother corporation factored the sister's accounts receivable at one and one-half percent, though the commercial rate was nine percent. Based on all of these factors the Tax Court found no business purpose for the sister corporation's existence. Furthermore, it found that there would have been no substantial difference in operations had the brother corporation operated the suburban store as a division. Therefore, the court concluded that the principal purpose for the separate incorporation of the suburban sister was the evasion of federal income tax by securing an additional surtax exemption.

Asserting that the existence of common control was insufficient in itself to invoke section 482, the court declared that the Commissioner must also establish that the brother corporation did not deal with the sister at arm's length, "as one uncontrolled corporation would have dealt with another uncontrolled corporation."⁸⁷ The Tax Court found that the taxpayer did not meet the arm's length standard because in a sale to an unrelated party of the right to use its goodwill, trade name, experienced buying and selling organizations, customer lists, and advertising format the taxpayer would have charged the vendee its total profits.⁸⁸ In other words, the court felt that the net income of the sister corporation was produced by these intangibles.⁸⁹ Therefore, to prevent

⁸⁶ 41 T.C. 821 (1964).

⁸⁷ *Id.* at 837; see Treas. Reg. § 1.482-1(b)(1) (1968).

⁸⁸ These items come within the transfer or use of intangible property provisions of the section 482 regulations. Treas. Reg. §§ 1.482-2(d)(1), and 1.482-2(d)(3). Where there is no "bona fide cost sharing arrangement," Treas. Reg. § 1.482-2(d)(4), the arm's length charge is determined in general (where no sufficiently similar transaction involving an unrelated party can be found) on the basis of a host of factors provided in Treas. Reg. § 1.482-2(d)(2)(iii). See generally Jenks, *Treasury Regulations Under Section 482*, TAX LAWYER 279, 302-06 (1970).

⁸⁹ For a clear articulation of this approach, see *Pacific Northwest Food Club, Inc.*, 33 P-H Tax Ct. Mem. 32, 37 (1964).

tax evasion and to reflect fairly the income of the single integrated business the court sustained the reallocation of the entire net income of the sister corporation.

Although the *Hamburgers York Road* court, like the *Ballentine* court, reasoned in terms of tax avoidance, in fact, *Hamburgers* went far beyond *Ballentine*, since the sister corporation in *Hamburgers* was not a complete sham, but had employees and facilities which arguably produced at least some of the net income of the integrated enterprise. Thus, the point of focus is the allocation of the *entire* net income where the entity reporting the income has its own employees and facilities. Several cases decided immediately after *Hamburgers York Road* did reallocate the entire net income of a controlled taxpayer, but in each instance the personnel of the corporation to which the income was attributed in fact produced the income,⁹⁰ and the corporate shell from which the income was allocated was a sham. On the other hand, a triad of Tax Court decisions handed down after *Hamburgers York Road* made only a partial allocation of net income where the entity reporting the income was not a complete sham, but paid employees who performed services producing part of the net income in question.⁹¹ Consequently, *Hamburgers York Road* potentially represented the high water mark in reallocation of net profits, and future development might have followed the ebb manifested by partial allocation of net income where the controlled taxpayer had its own employees and facilities.⁹²

Marc's Big Boy-Prospect

In *Marc's Big Boy-Prospect, Inc.*⁹³ the Tax Court looked beyond the actual transactions between controlled entities to the nature of the business relationship.⁹⁴ The case arose in the following factual context. A parent corporation obtained a nationally known restaurant franchise covering a multi-state area. The franchise agreement placed extensive advisory duties upon the franchisor in exchange for a fixed percentage of gross income. The parent then entered into subfranchise agreements

⁹⁰ See *Charles Town, Inc. v. Commissioner*, 372 F.2d 415 (4th Cir. 1967); *J. R. Land Co. v. United States*, 361 F.2d 607 (4th Cir. 1966); *Spicer Theater, Inc.* 44 T.C. 198 (1964), *aff'd*, 346 F.2d 704 (4th Cir. 1965).

⁹¹ *Pauline W. Ach*, 42 T.C. 114 (1964), *aff'd*, 358 F.2d 342 (6th Cir. 1966); *Nat Harrison Assocs., Inc.*, 42 T.C. 601 (1964); *Challenger, Inc.*, 33 P-H Tax Court Mem. 32 (1964).

⁹² See HERWITZ, *supra* note 64, at 185-87.

⁹³ 52 T.C. 1073 (1969).

⁹⁴ 52 T.C. at 1102. *Contra*, *Seminole Flavor Co.*, 4 T.C. 1215, 1228-30 (1945).

with eighteen subsidiaries. In addition to requiring that the parent corporation provide the subsidiaries with advisory services identical to those rendered by the national franchisor, the subfranchise agreement obligated the parent to perform substantial administrative services for the subsidiaries. The terms and conditions of the franchise agreement established the policy and operating procedures of the subsidiaries, except those regarding financing, locating, and leasing restaurant sites which were to be arranged by one of the dominant shareholders of the parent. The subfranchise agreements provided that the parent would recruit and train personnel, maintain a supervisory staff, and perform accounting services for the subsidiaries. The court noted that in addition to this highly integrated formal structure the parent paid the bills of the subsidiaries for which it was later reimbursed, and exercised complete control over recruitment. Finally, master insurance policies and a single pension plan covered employees of both the parent and the subsidiaries. Thus, the business enterprise in *Marc's Big Boy* was highly integrated both formally and functionally.

Patently, the parent did not make a fair profit for the spectrum of services it rendered to the subsidiaries.⁹⁵ Although the parent obtained revenue from three sources—franchise fees, payments for materials furnished, and management fees—the subfranchise agreement limited the amounts received by the parent from the first two sources to the amounts the parent owed the franchisor under similar provisions of the franchise agreement. “Thus, on two items that one might expect an independent, arm’s length sublicensor to earn profits there could be none”⁹⁶ Under the third item, management fees, the parent received a small profit, but there was no indication how the parties established the particular formula contained in the subfranchise agreement.

Indeed, the taxpayer did not even attempt to show that the fee structure was the equivalent of an arm’s-length fee for the services rendered; and *Marc's Big Boy* could thus be read to stand for the proposition that the Tax Court will sustain the Commissioner’s reallocation of the

⁹⁵ Arguably, the parent was not required to make a profit from such transaction. It could have elected, under Rev. Proc. 68-22, 1968-1 CUM. BULL. 819, to have the original proposed regulations apply, rather than those actually adopted. Treas. Reg. § 1.482-2(b). Under the proposed regulations, the arm’s length charge for services would be the management corporation’s cost (without a profit markup). Just as the arm’s length charge for a sublease is the lessee-sublessor’s expenses attributable to the property (rent) without a profit markup, Treas. Reg. § 1.482(2)(c)(ii), it is arguable that the arm’s length charge for a subfranchise should be the subfranchisor’s cost without a markup.

⁹⁶ 52 T.C. at 1101.

entire net profit, or entire gross income and deductions, when the taxpayer does not present sufficient evidence of the arm's length nature of the transactions to support at least a partial reallocation. Such a conclusion finds strong support in the court's ultimate findings of fact.⁹⁷

WBB [the parent] failed to prove that the dealings between it and its subsidiaries were equivalent to arm's length dealings between it and uncontrolled taxpayers. WBB failed to show that the Commissioner was arbitrary, capricious, or unreasonable in attributing to WBB the gross income and deductions of its subsidiaries.⁹⁸

The ultimate findings of fact, however, closed with the conclusion that the allocations of gross income and deductions to the parent were necessary to reflect its income accurately. Amplifying this finding in its opinion, the court asserted that had the parent and its subsidiaries dealt at arm's length, the parent would have required all the subsidiaries profits to compensate for the services it rendered. Thus, *Marc's Big Boy* did not turn on burden of proof; at best, the taxpayer's failure to show that the parent received adequate compensation from the subsidiaries was an alternative holding.⁹⁹

The Tax Court in *Marc's Big Boy* made several significant departures from its earlier course. First, in principle, but not totally in practice, the court abandoned the business purpose justification for multiple incorporation. Second, it acknowledged that other decisions had made partial allocations of net income, but declined to do so in the case before it. Third, although recognizing that other cases had analyzed specific transactions, the *Big Boy* court focused on the nature of the business relationship between the parent and subsidiaries. Fourth and most significantly, *Marc's Big Boy* is the first case to invoke the generation of income doctrine in the context of a functionally integrated business enterprise, thereby making the existence of an integrated business a determinative factor in a section 482 allocation.

Business Purpose—*Marc's Big Boy* reversed the position taken in *Hamburgers York Road* by expressly refusing to give weight to the

⁹⁷ An ultimate finding of fact is not strictly a finding of fact. It is a conclusion of law or at least a mixed question of law and fact. *Helvering v. Tex-Penn Oil Co.*, 300 U.S. 481, (1937).

⁹⁸ 52 T.C. at 1091.

⁹⁹ However, the Commissioner's principal argument on appeal is that the taxpayer failed to prove that an allocation other than that made by the Service was appropriate. Brief for Commissioner, pp. 29-30 (7th Cir. 1971).

presence of a business purpose for transactions between controlled multiple corporations. Although the motivation behind a transaction might be useful in determining whether it resulted in an evasion of taxes,¹⁰⁰ the court asserted that "neither tax motivations nor lack of business purpose is necessary to a finding of distortion if the transaction has the effect of distorting income in situations contemplated by section 482."¹⁰¹ The court's refusal to consider a business purpose was correct because the application of section 482 to achieve a clear reflection of income presupposes the recognition of the various entities;¹⁰² the issue in section 482 allocations is whether the transactions between the entities meet the arm's length standard.¹⁰³

The court's reasoning elsewhere in the opinion, however, was not entirely consistent with this disavowal of reliance on the business purpose doctrine. In establishing that the business was highly integrated, the court emphasized that there would have been no substantial difference in business operations had the subsidiaries not been separately incorporated.¹⁰⁴ Although a business purpose analysis would consider whether the parent corporation could have done everything the subsidiaries did, the propriety of a section 482 allocation to prevent distortion of income turns on what the subsidiaries did do, rather than what the parent might have done.¹⁰⁵ Consequently, just as the court did not consider the business purpose doctrine in its pristine form, the court should not have considered the fact that no substantial difference in operations in *Marc's Big Boy* would have resulted had the subsidiaries not been separately incorporated.

¹⁰⁰ See Hewitt, *Section 482—Allocation of Income and Deductions Among Related Taxpayers*, N.Y.U. 20TH INST. ON FED. TAX. 463, 490 (1962) (hereinafter cited as Hewitt) (where the section 482 allocation is made on the ground of tax evasion, proof of a valid business purpose is a defense). Indeed, commentators have suggested as a policy matter that section 482 should apply primarily to tax motivated intercompany transactions or at least apply less vigorously to situations where valid business reasons can be demonstrated for related party transactions. See Eustice, *supra* note 67, at 517; Jenks, *supra* note 88, at 313; Plumb & Kapp, *supra* note 85, at 819-20.

¹⁰¹ 52 T.C. at 1105.

¹⁰² Application of section 482 is not limited to a fraudulent or sham transaction. Treas. Reg. § 1.482-1(c) (1968).

¹⁰³ See HERWITZ, *supra* note 64, at 185. But see Pomeroy, *supra* note 76, at 257 (business purpose is a major factual element in the determination of an arm's length relationship).

¹⁰⁴ 52 T.C. at 1099.

¹⁰⁵ See *W. Braun Co. v. Commissioner*, 396 F.2d 264, 268 (2d Cir. 1968); *Seminole Flavor Co.*, 4 T.C. 1215, 1235 (1945); *Johnson Bronze Co.*, 34 P-H Tax Ct. Mem. 1689, 1705 (1965); HERWITZ, *supra* note 64, at 185.

Rejection of Partial Allocations—The Tax Court had previously made partial allocations of net income where there was little evidence in the record upon which to support such allocations,¹⁰⁶ explicitly utilizing the famous *Cohan* rule of approximation in several cases.¹⁰⁷ Nevertheless, the court in *Marc's Big Boy* refused to make a partial allocation.¹⁰⁸ The court asserted that the partial allocation was improper because the parties failed to produce a rational basis for approximating a partial allocation. The court did not, however, base its total allocation on the failure to establish a factual basis for a partial allocation; rather it held that the parent would have required all the profits of the subsidiaries had the parent, in an arm's length transaction, provided them the management services and franchise rights. Thus, as in the case of court's discussion of burden of proof, its statement that there was no rational basis for making a partial allocation was either dictum or an alternative holding.

The court's conclusion that the parent would have charged the subsidiaries their entire profits in an arm's length transaction is subject to question on two grounds. First, absent extenuating circumstances such as a desire to prevent a loss,¹⁰⁹ an uncontrolled party enters into a transaction to recognize an existing profit or with the expectation of making a future profit. Thus, one uncontrolled corporation would never surrender its entire profit to another uncontrolled corporation in return for intangibles and management services, however extensive.¹¹⁰

¹⁰⁶ See, e.g., *Nat Harrison Assocs. Inc.* 42 T.C. 601, 622 (1964); *Challenger, Inc.*, 33 P-H TAX CT. MEM. 2315, 2328 (1964).

¹⁰⁷ In *Cohan v. Commissioner*, 39 F.2d 540, 543-44 (2d Cir. 1930), Judge Learned Hand held that where the trial court is convinced that a taxpayer has incurred some of the claimed business expenses, but the taxpayer is unable to substantiate the exact amount of the expenditures, the court should make as close an approximation as it can, bearing heavily upon the taxpayer who is responsible for the inexactitude.

¹⁰⁸ 52 T.C. at 1105-06.

¹⁰⁹ Transactions entered into to effectuate social policies or loss-leader transactions could also satisfy the arm's length standard although no immediate profit motive may be present. But see *Baldwin-Lima-Hamilton Corp. v. United States*, 435 F.2d 182, 186 (7th Cir. 1970) (absence of profit not a consideration in applying the arm's length test).

¹¹⁰ See *W. Braun Co. v. Commissioner*, 396 F.2d 264, 269 (2d Cir. 1968); *Johnson Bronze Co.*, 34 P-H TAX CT. MEM. 1689, 1706 (1965); *HERWITZ*, *supra* note 64, at 183. The reluctance of the Tax Court to sustain a section 482 reallocation that would create a loss in the taxpayer reporting the income may be an extension of this principle. See *Huber Homes, Inc.*, 55 T.C. 598, 604-05 (1971); *PPG Indus., Inc.*, 55 T.C. 928, 998 (1970); *Lufkin Foundry & Mach. Co.*, 30 CCH TAX CT. MEM. 400 (1971). See generally Seghers, *The recent PPG case: Is it a Blueprint to Balance the IRS's 482 Allocation Powers?*, 34 J. TAXATION 370, 371 (1971).

Second, a number of decisions have held that a subsidiary or sister corporation that owns assets used in its business and pays employees who perform services for that business,¹¹¹ produces some portion of the net income which it reported.¹¹² Indeed, the Tax Court has followed this approach even where the management services of the related party were the most important factor in the earning process.¹¹³

The Tax Court's traditional refusal to disregard corporations actively conducting business highlights the interrelationship and tension between allocation of entire net income under section 482 and the sham doctrine. Under the sham doctrine an entity neither engaged in substantive business activity nor created for a substantial business purpose is disregarded, and the income reported by the sham is taxed to the entity that actually earned it.¹¹⁴ Under section 482 as applied in *Marc's Big Boy* the net income of one entity is also attributed to another entity, but technically the first entity is recognized for tax purposes.¹¹⁵ Thus, the practical effect of both approaches is the same.¹¹⁶

The Second Circuit avoided this untoward result in *W. Braun Co. v. Commissioner*,¹¹⁷ holding that where there is a business purpose to the challenged transaction or corporate structure the Commissioner cannot allocate the entire net income of one entity to another: "Section 482 does not give the Commissioner the power to disregard sep-

¹¹¹ Services appear to be a more significant factor than ownership of capital. See generally Kalish & Bodner, *Planning to Avoid Difficulties With 482 Adjustments For Related Entities*, 33 J. TAXATION 2, 4 (1970) (hereinafter cited as Kalish & Bodner).

¹¹² Philipp Bros. Chems. (Md.), 52 T.C. 240 (1969), *aff'd*, 435 F.2d 53 (2d Cir. 1970); Nat Harrison Assocs., Inc. 42 T.C. 601, 620 (1964); Grenada Indus., Inc., 17 T.C. 231 (1951), *aff'd*, 202 F.2d 873 (5th Cir.), *cert. denied*, 346 U.S. 819 (1953). H.R. 10650, 87th Cong., 2d Sess., § 6 (1962), would have modified section 482 to permit allocations with respect to sales of goods between domestic and foreign controlled taxpayers on the basis of assets, compensation of employees, and promotional expenses attributable to each taxpayer. See note 145 *infra*. This approach clearly recognizes the principle stated in text.

¹¹³ *Pauline W. Ach*, 42 T.C. 114, 126 (1964), *aff'd*, 358 F.2d 342 (6th Cir.), *cert. denied*, 385 U.S. 899 (1966).

¹¹⁴ See *Perry R. Bass*, 50 T.C. 595, 600 (1968).

¹¹⁵ See *Advance Mach. Exch. v. Commissioner*, 196 F.2d 1006, 1008 (2d Cir.), *cert. denied*, 344 U.S. 835 (1952); *Challenger, Inc.*, 33 P-H TAX CT. MEM. 2315, 2327 (1964).

¹¹⁶ A significant exception is that the section 482 regulations permit "offset" adjustments: [1] pre-allocation reimbursement agreements, *Treas. Reg. § 1.482-1(d)(3)* (1968), *amended by T.D. 6952* (4/15/68); [2] set-offs, *Treas. Reg. § 1.482-1(d)(3)*; and [3] recovery of allocated amounts by a section 482 transferee without double taxation, *Rev. Proc. 65-17, 1967-1 CUM. BULL. 833, amplified by Rev. Proc. 65-31, 1965-2 CUM. BULL. 1024, 1035 and extended by Amendment I, 1966-2 CUM. BULL. 1211, further amplified by Rev. Proc. 70-23, 1970 CUM. BULL. 505*.

¹¹⁷ 396 F.2d 264 (2d Cir. 1968).

arate corporate entities if they are being used for a bona fide business purpose.”¹¹⁸ Although this approach resolves the tension between net allocation under section 482 and the sham doctrine, it conflicts with the position that business purpose is irrelevant to allocations made to reflect income clearly.

The Second Circuit resolved this conflict in its recent decision, *Philipp Brothers Chemicals, Inc. (N.Y.) v. Commissioner*,¹¹⁹ stating that *Braun* was applicable only where the entity in question carried on substantial business activities. Although the court merely changed the disjunctive in the sham test—the corporation must carry on substantive business activities *or* must have been formed for a business purpose—to the conjunctive, the effect was to preclude net allocations under section 482 when the subsidiary corporation performs substantial business activities. Thus, reading *Philipp Brothers Chemicals* in light of the rule that income must be attributable to the activities of the entity to which it is allocated, rather than to the activities of the reporting entity,¹²⁰ suggests that a one hundred percent reallocation of net profits is always arbitrary where the reporting entity is a viable business and serves substantial business functions.¹²¹

Under the substantial business activities test the subsidiaries in *Marc's Big Boy* necessarily earned some portion of the enterprise's net income. The question then is whether the Tax Court *must* invoke the *Cohan* rule of approximation and make a partial allocation of net income in the absence of a rational basis for such estimate. No less an authority than the Senate Finance Committee has read *Cohan v. Commissioner* as holding “that where the evidence indicated that a taxpayer had incurred deductible expenses but their exact amount could not be determined, the court must make ‘as close an approximation as it can, rather than disallow the deduction entirely’.”¹²² Although *Cohan* dealt with

¹¹⁸ *Id.* at 268.

¹¹⁹ 435 F.2d 53 (2d Cir. 1970).

¹²⁰ *Pacific Northwest Food Club, Inc.*, 33 P-H TAX CT. MEM. 32, 36 (1964); *see Grenada Indus., Inc.*, 17 T.C. 231 (1951), *aff'd*, 202 F.2d 873 (5th Cir.), *cert. denied*, 346 U.S. 819 (1953).

¹²¹ *See Johnson Bronze Co.*, 34 P-H TAX CT. MEM. 1689, 1706 (1965). Indeed, in the leading section 482 case involving a professional service corporation (where arguably the professional and not the corporation performs all the services), over 50% of the net income reported by the corporation was not reallocated. *Borge v. Commissioner*, 405 F.2d 673 (2d Cir. 1968), *cert. denied*, 395 U.S. 933 (1969). *See generally* Horsley & Dray, *Compensating Officer—Stockholders of Professional Corporations: An Analysis*, 34 J. TAXATION 146 (1971) (hereinafter cited as Horsley & Dray).

¹²² S. REP. NO. 1881, 87th Cong., 2d Sess. (1962), *reprinted in* 1962-3 CUM. BULL. 707, 740.

entertainment expenses, the rule of approximation has been extended to cover the reasonableness of salaries, the valuation of inventory,¹²³ and most significantly partial allocations of net income under section 482.¹²⁴

As a result of *Cohan*, a plethora of Tax Court cases state that despite the absence of an accurate basis for determining the precise amount in question the court must make a reasonable estimate,¹²⁵ though some decisions do limit the applicability of *Cohan* to those cases where there is sufficient evidence as to dates, amounts, and specific items to support the computation of a reasonable estimate.¹²⁶ Some of these cases are reconcilable with *Cohan* as broad restatements of the principle that the taxpayer must first show that he did perform some income-earning activity before the allocation of any amount is proper.¹²⁷ Other courts, however, require the production of reliable figures from which to calculate a reasonable estimate as a prerequisite to the application of the *Cohan* rule.¹²⁸ And one line of decisions construes *Cohan* to mean that a court may, rather than must, make an estimate.¹²⁹ Nevertheless, conceding for the sake of argument that the evidence in *Marc's Big Boy* provided no reasonable basis for approximation, the Commissioner's allocation of the entire net income to the parent was arbitrary, since under the substantial business activities test the subsidiaries earned some income. In such circumstances, *Helvering v. Taylor*¹³⁰ dictates that the appellate court remand the case for further hearings to determine the approximate partial income attributable to the subsidiaries.

¹²³ See Lillian Pascarelli, 55 T.C. 1082, 1096 (1971), and cases cited therein; Kramer, *Estimated Income and Expense in the Tax Law*, 32 TAXES 906 (1954); Gluck, *How Cohan Works: Allowance of Business Expense Deductions When No Exact Records Are Kept*, 6 RUTGERS L. REV. 375, 383 n. 35 (1952).

¹²⁴ Pauline W. Acli, 42 T.C. 114 (1964), *aff'd*, 358 F.2d 342 (6th Cir.), *cert. denied*, 385 U.S. 899 (1966); Challenger, Inc., 33 P-H TAX CT. MEM. 2315, 2328 (1964); Eustice, *supra* note 67, at 495.

¹²⁵ See, e.g., Estate of W. D. Bartlett, 22 T.C. 1228, 1231 (1954).

¹²⁶ See, e.g., Plisco v. United States, 306 F.2d 784, 787 (D.C. Cir. 1962), *cert. denied*, 371 U.S. 948 (1963); Eugene A. Carter, 51 T.C. 932, 937 (1969) (dictum); A. Finkl & Sons, 38 T.C. 886, 903-05 (1962).

¹²⁷ Mayrath v. Commissioner, 357 F.2d 209, 214 (5th Cir. 1966); Oates v. Commissioner, 316 F.2d 56, 59 (8th Cir. 1963); Robert Neaderland, 52 T.C. 532, 539 (1969), *aff'd*, 424 F.2d 639 (2d Cir.), *cert. denied*, 400 U.S. 827 (1970).

¹²⁸ See, e.g., Plisco v. United States, 306 F.2d 784, 787 (D.C. Cir. 1962), *cert. denied*, 371 U.S. 948 (1963).

¹²⁹ Williams v. United States, 245 F.2d 559, 560 (5th Cir. 1957). *Williams* was a refund suit and is, therefore, distinguishable: Unlike a Tax Court proceeding, in a refund suit the taxpayer must prove the correct amount of tax payable to prevail. Eustice, *supra* note 67, at 495 n.115.

¹³⁰ 293 U.S. 507 (1935). See Plumb & Kapp, *supra* note 85, at 830.

Thus, in *Marc's Big Boy* the trial court should have made an approximation or reopened the record for further evidence of the arm's length charge for the services.

Abandonment of the Transactional Approach—In *Marc's Big Boy* the Tax Court acknowledged that in other section 482 cases it had focused on the arm's length equivalency of specific transactions between controlled corporations.¹³¹ Moreover, the Tax Court has held that an allocation under section 482 is arbitrary when the Commissioner fails to attack specific transactions and argues only that the business arrangement was devised to evade taxes.¹³² Thus, the court in *Marc's Big Boy* confronted precedent that not only approved of the transactional approach under section 482, but ostensibly required it. Yet the court elected to focus on the entire course of dealings between the parent and its subsidiaries, rather than on specific transactions.¹³³

The court presented two arguments to justify abandoning the transactional approach. First, the court asserted that neither the Commissioner's deficiency notice, nor the conduct of the parties at trial placed specific transactions at issue; instead, they focused on whether the subsidiaries were separate taxable entities and business enterprises.¹³⁴ Second, the court stated that the legislative history accompanying the enactment of the surtax exemption and the regulations under section 482 contemplated the approach adopted by the parties.¹³⁵ The validity of the court's first argument for the abandonment of the transactional approach is dependent upon the validity of the second argument—that is, the failure of the parties to argue the transactional approach does not justify the court's abandoning that approach unless section 482 permits and contemplates an analysis in terms of an enterprise's entire course of dealings.

The court relied upon the Senate report accompanying the original enactment of the surtax exemption to establish that the drafters of section 482 contemplated allocations based on an analysis of the enterprise's business structure. The report stated that the predecessors to sections 482 and 269 would prevent the evasion of taxes through fragmenting "a business enterprise into two or more corporations . . . to

¹³¹ 52 T.C. at 1093. See, e.g., *Ballentine Motor Co.*, 39 T.C. 348, 356-61 (1962), *aff'd*, 321 F.2d 796 (4th Cir. 1963).

¹³² *Seminole Flavor Co.*, 4 T.C. 1215, 1229-30 (1945).

¹³³ 52 T.C. at 1094.

¹³⁴ *Id.* at 1093-94.

¹³⁵ *Id.* at 1094.

carry on an integrated business enterprise"¹³⁶ Although at most the Senate report suggested only that the intent to evade taxes would trigger the course of dealings approach under section 482, the court in *Marc's Big Boy* invoked this approach to reflect clearly the income of the parties.¹³⁷ Thus, the court stripped the taxpayer of a business purpose defense that would have been available to him in a proceeding triggered by an alleged evasion of taxes.¹³⁸ That the natural consequences of the court's position is the denial of a business purpose defense points up the inaptness of the course of dealings approach in section 482 allocations. A close analysis of the Senate report and subsequent legislative history surrounding the enactment of section 1551 and the multiple corporation provisions of the Revenue Act of 1964 reveals that Congress intended to dissuade the fragmentation of *existing* integrated businesses¹³⁹ without inhibiting the expansion of integrated enterprises. The retention of the business purpose defense to a section 482 allocation is essential to the realization of this congressional policy. Since multiple incorporations resulting from fragmentation normally lack a business purpose, the related corporations are subject to a section 482 allocation to prevent tax evasion. On the other hand, multiple corporations created in the expansion of an integrated enterprise, particularly into different geographic locales, normally meet the business purpose test and should, therefore, be exempt from an allocation under section 482 to prevent tax evasion.¹⁴⁰ Thus, the Senate report offers no support for a course of dealings justification for a section 482 allocation made, not to prevent tax evasion, but to reflect income clearly.¹⁴¹

Although the regulations under section 482 now provide specific rules for allocation in several types of business transactions,¹⁴² the Tax

¹³⁶ S. REP. NO. 2375, 81st Cong., 2d Sess. (1950), reprinted in 1950-2 CUM. BULL. 533, 534.

¹³⁷ Clear reflection of income and prevention of tax avoidance are independent grounds for application of section 482. *Central Cuba Sugar Co. v. Commissioner*, 198 F.2d 214 (2d Cir.), cert. denied, 344 U.S. 874 (1952). The Tax Court in *Marc's Big Boy* upheld the allocation on the clear reflection of income basis, 52 T.C. at 1104. The Service had argued both bases, 52 T.C. at 1074 n.4, 1091.

¹³⁸ See Hewitt, *supra* note 100, at 490.

¹³⁹ See notes 16-21 *supra*, and accompanying text.

¹⁴⁰ Hewitt, *supra* note 100, at 490 (1962). See generally note 102 *supra*.

¹⁴¹ See S. REP. NO. 2375, 81st Cong., 2d Sess. (1950). The Tax Court has held that this particular committee report does not lead automatically to upholding a section 482 reallocation in the context of an integrated business; a review of the facts of each case is required. *Dorba Homes, Inc.*, 36 P-H TAX CT. MEM. 753, 767-68 (1967), *rev'd on other grounds*, 403 F.2d 502 (2d Cir. 1968).

¹⁴² Treas. Reg. § 1.482-2 (1968).

Court totally ignored these “intercompany business transaction regulations” and decided *Marc’s Big Boy* under older, general provisions in the regulations which the court interpreted to require an analysis of the course of dealings between the corporations.¹⁴³ The regulations that the court relied upon were framed in general terms and do not provide a functional definition of the arm’s length standard.¹⁴⁴ The imprecision of these regulations raised problems of administration and business planning and were the impetus for a series of legislative and administrative reforms, beginning with the Revenue Act of 1962, to make standards for allocation under section 482 more definite.

For example, to increase certainty in the taxation of international corporations the House proposed to include in the Revenue Act of 1962 specific allocation rules for intercompany sales of tangible property between controlled domestic and foreign entities.¹⁴⁵ The House provision would have amended section 482 to allow the Commissioner to base allocations of the profits of such sales on the relative proportions of assets, compensation of officers and employees, and sales and promotional expenses attributable to the United States and the foreign country. The purpose of the House provision was to permit a direct allocation of taxable income which would avoid the complexities of allocation under the arm’s length standard.¹⁴⁶ The House provision, in effect, would have authorized an allocation of taxable income based upon the entire course of dealings between the controlled taxpayers. The essential difference between the approach proposed by the House and that adopted by the court in *Marc’s Big Boy* is that the House proposal included precise standards to define the course of dealing between two controlled taxpayers.

The Senate and the Conference Committee, nevertheless, rejected the

¹⁴³ Treas. Reg. §§ 1.482-1(c) (1962), and 1.482-1(a)(6) (1962). The common denominator in these two provisions is whether the taxpayer *in the conduct of his affairs* dealt as if at arm’s length with the other controlled taxpayers. Arguably, conduct of affairs refers to the aggregate of specific transactions, arrangements, etc., each of which must be measured separately against the arm’s length standard. Indeed, the House has commented that the usefulness of section 482 is limited when there are thousands of different transactions between the controlled taxpayers and once proposed a division of taxable income (the *Big Boy* approach, in effect) to overcome this problem. H.R. 1447, 87th Cong., 2d Sess., 28-29 (1962), reprinted in 1962-3 CUM. BULL. 432-33.

¹⁴⁴ The predecessors to Treas. Reg. §§ 1.482-1(a)-(c) (1962) had been promulgated in 1934, essentially in their present form. See Jenks, *supra* note 88, at 280, 281.

¹⁴⁵ H.R. 10650, 87th Cong., 2d Sess. § 6 (1962).

¹⁴⁶ H.R. 1447, 87th Cong., 2d Sess., 29-30 (1962), reprinted in 1962-3 CUM. BULL. 432-33.

House proposal, asserting that the same objectives could be obtained through amendment of the regulations under section 482. Therefore, the Congress directed the Treasury Department to

explore the possibility of developing and promulgating regulations under this authority which would provide additional guidelines and formulas for the allocation of income and deductions in cases involving foreign income.¹⁴⁷

The Treasury Department issued proposed regulations in 1965 and 1966 and promulgated final regulations in 1968 and 1969 which provided specific guidelines for allocation under section 482. Significantly, Treasury neither adopted the course of dealings approach suggested by the House, nor limited the guidelines to transactions with controlled foreign entities. Rather, Treasury attempted to delineate the arm's length standard by focusing on five broad types of intercompany transactions: [1] loans or advances, [2] performance of service, [3] use of tangible property, [4] transfer or use of intangible property, and [5] sales of tangible property.¹⁴⁸ (These regulations are referred to as either the "specific intercompany transaction" or "amendatory" regulations.) Because Treasury limited the scope of its guidelines, the Commissioner may, of course, resort to the traditional method of allocation—pinpointing items of income or deduction and reallocating them to the entity that should have reported them—in situations not within the five transactions specifically covered by the amendatory regulations. One commentator has labeled the traditional method the "sham transaction" method, in contrast to the more specific approach adopted by the regulations.¹⁴⁹ The narrow question is whether the Commissioner can ignore the amendatory regulations in favor of the sham transaction approach or the course of dealings approach in situations where the corporations involved have engaged in specifically covered transactions. *Marc's Big Boy* involved two such specifically covered intercompany transactions—the rendition of management services, and the use of intangible property.

The legislative debate that precipitated the promulgation of the specific intercompany transaction regulations demonstrates the impro-

¹⁴⁷ H.R. 2508, 87th Cong., 2d Sess. 19 (1962) reprinted in 1962-3 CUM BULL. 1146-47.

¹⁴⁸ Treas. Reg. § 1.482-2 (1968), amended by T.D. 6964, 7-24-68, and T.D. 6998, (Jan. 17, 1969). See generally Jenks, *supra* note 88, at 281; Cohen, *Section 482: Treasury's Efforts to Teach an Old Dog Some New Tricks*, 43 TAXES 835 (1965).

¹⁴⁹ Hamlin, *Correct Allocations Under Section 482 Are Still Difficult Despite New Regs.*, 33 J. TAXATION 358, 359 (1970).

priety of basing a section 482 allocation on an analysis of the entire course of dealings when the specific regulations are applicable. The Senate's rejection of the House's proposed allocation method in the Revenue Act of 1962, indicates that Congress was not prepared to abandon a transactional analysis for an analysis of the entire course of dealings between the related corporations. Moreover, the Conference Committee's belief that regulations could accomplish the objectives of the House Bill should not be read as an endorsement of the means proposed in the Bill. To the contrary, the fact that Treasury adopted a precise arm's length transactional method to achieve the objectives of the House Bill should preclude the use of a course of dealing method in situations within the scope of the transactions outlined in the regulations.

The regulations themselves indicate that resort to the amendatory regulations is mandatory when dealing with the situations they cover. For example, Treasury Regulation section 1.482-1(d)(1), which establishes the basis for the sham transaction approach specifically refers to the intercompany business transaction regulations "for specific rules relating to methods of allocations in the case of several types of business transactions." And the specific intercompany transaction regulations are entitled, "Determination of taxable income in specific situations."

Finally, sound policy supports the conclusion that section 482 allocations must be based on the specific transactional regulations wherever those regulations are apposite. At the time these regulations were promulgated the Assistant Secretary of Treasury for Tax Policy asserted that the guidelines were intended to aid revenue agents in resolving allocation issues, and to guide taxpayers in minimizing dispute on audit so that stability in business planning would not be upset.¹⁵⁰ The regulations relieve the individual revenue agent of the duty to raise and solve allocation problems on an *ad hoc* basis in the typical skirmish between the Service and taxpayers, and interpose guidelines that represent "careful thinking at top levels of business, the professions, and Government" ¹⁵¹ If the Commissioner could by-pass applicable specific intercompany transaction regulations to allocate the entire net income of an integrated business enterprise to the management entity because the components of the enterprise were not operated as separate businesses, he would subvert these policy considerations.

The Commissioner's ability to circumvent the specific intercompany

¹⁵⁰ Surrey, *supra* note 11, at 76.

¹⁵¹ *Id.*

transaction regulations could also frustrate the fundamental policy consideration in the taxation of international enterprises. The goal of an allocation of profits among the components of a multinational enterprise is to effect a fair sharing of the tax revenues to be derived from those profits among the countries touched by the enterprise.¹⁵² Allocating the entire net income of a multinational enterprise to a domestic management corporation is hardly consonant with this goal.¹⁵³

Having abandoned the transactional approach, the court in *Marc's Big Boy* embarked upon an analysis of the petitioner's entire course of dealings to determine whether the subsidiaries were separate taxable

¹⁵² *Id.*

¹⁵³ Despite the myriad reasons for requiring the Commissioner to base section 482 allocations on the specific regulations whenever possible, the courts have yet to rule on the question. In two cases, however, the courts did consider the issue, though neither court was presented with a situation analogous to that in *Marc's Big Boy*.

In *Lufkin Foundry & Machine Co.*, 40 P-H TAX CT. MEM. 422 (1971), the taxpayer had established its pricing method prior to the promulgation of the intercompany business transaction regulations. It, nevertheless, argued that its challenged resale pricing method corresponded to the resale price method sanctioned by Treasury Regulation section 1.482-2(c)(3). The court, however, did not attempt to consider the case within the confines of these regulations. Rather, the court looked to the sound basis of the pricing arrangement, the reasonableness of the division of pre-tax profits among the group, and the fact that the Commissioner's reallocation would have left the Western Hemisphere Trade Corporations that reported the income in loss positions. Two important factors distinguish *Lufkin* from *Marc's Big Boy*. First, regarding the question whether the Commissioner must base 482 allocations on the specific regulations wherever possible, it is true that the court upheld an allocation not based on those regulations. But the taxpayer had developed his pricing scheme before the promulgation of the amendatory regulations; therefore, he could not have relied on the regulations to provide him a "safe haven" from section 482 allocations. Second, regarding whether a course of dealings approach may support a section 482 allocation to reflect income properly, it should be noted that in *Lufkin* the court was not presented with an attempt to reallocate net income; rather, the focus in *Lufkin* was transactional.

In a subsequent tangible property pricing decision, *American Terrazzo Strip Co.*, 56 T.C. No. 76 (Aug. 9, 1971), the Tax Court stated that it was reallocating gross income pursuant to the standards for sales of tangible property contained in the specific intercompany transaction regulations, but it proceeded to uphold reallocations despite its finding that the sales were made at prices equal to those paid in comparable uncontrolled sales. Thus the court apparently ignored the specific method for determining arm's length price dictated by the regulations. These allocations, however, were made to compensate for intangible factors involved in the intercompany relationship which were not commonly present in an uncontrolled relationship. A close examination of these factors reveals that the 482 adjustments were in substance not made to reflect an arm's length price for the sales, but to reflect arm's length charges for various types of services performed by the buyer-parent which are not covered by the specific regulations. Thus, the *American Terrazzo* decision does not indicate whether the application of the specific regulations is mandatory, since the allocation it upheld involved a transaction not specifically covered.

entities or mere components of a single highly integrated enterprise. Although the Service had asserted repeatedly that the presence of a highly integrated multi-corporate business in itself justified both the application of section 482¹⁵⁴ and the allocation of net income,¹⁵⁵ until *Hamburgers York Road, Inc.*,¹⁵⁶ the Tax Court had refused to base a section 482 allocation of net income on the mere existence of a highly integrated business.¹⁵⁷ Rather the court's position had been that

segments of what might have been an integrated business may be handled by separate taxpayers; and that the income of such separate taxpayers should not be combined for income tax purposes.¹⁵⁸

Some of these pre-*Hamburgers York Road* decisions involved a functional fragmentation of an integrated enterprise,¹⁵⁹ but most involved vertical separations, for example, the division of manufacturing and foundry operations,¹⁶⁰ or the split-up of produce and fruit commission

¹⁵⁴ See, e.g., *Buffalo Meter Co.*, 10 T.C. 83 (1948); *Seminole Flavor Co.*, 4 T.C. 1215 (1945).

¹⁵⁵ See, e.g., *Shaw Const. Co.*, 35 T.C. 1102 (1961), *aff'd*, 323 F.2d 316 (9th Cir. 1963); *Aldon Homes, Inc.*, 33 T.C. 582 (1959).

¹⁵⁶ 41 T.C. 821 (1964). The immediate reaction to *Hamburgers York Road* indicated that the most significant aspect of the case was the court's placing great emphasis on the benefit of the intangible property to the new corporations. See, e.g., Elder, *Operating Problems of Multiple Corporations*, N.Y.U. 24TH INST. ON FED. TAX. 1145, 1166 (1966). This aspect of the decision was more in line with the section 482 transactional approach than the court's conclusion that the controlling corporation and its shareholders treated the sister corporation as a component in an integrated business. The significance of this second aspect became apparent only in the light of recent developments. See, e.g., Hoefs, *supra* note 79, at 613-14.

¹⁵⁷ See cases cited in notes 155 and 156 *supra*. The Government scored some initial success where an integrated business was split vertically, so that two entities conducted on a smaller scale in competition with each other the same pre-separation business. See Sherman, *A Case History of Section 45*, 29 TAXES 13, 22-23 (1951) (hereinafter cited as Sherman).

¹⁵⁸ *Moke Epstein, Inc.*, 29 T.C. 1005, 1011 (1958) (The issue involved a corporation's ability to split-off some activities into a partnership to avoid excess profits tax on corporate earnings.); *accord*, *Dorba Homes, Inc.*, 36 P-H TAX CT. MEM. 753 (1967), *rev'd on other grounds*, 403 F.2d 502 (2d Cir. 1968); *cf.* *Sanford H. Hartman*, 43 T.C. 105 (1964). It should be noted that the Tax Court's decision in *Moke Epstein* presupposes that the entity reporting the income actually carried out the income producing activity, and that any other entities contributing to the production of income were compensated fairly. See *Plumb & Kapp*, *supra* note 85, at 817-18.

¹⁵⁹ See, e.g., *Estate of Julius I. Byrne*, 16 T.C. 1234 (1951); *Seminole Flavor Co.*, 4 T.C. 1215 (1945). See generally Sherman, *supra* note 157, at 25-26.

¹⁶⁰ *Buffalo Meter Co.*, 10 T.C. 83 (1948).

sales businesses.¹⁶¹ In these vertical separation cases, when the Tax Court found that the corporations involved existed independently from one another,¹⁶² or that the division of the functions among the corporations was natural and proper,¹⁶³ it refused to sanction an allocation of net income.

The mere fact that the multi-corporate enterprise resulted from a functional, rather than a vertical, split-up of a pre-existing integrated business should not in itself support an allocation of net income. This principle received its most detailed discussion in a non-section 482 case,¹⁶⁴ where the government asserted that a partnership which took over the sales and merchandizing functions of an integrated business was merely a division of the corporation and not a separate entity for tax purposes. The Tax Court upheld the right of the taxpayer to fragmentize businesses previously conducted as an integrated unit into separate organizations, each actively conducting a functionally separate business. The court found that the partnership was not a sham: it had employees and carried on an extensive business of merchandizing, distributing, and selling. Moreover, the court also found the division to be natural and proper, and that there was no intermingling of funds or activities.¹⁶⁵

In *Marc's Big Boy* the Tax Court effectively overruled these earlier cases. The court stated that the question was whether the subsidiaries were formed and operated as separate businesses.¹⁶⁶ The court then examined the course of dealings between the management-parent corporation and the subsidiaries, and its opinion marshalled extensive facts to show that the parent conducted its affairs and those of the subsidiaries as a single, integrated business enterprise. On the basis of these findings the court concluded that the Commissioner's reallocation was not arbitrary, unless the taxpayer could show that the parent received proper

¹⁶¹ *Miles Cohley Co.*, 10 T.C. 754 (1948), *aff'd*, 173 F.2d 958 (4th Cir. 1949).

¹⁶² *Buffalo Meter Co.*, 10 T.C. 83, 89 (1948).

¹⁶³ *Moke Epstein, Inc.*, 29 T.C. 1005, 1010 (1958). The court was implicitly contrasting this type of vertical split-up with one in which an established single line business is divided into competing units, which is a departure from normal business behavior and hence unnatural. See *Sherman*, *supra* note 157, at 22-23.

¹⁶⁴ *Sanford H. Hartman*, 43 T.C. 105, 116-17 (1964).

¹⁶⁵ By "natural and proper," the court meant that the separation of merchandising and selling functions from the other functions made "common sense." See generally note 163 *supra*. When each formally separate entity confines itself to the activities for which it was formed, the division is natural and proper.

¹⁶⁶ 52 T.C. at 1094.

compensation.¹⁶⁷ Although the court stated that the taxpayer's failure to show adequate compensation to the parent-management corporation was an important factor in its decision,¹⁶⁸ a close reading of the opinion reveals that under the court's rationale no compensation less than the entire profits of the subsidiaries would have been adequate. The implicit determination in the court's treatment of adequate compensation for the parent-management corporation is that the management entity generated the entire income of the subsidiaries.¹⁶⁹ Therefore, the significance of the presence of an integrated business is that it supports an application of the generation of income doctrine. The implicit adoption of this doctrine constitutes *Marc's Big Boy's* most radical departure from established precedent.

Adoption of the Generation of Income Doctrine—Perhaps the most significant aspect of *Marc's Big Boy* was its reliance on the generation of income doctrine to support a reallocation of income under section 482. Such a tack is both novel and unwise.

The generation of income doctrine is a corollary of the more common assignment of income doctrine. Both are based on the proposition that the entity that controls income should suffer the incidence of tax on it; they differ, however, in the perspective from which they view the control element. The assignment of income doctrine focuses on the power to control the disposition of income,¹⁷⁰ while the generation of income doctrine focuses on the power to control the creation of income.

Historically, the Commissioner has argued the generation of income doctrine in three factual contexts: [1] where the taxpayer actually earned the income, but never had the power to dispose of it;¹⁷¹ [2] where the taxpayer had the power to designate the person who would earn the income;¹⁷² and [3] where the taxpayer exercises actual con-

¹⁶⁷ *Id.* at 1099.

¹⁶⁸ *Id.* at 1104.

¹⁶⁹ *Id.*

¹⁷⁰ Under the assignment of income doctrine, income is taxed to the person who earns it, *Commissioner v. Culbertson*, 337 U.S. 733, 739-40 (1949), and the tax cannot be avoided by an anticipatory assignment, *Helvering v. Horst*, 311 U.S. 112 (1940); *Lucas v. Earl*, 281 U.S. 111, 114-15 (1930).

¹⁷¹ *Paul A. Teschner*, 38 T.C. 1003 (1962).

¹⁷² *Robert P. Crowley*, 34 T.C. 333 (1960). See generally *Eustice, Contract Rights, Capital Gains, and Assignment of Income—The Ferrer Case*, 20 TAX L. REV. 1, 43 (1962) (hereinafter cited as *Eustice, Contract Rights*).

trol over the entity that earns the income.¹⁷³ But until *Marc's Big Boy*, the Commissioner had scant success with his arguments.¹⁷⁴

What little success the Commissioner has had in using the generation of income doctrine has come largely in cases, brought under section 61, involving "loaned employees." In these situations an employer "loans out" an employee at a premium while continuing to pay the employee his regular salary. Often the Commissioner will want to attribute the income to the higher bracket employee, rather than to his corporate employer. Whether or not he succeeds depends on whom the court deems to be the true earner of the personal service income.¹⁷⁵ The Tax Court, in *Richard Rubin*,¹⁷⁶ looked to the facts to find who controlled the earning of the income:

If such control lies with the taxpayer who actually performs the services, then he remains taxable on the earnings from his personal services, whether or not he chooses to divert the receipt of that compensation to a third party. However, if the direction and control of the performer's activities resides in a superior authority, and the consideration paid for the performance of those services is made to the person having such ultimate direction and control, then the mere fact that the taxpayer has performed the services does not render him taxable on the amount paid for these services.¹⁷⁷

But the Supreme Court in *National Carbide Corp. v. Commissioner*,¹⁷⁸ expressly rejected a generation-of-income type approach in a case involving a highly integrated multi-corporate business structure. In that case, the parent corporation furnished working capital, executive management, and office facilities to three wholly-owned manufacturing subsidiaries. For these services, the parent corporation took all the profits

¹⁷³ *Local Fin. Corp. v. Commissioner*, 407 F.2d 629 (7th Cir.), *cert. denied*, 396 U.S. 956 (1969).

¹⁷⁴ A significant exception is *Local Finance Co. v. Commissioner*, 407 F.2d 629 (7th Cir., *cert. denied*, 396 U.S. 956 (1969)). The Tenth Circuit in refusing to follow *Local Finance* stated that the section 482 generation of income doctrine contained therein ran contrary to all other decisions. *First Sec. Bank v. Comm'r*, 436 F.2d 1192, 1197 (10th Cir.), *cert. granted* — U.S. — (10/12/71).

¹⁷⁵ *Richard Rubin*, 51 T.C. 251, 265-66 (1968), *rev'd*, 429 F.2d 650 (2d Cir. 1970). See generally Lyon & Eustice, *Assignment of Income: Fruit and Tree as Irrigated by the P.G. Lake Case*, 17 TAX L. REV. 293, 391-93 (1962) (hereinafter cited as Lyon & Eustice).

¹⁷⁶ 51 T.C. 251 (1968).

¹⁷⁷ *Id.* at 265-66.

¹⁷⁸ 336 U.S. 422 (1949).

of the subsidiaries in excess of six percent. In contrast to *Marc's Big Boy*, the parent in *National Carbide* was arguing (in order to minimize the excess profits tax¹⁷⁹) that it was taxable on the income earned by the subsidiaries. The Court sided with the Commissioner, holding that "complete ownership . . . and control dependent upon such ownership . . . [is] no longer of significance in determining taxability."¹⁸⁰ Thus, the Supreme Court in *National Carbide* rejected the generation of income approach for the attribution of income to a parent in a highly integrated multi-corporate business enterprise. Moreover, in explaining how the parent could extract "the entire earnings of [the subsidiaries], except for trifling amounts"¹⁸¹ if it did not earn the income the Court said the earnings "are turned over to [the parent] not because the latter could command this income if [the subsidiaries] were owned by third persons, but because it owns and thus completely dominates the subsidiaries."¹⁸² The question now is whether a doctrine, rejected by the Supreme Court in a section 61 case, should be engrafted onto section 482.

There are, in fact, good reasons for keeping the assignment of income doctrine and section 482 separate. The doctrine is a blunt tool; section 482, on the other hand, was intended to fine tune the taxation of related, but separate, taxable entities. Indeed, the Second Circuit reversed the Tax Court in *Richard Rubin* precisely because the lower court had employed the assignment of income doctrine rather than the more flexible 482 standards.¹⁸³ Thus, the use of the generation of income doctrine in *Marc's Big Boy* to support a section 482 allocation is most unfortunate. Its use forces the court to disregard corporate entities that are not shams, and causes intercorporate dealings to be judged, under section 482, by the same all-or-nothing standards normally associated with section 61. Moreover, applying the generation of income doctrine in section 482 cases deprives the law of the predictability that would have attended 482 cases had the specific guidelines prescribed in the regulations prevailed.

¹⁷⁹ Tax Adjustment Act of 1945, Pub. L. No. 172 (1945).

¹⁸⁰ 336 U.S. at 438.

¹⁸¹ *Id.* at 438.

¹⁸² *Id.*

¹⁸³ 429 F.2d at 653. The court in *Rubin* held that the use of the blunt, "all-or-nothing" approach of section 61 was not appropriate, since partial allocation under section 482 was available. Extending this argument, one could allege that allocation of entire net profits under section 482 is impermissible when the more sophisticated specific inter-company transactional regulations are applicable.

The absurdity of applying the generation of income doctrine in *Marc's Big Boy* is apparent from a consideration of the inevitable results of the court's holding. Under the court's reasoning, the subsidiaries were required to render substantial sales and marketing services to the parent at cost. Thus, unlike loaned employees, the subsidiaries would receive no compensation for the services they performed. On the other hand, had the court continued to apply the transactional analysis prescribed in the regulations, it would have sought the arm's length charge for the sales services rendered by the subsidiaries to the parents who "earned" the income. Under the regulations, that arm's length charge cannot equal the subsidiaries' cost where the subsidiaries rendered substantial services to the parent.¹⁸⁴ Even if the court abandons the specific transactional approach and focuses on the entire course of dealings between the parties, it should look to the substance of the functions performed at each level of the integrated enterprise,¹⁸⁵ ascertain the arm's length charge for the total spectrum of services rendered, and allocate to the management and sales corporations only the value of the services each actually performs. By applying the generation of income doctrine in *Marc's Big Boy* instead of seeking to ascertain the arm's length charge for the services actually rendered by the parent and the subsidiaries, the Tax Court made a serious error.

Marc's Big Boy: A Recapitulation—In applying the sham doctrine, courts have frequently engaged in a course of dealings analysis. But the alphabet corporation cases were the first to infer the existence of a sham from the existence of a highly integrated multi-corporate enterprise. In the alphabet cases, however, the subsidiaries were true shells providing no substantive services to the total enterprise. *Hamburgers York Road* was the first case in which the Tax Court based a section 482 allocation on the existence of a highly integrated business enterprise; however, many commentators at the time *Hamburgers York Road* was decided felt that it was, in reality, a sham case.¹⁸⁶ Finally, in *Marc's Big*

¹⁸⁴ Treas. Reg., §§ 1.482-2(b)(3) & (7) (1968).

¹⁸⁵ In determining the substance of the activities of the various corporate components of an integrated enterprise, a court should look to the following factors: the proportion of assets held by the components, the number of persons employed by the components and their relative compensation, other items of expense attributable to each component. These factors were proposed in the 1962 amendment to section 482 which would have prescribed the method for allocating income between related foreign and domestic corporations. See note 145 *supra*.

¹⁸⁶ See, e.g., Hoefs, *supra* note 79, at 164 n. 45. Had the court expressly rested on the sham doctrine, rather than on the section 482, the case would have caused less concern among the members of the tax bar. See Eustice, *supra* note 67, at 484. Subse-

Boy, the court relied on the existence of a highly integrated multi-corporate enterprise to support a net income allocation under 482 in circumstances where the Commissioner clearly could not have succeeded in a section 61 sham attack.

In order to support its unprecedented holding, the court in *Marc's Big Boy* drew eclectically from section 61 and section 482 theory. The court sounded in sham by focusing on whether the subsidiaries were formed and operated as separate taxable entities and business enterprises. But since section 482 assumes the reality of the subsidiaries as viable business entities, the taxpayer was precluded from prevailing on the usual sham defense that each subsidiary engaged in substantive business activity. On the other hand, by concluding that the parent generated the entire income of the subsidiaries, the court prevented the parent from showing that specific transactions between it and the subsidiaries were equivalent to arm's length transactions.¹⁸⁷ Thus, close analysis of the court's approach reveals that it is an amalgam of the sham doctrine under section 61, and a course of dealings inquiry under section 482. This alloy effectively deprives the taxpayer of the traditional defenses to a sham attack based on section 61 and to a reallocation under section 482.

As an inevitable result of this approach, the Commissioner may now allocate the entire net income of an integrated business enterprise to the management entity pursuant to the generation of income doctrine, as applied through section 482. Such a broad brush application of section 482 is not grounded in sound tax policy. Ignoring the specifically applicable regulations is contrary to the growing tendency to provide safe harbors for tax planning, and an expansive course-of-dealings analysis under section 482 is inconsistent with the *Rubin* demand for greater flexibility and with the emerging doctrine prohibiting the reallocation of the entire net income from a reporting entity that actually carried on substantial business activities.

ILLOGICAL RAMIFICATIONS OF THE GENERATION OF INCOME DOCTRINE

The Tax Court rested its decision in *Marc's Big Boy* upon the conclusion that the parent generated the entire net income of the enterprise

quent cases in the Second Circuit held that the sham doctrine could not serve as the basis for a section 482 allocation if the subsidiaries involved carry on substantial business activity. See text at notes 117-21 *infra*. Therefore, *Hamburgers* in retrospect could not have been a sham case, since the suburban sister performed substantive selling functions.

¹⁸⁷ See Note, *Multiple Incorporations*, *supra* note 71, at 496.

by exercising comprehensive control over the wholly owned subsidiaries. But the use of the generation of income doctrine to support a section 482 allocation of net income is not supported by legislative history or judicial interpretation. Furthermore, applying the doctrine consistently throughout the tax law would result in unjustifiable absurdities and inconsistencies.

Attribution of Income in the Absence of Common Ownership

Since the Commissioner can invoke section 482 to allocate income between two or more organizations "owned or controlled directly or indirectly by the same interests"¹⁸⁸ the statute apparently would not require common ownership as a prerequisite to an allocation under section 482, but rather would sanction such an allocation wherever there is common control.¹⁸⁹ Although the courts initially refused to allow the Commissioner to allocate income among entities not under common ownership,¹⁹⁰ in *Charles Town, Inc. v. Commissioner*¹⁹¹ the Fourth Circuit sustained the Commissioner's determination that the same persons maintained sufficient control to justify an allocation under section 482, even though they owned just two percent of one of the businesses. Thus it appears that the Commissioner can allocate income among entities not commonly owned, if he can establish that in reality the same interests control the entities.¹⁹²

By relying on common control rather than common ownership the Commissioner could invoke section 482 and the generation of income doctrine to create a fantasia of taxation. For example, assume that, pursuant to a section 355 split-up of a functionally integrated business, unrelated shareholders of the parent-management corporation exchange their entire interest in the parent for all the stock of a sales subsidiary.

¹⁸⁸ INT. REV. CODE of 1954, § 482 [emphasis added].

¹⁸⁹ Eustice, *supra* note 67, at 486-87; Pomeroy, *supra* note 76, at 256. Control for the purposes of section 482 is not determined on the basis of proportion of ownership, but rather is defined as "any kind of control, direct or indirect, whether legally enforceable, and however exercisable or exercised." Treas. Reg. § 1.482-2(a)(3) (1968).

¹⁹⁰ See, e.g., *John L. Denning & Co. v. Commissioner*, 180 F.2d 288 (10th Cir. 1950).

¹⁹¹ 372 F.2d 415 (4th Cir.), *cert. denied*, 389 U.S. 841 (1967); see *Hall v. Commissioner*, 294 F.2d 82 (5th Cir. 1961) (presumption of control arising from arbitrary shifting of income sufficient ground to invoke section 482 in absence of proof of common ownership). See generally Hewitt, *Section 482—Reallocation of Income and Deductions Between Related Persons—Up to Date*, N.Y.U. 22D INST. ON FED. TAX 381, 382-84 (1964).

¹⁹² Note that under the assignment of income doctrine pursuant to section 61, the power to dispose of income rather than the ownership of the source of the income is prerequisite to attribution. See note 170 *supra*, and accompanying text.

Assume further that this functionally integrated business is a franchise sales enterprise in which the management corporation, pursuant to a contract, prescribes and extensively supervises the operations of the independent sales corporation. The only difference between this hypothetical and the situation in *Marc's Big Boy* is the absence of common ownership. In both situations the sales corporations are subject to the strict control of the management corporations, and thus to the extent that section 482 is applicable to control without ownership, both management corporations should be subject to the same methods of allocation. If the generation of income doctrine invoked in *Marc's Big Boy* were applied to the hypothetical enterprise, the sales corporation would show no profit for federal tax purposes, and the unrelated management corporation would be taxable on profits available only to the sales corporation and its shareholders. The irrationality of imposing tax liability in such a manner casts serious doubt on the validity of the basic premise that income reported by one entity is actually earned by the entity that completely manages and controls it.

Consolidated Returns

An integrated business enterprise may qualify as an "affiliated group"¹⁹³ of corporations and thus may elect to file a consolidated return.¹⁹⁴ A principal advantage of filing a consolidated return is that the losses of one affiliate may offset the profits of the other members of the group.¹⁹⁵ The regulations also provide that an affiliate corporation reporting a net operating loss in a "separate return year" may carry over that loss and offset it against the profits of the affiliated group in a "consolidated return year."¹⁹⁶ The "separate return year limitations" provisions of the regulations¹⁹⁷ impose two conditions upon offsetting the pre-

¹⁹³ An "affiliated group" is a chain of corporations connected through stock ownership with a common parent where [1] at least 80% of the voting power of all classes of stock and at least 80 % of each class of nonvoting stock of each corporation in the group is owned directly by one or more other corporations in the group; and [2] the common parent owns directly 80% of the voting power of all classes of stock and 80% of each class of nonvoting stock in at least one of the other corporations included in the group. INT. REV. CODE of 1954, § 1504(a).

¹⁹⁴ *Id.* at § 1501.

¹⁹⁵ See BITTKER & EUSTICE, *supra* note 2, at 696.

¹⁹⁶ Treas. Reg. § 1.1502-21(b)(1) (1966). The term "separate return year" means a taxable year for which a corporation files a separate return or joins in filing a consolidated return with another group. *Id.* § 1.1502-1(e). The term "consolidated return year" means a taxable year in which an affiliated group files a consolidated return. *Id.* § 1.1502-1(d).

¹⁹⁷ *Id.* § 1.1502-1(f).

consolidation losses of an affiliated corporation against the total post-consolidation profits of the group. First, the members of the affiliated group must not have elected multiple surtax exemptions under section 1562 during the separate return year.¹⁹⁸ Second, the corporation reporting the loss in the separate return year must have been affiliated with the group for every day of that year.¹⁹⁹ Should a taxpayer fail to meet either of these conditions, the separate return year losses of an affiliated corporation can be carried over and offset only against the post-consolidation return income attributable to the corporation that incurred the loss.²⁰⁰

When confronted with an integrated business enterprise that files a consolidated return but fails to meet the conditions of the separate return limitations, the Commissioner, relying on the generation of income doctrine, might attempt to allocate the entire net income of the enterprise to the management entity and thereby prevent the use of any pre-consolidation losses incurred by the other components of the enterprise.²⁰¹ The taxpayer's natural response to the Commissioner's action would be to argue that if the post-consolidated return income were attributable to the management corporation, then the pre-consolidated return losses reported by the other components should also be attributable to the management corporation. In effect, the taxpayer would argue that if the Commissioner can invoke the generation of income doctrine to allocate income in post-consolidation years to the management corporation, the doctrine must apply with equal force to income generated in pre-consolidation years. Under this approach, consolidation income would have to be computed as if it were generated solely by the management corporation. This computation would first entail off-setting the losses of the affiliate corporation against the income of the entire enterprise. This computation would produce an equitable result only when the tax on the income allocated to the management corporation would be as great as the aggregate tax paid by the components of the integrated enterprise after utilizing the multiple surtax exemption. The allocation would produce harsh results, however, if under such a re-computation the entire enterprise would have paid less tax than the sum

¹⁹⁸ *Id.*

¹⁹⁹ *Id.* § 1.1502-1(f)(2)(ii).

²⁰⁰ *Id.* § 1.1502-21(c).

²⁰¹ See Dunn, *The New Consolidated Return Regulations May Preempt the Field in Determining the Allowance of Operating Losses*, 23 TAX L. REV. 185, 201 (1968); Farber, *Intercompany Accounting Among Related Companies: Relationship between Section 482 and Consolidated Returns Provisions*, N.Y.U. 26TH INST. ON FED. TAX. 719, 721-22 (1968).

of the taxes incurred by the components, because the statute of limitations would probably bar a refund claim²⁰² and, if the enterprise enjoyed a net profit, there would be no loss to carry forward. Moreover, to the extent that the statute of limitations precludes a refund of tax for the separate return years in question,²⁰³ the application of the generation of income doctrine would open a Pandora's Box by requiring the recomputation of taxable income in a closed year to determine the existence and amount of loss that may be offset against the current income of the affiliated group.²⁰⁴

It is possible that an integrated business enterprise could avoid the risk of losing the tax benefit of a component's net operating losses by not filing a consolidated return. Although the Commissioner might allocate the net income of the components to the management corporation under the generation of income doctrine, the term "net income" usually implies income after the utilization of all deductions, including any net operating loss.²⁰⁵ Similarly a reallocation of gross income and deductions would include the net operating loss carried forward as a deduction. Nevertheless, the fact that an integrated business enterprise might refrain from filing a consolidated return in order to assure that the Commissioner could not invoke the generation of income doctrine to extinguish the net operating loss carry overs of its components indicates that the doctrine could frustrate an elaborate legislative scheme.

²⁰² INT. REV. CODE OF 1954, § 6511(a) (a refund claim must be filed within three years from the time the return was filed or within two years of the time the tax was paid, whichever period is longer). It is possible that the taxpayer could invoke sections 1311 to 1315 to remove the bar of the statute of limitations if it can procure a determination from the Tax Court or Treasury (§ 1313(a)) that prohibiting the non-management corporation from using its preconsolidation losses to offset the preconsolidation income of the entire enterprise was a disallowance of "a deduction or credit which should have been allowed to, but was not allowed to, the taxpayer for another taxable year . . ." *Id.* § 1312(4). Nevertheless, in order to avail itself of an adjustment the taxpayer must maintain in writing to Treasury or before the Tax Court that it is entitled to the deduction prior to the time that the statute of limitations bars the claim for the deduction. *Id.* § 1311(2)(B). The crucial factor then is whether the year in which the loss occurred is still open when the enterprise first asserts that it is entitled to a deduction for the affiliate's net operating loss.

²⁰³ INT. REV. CODE OF 1954, § 6501(a) (the amount of tax must be assessed within three years after the return is filed).

²⁰⁴ See *Springfield St. R.R. v. United States*, 312 F.2d 752 (Ct. Cl. 1963) (courts have power to examine tax matters in closed years to determine tax liability for an open year).

²⁰⁵ See *Delhar, Inc. v. United States*, 71-1 U.S. Tax Cas. ¶ 9107, 26 Am. Fed. Tax R.2d 5888 (S.D. Fla. 1970) (investment credit reallocated). But see *Advance Mach. Exch., Inc. v. Commissioner*, 196 F.2d 1006 (2d Cir.), *cert. denied*, 344 U.S. 835 (1952) (credit for excess profits tax not reallocated). See generally *Pomeroy*, *supra* note 76, at 260.

Divisive Reorganizations

The court's conclusion in *Marc's Big Boy* that the subsidiaries did not earn any income conflicts with recent interpretations of the "active business" requirement under section 355. Section 355 provides for the non-recognition of gain or loss resulting from the separation of one or more businesses formerly operated by a single corporation.²⁰⁶ As prerequisites for non-recognition the section requires [1] that immediately after the distribution of stock in the controlled corporation both the distributing corporation and the controlled corporation be engaged in the active conduct of a trade or business;²⁰⁷ and [2] that such businesses must have been actively conducted during the five-year period ending on the date of distribution.²⁰⁸ Although the regulations defining the "active business" requirement seem to preclude a section 355 division of a functionally integrated corporation, judicial interpretation of the purpose of the requirement has led commentators to conclude that components of a functionally integrated corporation can each actively conduct a separate trade or business.

The Tax Court's conclusion in *Marc's Big Boy* that the restaurant subsidiaries did not earn any income is not inconsistent with the interpretation of the active business requirement that Treasury promulgated in 1955.²⁰⁹ Under those regulations the determinative ingredient of the active business requirement was the definition of a trade or business. The regulations define a trade or business as a group of activities that includes "every operation which forms a part of, or a step in, the process of earning income or profit from such group."²¹⁰ Based upon this definition Treasury offered an example asserting that the components of a functionally integrated corporation could not actively conduct separate trades or businesses.²¹¹

Three theories support this example. First, Treasury has asserted that there can be no division of a single business.²¹² Second, defining an active

²⁰⁶ INT. REV. CODE of 1954, § 355. Section 355 provides the exclusive vehicle for the tax-free fragmentation of a single corporation. See generally Jacobs, *The Anatomy of a Spin-Off*, 1967 DUKE L.J. 1 (hereinafter cited as Jacobs); Morris, *Combining Divisive and Amalgamation Reorganizations: Section 355 Fails Again*, 46 TEXAS L. REV. 315, 316 (1968).

²⁰⁷ INT. REV. CODE of 1954, § 355(a)(1)(C) and 355(b)(1)(A).

²⁰⁸ *Id.* at § 355(b)(2)(B).

²⁰⁹ Treas. Reg. § 1.355-1(c) (1955).

²¹⁰ *Id.*

²¹¹ Treas. Reg. § 1.355-1(d) (Example 11) (1955).

²¹² *Id.* § 1.355-1(a) (1955) (section 355 does not apply to the division of a single business). But see Edmund P. Coady, 35 T.C. 771 (1960), *aff'd per curiam*, 289 F.2d

business to include every step in the process of earning income precludes a single step in the process from actively conducting business.²¹³ Third, an entity actively conducting business must produce income independently.²¹⁴ Nevertheless, these theories can justify the example only if the regulations upon which the example is based are a reasonable implementation of the active business requirement contained in section 355.²¹⁵ The Tax Court recently held that the purpose of the active business requirement

is to prevent the tax-free segregation of passive investment type assets into an inactive corporate entity; thus enabling future sale at capital gains rates of the inactive portion of the distributing corporation's business. The inactive assets may well represent the accumulated earnings and profits of the continuing business activities.²¹⁶

Therefore, the active business requirement should not bar a section 355 division of a functionally integrated corporation unless the theories supporting such a prohibition establish that the prohibition is necessary to prevent the segregation of passive assets.

The first theory, that there can be no division of a single business, was rejected in *Edmond P. Coady*.²¹⁷ There the Tax Court asserted that the function of the active business requirement is to prevent the tax-free separation of active and inactive assets into active and inactive corporations. In so reading the statute the court could find no "language denying the benefits of section 355 to the division of a single trade or business."²¹⁸

Although the theory that an active business must include every step in the process of earning income might justify the prohibition against

490 (6th Cir. 1961), *non-acquiesced in* Rev. Rul. 61-198, 1961-2 CUM. BULL. 61, *non-acquiescence revoked*, Rev. Rul. 64-147, 1964-1 (part 1) CUM. BULL. at 36 (allowing a vertical division of a single taxpayer under section 355).

²¹³ Treas. Reg. § 1.355-1(c); *see id.* § 1.355-1(c)(3):

A group of activities which, while part of a business operated for a profit, are not in themselves independently producing income even though such activities would produce income with the addition of other activities or with large increases in activities previously incidental or insubstantial.

²¹⁴ *See id.* § 1.355-1(d) (Examples 5 and 11).

²¹⁵ *Commissioner v. South Tex. Lumber Co.*, 33 U.S. 496, 501 (1948) (regulations that are reasonable and consistent interpretations of statutory provisions must be sustained).

²¹⁶ *E. Ward King*, 55 T.C. 677, 696 (1971). Note that distributions of *earnings* and profits are normally dividends taxable to the shareholders as ordinary income. *See* INT. REV. CODE OF 1954, §§ 316, 301(c).

²¹⁷ 33 T.C. 771 (1960), *aff'd per curiam*, 289 F.2d 490 (6th Cir. 1961).

²¹⁸ 33 T.C. at 778.

splitting off incidental activities,²¹⁹ it does not necessarily reflect the segregation of passive assets test. Moreover, one commentator has read *Coady* as authority for the proposition that a functionally integrated corporation may be composed of several steps each actively conducting business.²²⁰ Therefore, the validity of this second theory as a general principal is subject to considerable doubt.²²¹

The third theory supporting the regulations is also unpersuasive. Although each component of an integrated business may not be economically independent, each component does earn income in the economic sense²²² and contributes to the success of the venture as a whole.²²³ The assets of a component derive their value from substantive income earning activity and are not the type of assets that represent the accumulated earnings and profits of the continuing corporation.²²⁴ Therefore, the assets of a component of a functionally integrated business are not "passive assets", the sale of which pursuant to a corporate division would allow a shareholder to convert ordinary income into capital gain. Thus the third theory offers no support for a prohibition on section 355 divisions of functionally integrated businesses. If the three theories upon which the regulations are based are improper, each layer of a functionally integrated business may qualify as an active business. Although the courts have not yet spoken clearly,²²⁵ commentators have concluded uniformly that section 355 does apply to the division of a vertically integrated business.²²⁶

²¹⁹ Whitman, *supra* note 1, at 1221-22. One commentator has concluded that in the light of case law the requirement of inclusion of every step in the production of income should be limited to manufacturing a product and should not include its marketing or obtaining raw materials for the manufacturing process; however, in a retail business, business selling activities should be inseparable from purchasing and display activities, which are necessary parts of the "group." Massee, *supra* note 3, at 466.

²²⁰ Whitman, *supra* note 1, at 1223.

²²¹ *Id.*; Massee, *supra* note 3, at 462-63.

²²² Jacobs, *supra* note 206, at 26.

²²³ Whitman, *supra* note 1, at 1223.

²²⁴ Massee, *supra* note 3, at 463.

²²⁵ See, e.g., Marne S. Wilson, 42 T.C. 914, 926 (1964), *rev'd on other grounds*, 353 F.2d 184 (9th Cir. 1965) (Tax Court refused to rule on horizontal division issue). See generally Whitman, *supra* note 1, at 1223 n. 149. In *Rafferty v. Commissioner*, 71-2 U.S. Tax Cas. ¶ 9101 n.10 (1st Cir. 1971), decided after this Article was substantially completed, the court rejected the commissioner's contention favoring a broad reading of the independent production of income. It found those regulations to be largely a restatement of the rejected separate business requirement (see note 212 *supra*), and stated that the "*Coady* rationale is also applicable to functional divisions of existing businesses."

²²⁶ See, e.g., Whitman, *supra* note 1; Massee, *supra* note 3; Jacobs, *supra* note 206.

The test that commentators have suggested to determine whether a component of a functionally integrated corporation meets the active business requirement is whether the component performs a reasonably complete service that contributes to the financial success of the venture as a whole.²²⁷ Under this test the essential concept of an active trade or business is that the entity earn income.²²⁸ The subsidiaries in *Marc's Big Boy* would meet the active business requirement under this standard. The sales subsidiaries performed a complete service, contributing to the financial success of the entire enterprise. Nevertheless, in *Marc's Big Boy* the Tax Court concluded under the generation of income doctrine that the sales subsidiaries earned no income. Accordingly, the Tax Court's decision produces conceptual asymmetry: although the restaurant subsidiaries actively conducted business, they earned no income.

Corporate Mergers

The Tax Court's holding in *Marc's Big Boy* that the management entity of an integrated enterprise earns the entire income of that enterprise also conflicts with the position of the Supreme Court on loss carry-overs following mergers and with the position the Service has taken on F reorganizations. In *Libson Shops, Inc. v. Koehler*²²⁹ sixteen sales corporations were merged into a single management corporation. This surviving corporation then conducted the entire business as a single enterprise. The amalgamated corporation sought to carry forward pre-merger losses incurred by the sales corporations to offset post-merger income. The Supreme Court in construing the predecessor²³⁰ to section 172 accepted the Government's alternative contention that the carry-over privilege was not available unless there was "continuity of business enterprise." In other words, it held that pre-merger losses could offset current income only to the extent that the latter was derived from substantially the same business which produced the loss. Ignoring the fact the pre-merger business constituted an integrated enterprise, the

²²⁷ Whitman, *supra* note 1, at 1223.

²²⁸ See Andrew M. Spheeris, 54 T.C. 1353, 1363 (1970).

²²⁹ 353 U.S. 382 (1957).

²³⁰ INT. REV. CODE of 1939, § 122(b)(2)(c). That provision provided in pertinent part as follows: "If for any taxable year . . . , the taxpayer has a net operating loss, such net operating loss shall be a net operating loss carry-over for each of three succeeding taxable years" (Emphasis added). The meaning of the term taxpayer, which does not exist in the 1954 Code's counterpart to this provision, was the focal point of the Court's inquiry.

Court found that the pre-merger enterprise was composed of "several businesses." A corollary of this holding is that in a multi-corporate integrated enterprise the income reported by the sales corporations is not all attributable to or earned by the management corporation. An opposite conclusion would require that the surviving management corporation be the same taxpayer that incurred the loss thereby contradicting the *Libson* holding.

Libson Shops also casts doubt on a recent trend in reorganizations of a single integrated business enterprise that, although conceptually consistent with *Marc's Big Boy*, is opposed by the Service. In *Home Construction Corp. v. United States*,²³¹ the Fifth Circuit accepted the taxpayer's contention that the consolidation of more than one corporate entity can satisfy the mere change in identity or form definition of an F reorganization.²³² An F reorganization is the only type of reorganization in which post-merger losses can be carried back and applied against the income of a corporation disappearing in the merger.²³³ Contrary to the major premise of *Libson Shops* the Fifth Circuit found that the amalgamated corporation was the alter ego of the pre-merger corporations that had conducted a single integrated business. The court rested its conclusion upon findings of [1] an identity of shareholder and proprietary interest; [2] *unimpaired continuity of the essential business enterprise*, and [3] no substantive difference between taxpayer's pre-merger operation consisting of multiple corporations and its post-merger operation consisting of numerous divisions of a single corporation.²³⁴ These are some of the same factors upon which the Tax Court rested its decision in *Marc's Big Boy*. Indeed, the development in these two areas is one of parallel evolution. Nevertheless, the Service, in a curious reversal of position²³⁵ resists strenuously the application of F reorganiza-

²³¹ 439 F.2d 1165 (5th Cir. 1971) (merger of 123 corporations).

²³² INT. REV. CODE of 1954, § 368(a)(1)(F).

²³³ *Id.* § 381(b)(3). The F reorganization overrides other reorganization provisions. Treas. Reg. § 1.381(b)-1(a)(2); Rev. Rul. 57-276, 1957-1 CUM. BULL. 126.

²³⁴ The lower court stated the issue as follows:

Does a reorganization involving a statutory merger of *functionally related corporations which comprise integral parts of a unified and centrally managed and controlled over-all business enterprise* into a single corporation with no change in stockholders or their proprietary interests, no change in the ownership, form or location of the corporate assets, no change in the corporate personnel or management, and no change in the type, scope and method of business operations, constitute a 'mere change in identity, form, or place of organization'?

(Emphasis added). 311 F. Supp. 830, 835 (S.D. Ala. 1969). See generally Frank, *F Reorganization—A New Life Under the Tax Reform Act?*, 49 Taxes 169 (1971).

²³⁵ Ironically, the application of § 368(a)(1)(F) was first urged by the Commissioner

tion status to mergers involving a single, integrated business conducted in multi-corporate form.

Constructive Dividends

The generation of income doctrine, as applied in *Marc's Big Boy*, also conflicts with the Service's posture in the area of constructive dividends. Arguing that a shareholder is entitled to an adequate return on his equity, the Service asserts that when a corporation pays no dividends to a shareholder-employee, a portion of the employee's compensation is a dividend, the payment of which is not a deduction.²³⁶ The effect of the decision in *Marc's Big Boy* is to refute this position: for the court denied the subsidiaries any return on their capital invested in facilities or employees.

Moreover, the joint application of the concept of a constructive dividend and the doctrine of generation of income produces a paradoxical result. If a sales corporation in a closely integrated business enterprise earns no taxable income, it has no current earnings and profits. Therefore, assuming no accumulated earnings and profits, if one of the restaurant subsidiaries in *Marc's Big Boy* were spun-off to a shareholder-employee, that portion of his compensation treated as a constructive dividend would be a dividend distributed out of capital, since there would be no current earnings under the generation of income doctrine. Thus, assuming no accumulated earnings and profits, the constructive dividend could be tax-free up to an amount equal to the shareholder-employee's basis in his stock and taxed at capital gains rates thereafter.²³⁷

in the context of the liquidation-reincorporation problem. The shareholders of the old corporation liquidate it under section 331, withdrawing accumulated earnings in the form of cash at capital gains rate (INT. REV. CODE of 1954, §§ 331, 1001, and 1221) and obtaining a stepped-up fair market value basis for the other assets under section 334(a), which they then transfer with a carry-over basis to a new corporation owned in substantially the same proportions (*Id.* §§ 351, 362(a)(1)). One of the Service's counter attacks is that the entire transaction constitutes an F reorganization with the cash being distributed as a boot-dividend under section 356(a)(2), or preferably as a functionally unrelated dividend under section 301. See Pugh, *The F Reorganization: Reveille For A Sleeping Giant?*, 24 TAX L. REV. 437, 443-45 (1969) (hereinafter cited as Pugh).

²³⁶ See Horsley & Dray, *supra* note 121, at 147.

²³⁷ A distribution of money, securities or other property (except stock in the corporation making the distribution, subject to certain further exceptions in section 305) by a corporation with respect to its stock is included in gross income to the extent that it is a dividend. INT. REV. CODE of 1954, §§ 301(a), 301(c), and 317(a). A dividend is a § 301 distribution made out of [1] accumulated earnings and profits or [2] out of earnings and profits of the taxable year. *Id.* § 316. The portion of such distribution

As a further twist, accumulated earnings might also prove no barrier to preferential treatment. Due to the absence of a statute of limitations on recomputation of earnings and profits, such a shareholder, unless barred by the doctrine of quasi-estoppel,²³⁸ could argue that his corporation had no accumulated earnings and profits arising in closed years under the *Big Boy* rationale.²³⁹

CONCLUSION AND PROPOSAL FOR ADMINISTRATIVE REFORM

The Tax Court's position that in an integrated business enterprise a management corporation, completely controlling the other entities, generates and is taxable upon the entire income of the enterprise is in conflict with many areas of tax law. This conflict compels the Service to abandon the *Marc's Big Boy* approach in favor of a standard of allocation under section 482 that considers the substantive business activities of all the functionally separated corporations in an integrated enterprise. Such a standard would not deny absolutely the benefit of multiple surtax exemptions to affiliated corporations carrying on substantive business activities in the framework of an integrated enterprise, but would only undo artificial shifting of income undertaken to acquire the tax advantage of such exemptions.

For taxable years beginning after December 31, 1974, and during the latter part of the phase-out period for multiple surtax exemptions, the principal potentiality for abuse will lie in avoiding the definition of "controlled group of corporations." If multiple corporations are able to operate as "one economic entity," and at the same time avoid this definition, an appropriate legislative response would be to define statutorily a controlled group to include every venture that constitutes a single integrated business enterprise. However, during the phase-out period there is a strong policy argument that no new administrative or judicial approach should be constructed to deny the remaining, but steadily decreasing benefits of multiple surtax exemptions. One could

which is not a dividend reduces the adjusted basis of the stock, *Id.* § 301(c)(2), and any excess is treated as capital gain, *Id.* § 301(c)(3)(A).

²³⁸ Lee, *Shareholder Withdrawal—Loan or Dividend: Repayments, Estoppel, and Other Anomalies*, 12 WM. & MARY L. REV. 512, 553-60 (1971).

²³⁹ Although section 482 is probably a one-way street with only the Commissioner having the power to invoke it, Treas. Reg. § 1.482-1(b)(3) (1962); Eustice, *supra* note 67, at 484; *see generally* Sherman, *supra* note 157, at 29-32; *but see* Cooper, *Section 45*, 4 TAX L. REV. 131 (1948), it would appear that the taxpayer is entitled to invoke section 61(a), and thus achieve much the same result as a section 42 reallocation of entire net income.

argue that Congress, aware of the overall economic impact of an immediate elimination of multiple surtax exemptions chose a gradual approach.²⁴⁰ If, however, the Service is willing to second-guess Congress, it should attack the multiple surtax exemption through section 269, focusing on the business purposes for multiple incorporation of an integrated business.

Section 269 is designed to disallow a tax benefit that would distort the liability of a particular taxpayer. The regulations provide that such distortion may be manifested when the essential nature of the taxpayer's situation is examined in the light of the basic purpose Congress intended to effectuate through the benefit.²⁴¹ The surtax exemption was intended as a concession for small business. Use of multiple surtax exemptions by a single integrated business is inconsistent with this limited purpose. Nevertheless neither the surtax provisions nor section 269 bar the use of the exemption by large corporations. Therefore, the crucial question under section 269 must be the purpose of the transaction.

The regulations under section 269 state that tax avoidance is the purpose of a transaction in which two or more corporations are formed instead of a single corporation merely to secure the benefit of multiple surtax exemptions.²⁴² On the other hand, the legislative history of section 1551 and the multiple corporation provisions contained in the Revenue Act of 1964 indicate that formation of additional corporations is a legitimate business purpose if done to expand an existing integrated business, to engage in different businesses in the same geographic area, or to engage in the same business in different geographic locales. These two conflicting policies must be resolved if the objective is immediate elimination of multiple surtax exemptions in multi-corporate integrated enterprises.

The principal purpose test under section 269 does not require the absence of any business purpose for the transaction at issue, it merely requires that the tax avoidance purpose exceed in importance any other purpose.²⁴³ Thus the Service could adopt the position that in an inte-

²⁴⁰ Of interest in this context is H.R. 6640, 92d Cong., 1st Sess. (1971) (an identical bill H.R. 19858, 91st Cong., 2d Sess. (1970) failed to emerge from Committee in the previous session), which would under certain circumstances suspend in effect the application of section 269 and 1551 to multiple corporations during the phase-out period. See note 245 *infra*, and accompanying text.

²⁴¹ Treas. Reg. § 1.269-2(b) (1962).

²⁴² Treas. Reg. § 1.269-3(b)(2) (1962).

²⁴³ Treas. Reg. § 1.269-3(a)(2) (1962).

grated enterprise the purpose of securing multiple surtax exemptions will generally outweigh the business purposes of expansion into different geographic areas or different businesses. Although the legislative history cited above indicates the Congress felt that the converse was true, Congress' interpretation of existing law, as contrasted with contemporaneous committee prints accompanying a new enactment, is not binding on a court.²⁴⁴ Furthermore, had Congress desired to sanctify expansion of an integrated enterprise, it could have done so expressly. A bill proposed in the 91st Congress and reintroduced in the 92d Congress²⁴⁵ would have precluded the application of sections 269 and 1551 to disallow the surtax exemption to any corporation organized prior to January 1, 1970, "as part of a program of business expansion to engage in business in a separate marketing location not previously served" by the affiliated group, unless the corporation was formed in the split-up of an existing business. In any event, asserting that obtaining multiple surtax exemptions meets the principal purpose test of section 269 is preferable to a distortion of section 482 through reallocating the entire taxable income of a corporation that is not a sham.

In abandoning its position that the management entity in an integrated business enterprise earns and is taxable on the entire income of the enterprise Treasury should create specific safe havens in the "performance of services for another" portion of the amended regulations.²⁴⁶ The current regulations value management services at an arm's length charge deemed equal to the performer's cost without a profit mark-up *except* where the services are an integral part of the business activity of either the performer or the recipient.²⁴⁷ The exception includes the following circumstances:²⁴⁸ [1] where the performer or recipient is engaged in the business of rendering management services to unrelated parties; [2] where rendering management services to related parties is one of the principal activities of the performer;²⁴⁹ [3] where the per-

²⁴⁴ *Golsen v. Commissioner*, 445 F.2d 985, 990 (10th Cir.), *cert. denied*, — U.S. — (1971). Cf. *Sicanoff Vegetable Oil Corp.*, 27 T.C. 1056, 1073 (1957), *rev'd on other grounds*, 251 F.2d 764 (7th Cir. 1958).

²⁴⁵ H.R. 19859, 91st Cong., 2d Sess. (1970); H.R. 6640, 92d Cong., 1st Sess. (1971).

²⁴⁶ Treas. Reg. § 1.482-2(b) (1968), *amended by* T.D. 6964, 7-24-68 and T.D. 6998, (1-17-69).

²⁴⁷ Treas. Reg. § 1.482-2(b)(3).

²⁴⁸ Treas. Reg. § 1.482-2(b)(7).

²⁴⁹ Treas. Reg. § 1.482-2(b)(7)(ii)(a). There is a safe cove: an exception to the exception if the cost of services does not exceed 25% of the total annual expenses of the performer.

former is peculiarly capable of rendering the services and they constitute a principal element in the operations of the recipient; and [4] where the recipient has received the benefit of a substantial amount of management services from one or more related parties in the taxable year.²⁵⁰ In the typical integrated enterprise the management services would fall into at least one of these exceptions,²⁵¹ in which case the only standard contained in the regulations for determining the arm's length charge is the amount which would have been charged for similar services in independent transactions with unrelated party under similar circumstances considering all relevant facts.²⁵²

The proposed regulations that preceded the current regulations contained a much narrower exception to the generally applicable arm's length charge of cost.²⁵³ Value, rather than cost, was the applicable charge only where the services were a part of the trade or business of the performing corporation. Thus the proposed regulations implicitly required that a significant amount of services be rendered to unrelated parties.²⁵⁴ The simplest route to certainty would be a return to the proposed regulation's approach, substituting for the integral part of trade or business exception an exception when the trade or business of the management corporation is rendering services to unrelated parties. However, under this approach the performer of management services in an integrated enterprise would not be taxable on any part of the net income of the entire enterprise—a result as difficult to justify as the *Big Boy* conclusion that it is taxable on the entire profit. In short, the present exceptions to the cost rule are more responsive to the underlying policies of section 482 than the trade or business exception of the proposed regulations.²⁵⁵ It is the absence of a safe haven for determining *value* of the services that needs to be supplied.

One approach for determining such value would be the "cost plus

²⁵⁰ Again there is a minor safe haven if the total cost to the performers of the services rendered do not exceed 25% of the expenses of the recipient. Treas. Reg. § 1.482-2 (b) (7) (iv) (1968).

²⁵¹ One commentator has pointed out that the second exception in text appears to be directed, in part, at management corporations formed to render administrative services to a group of controlled corporations. Jenks, *supra* note 88, at 298.

²⁵² *Id.* at 299 (regulations "afford no clue" as to how a profit markup, where required, is to be determined).

²⁵³ Prop. Treas. Reg. § 1.482-2(b) (7), 31 Fed. Reg. 10,394 (1966); see generally Eustice, *supra* note 67, at 505.

²⁵⁴ Eustice, *supra* note 67, at 505.

²⁵⁵ Eustice, *Affiliated Corporations Revisited, Recent Developments Under Sections 482 and 367*, 24 TAX L. REV. 101, 107 (1968).

method." Under this approach, which is one of the alternative methods adopted by the regulations in the area of sales of tangible property,²⁵⁶ the value of management services would be the sum of their cost to the performer plus an appropriate specific gross profit percentage. The principal difficulty with this approach is that it requires the regulations to set forth a specific gross profit percentage in order to provide a safe haven. The administrative position in the past has been that the variation in profit margins both industry to industry, among companies within an industry, and even among product lines within a single company is too great to permit a single percentage, or series of percentages, as profit mark-ups.²⁵⁷

The solution lies in a fair division of profits approach.²⁵⁸ One technique would be to allocate an amount equal to five percent of gross sales or fifty percent of net income, whichever is greater, to the sales corporation and to allocate the remainder to the management entity. An actual implementation of this approach may be seen in the House's proposed Domestic International Sales Corporation or "DISC" provisions.²⁵⁹ The profits of a DISC, a domestic corporation engaged almost exclusively in the export business, would not be taxed to it, but only to its shareholders when repatriated to them. To avoid the complexities of pricing under section 482 in the case of sales by an affiliated domestic corporation to a related DISC,²⁶⁰ two pricing rules are provided to determine the permissible deferred profits in the DISC—even if the sale is not the equivalent of an arm's length bargain. A DISC may earn a portion of the combined profit on the export sales equal to four percent of its disqualified export gross receipts (plus ten percent of its export promotion expenses attributable to the sale, which is intended to encourage the transfer of foreign sales functions and activities to the DISC),²⁶¹ or fifty percent of the combined taxable income of the DISC and the related party arising from the sale (plus ten percent of the attributable export promotion expenses) whichever is greater.

A fixed percentage of gross sales or of net income suffers, however, from the same failing as a fixed profit mark-up: this percentage may not reflect the contribution each component of an integrated business

²⁵⁶ Treas. Reg. § 1.482-2(e) (4) (1968).

²⁵⁷ Surrey, *supra* note 11, at 76; see generally Jenks, *supra* note 88, at 311.

²⁵⁸ See generally Jenks, *The "Creation of Income" Doctrine: A Comment on the Proposed Section 482 Regulations*, 43 TAXES 486, 493 (1965).

²⁵⁹ H.R. 10947, § 501, 92d Cong., 1st Sess. (1971).

²⁶⁰ H.R. Rep. No. 92-533, 92d Cong., 1st Sess. 73 (1971); accord, S. Rep. No. 92-437, 91st Cong., 1st Sess. 107 (1971).

²⁶¹ *Id.* at 75, 108.

makes to the entire profit of the enterprise. A method which comes closer to accomplishing that goal would be an optional allocation formula based on the ratio of assets, compensation of employees, business expenses, etc., attributable to each component and attributable to the entire enterprise. This approach (which is similar to the 1962 House proposal to modify section 482 with respect to sales of tangible goods between domestic and foreign controlled taxpayers) looks to the entire business arrangement between the affiliated corporations as did the *Big Boy* court. But it avoids many of the problems of that decision. Such an allocation formula approach expressly recognizes that where a controlled corporation owns assets used in its business and pays employees who perform services for that business, it earns some portion of the enterprise's income. This fundamental principle was ignored in *Marc's Big Boy*. This approach, of course, would satisfy any requirement that the amendatory regulations be used where applicable. It would also meet the Second Circuit's concern that an allocation be flexible and responsive to the principle that separate taxpayers be recognized for tax purposes in all but extreme instances. The approach focuses on the income producing activities and assets of each component, including management, rather than merely on the management control, and thereby avoids the erroneous generation of income doctrine. Though a formula division of profits does not specifically consider each intercompany transaction but rather the entire structure of the integrated enterprise, a reasonable division of income in the ultimate analysis should reach the same monetary result as the aggregate application of the arm's length standard to each transaction. Certainly a reasonable division of profits has been used as a proof to determine whether the arm's length equivalency had been satisfied.²⁶²

Creation of safe havens based on a formula allocation of net income under the performance of services portion of the regulations would provide certainty primarily to integrated service industries where the controlled taxpayers selling at retail do not sell property produced by an affiliate. In other circumstances a fair division of net income would apply to management services; but an arm's length approach now provided in the amendatory regulations would apply to sales of tangible property. To avoid the problems of determination of the portions of the entire enterprise's income to which each standard would be applied, and of coordination of the results of such application, formula

²⁶² See *PPG Indus., Inc.*, 55 T.C. 928, 997 (1970); *Lufkin Foundry & Mach. Co.*, 40 P-H TAX CT. MEM. 422, 460 (1971).

allocation could be limited to situations where the only intercompany transactions consist of rendering management services. The opposite extreme would be to abandon the search for the elusive arm's length charge contained in the present amended regulations and apply a formula allocation of profits standard to all intercompany transactions. An across-the-board application of a formula allocation appears, however, best suited to a single, integrated business enterprise because all components of the enterprise contribute to its income. Accordingly, this formula allocation approach should not only apply to intercompany transactions of an integrated enterprise, but should apply to all such transactions.

The proposed approach could coexist with the DISC proposals by expanding the latter's reference to arm's length charge (deferral of the greater of 50 percent of net profits, or arm's length charge) to include a formula allocation of net profits in an integrated business. This would lead to three standards for division of profits: [1] the DISC 50 percent of net profits, [2] 10 percent of gross sales, and [3] a formula allocation. But the alternative of an allocation formula is no more objectionable than an arm's length charge alternative. A serious criticism might, however be raised that availability of a safe haven formula allocation to an integrated international enterprise would permit the use of foreign export subsidiaries operating in tax haven jurisdictions as tax deferral alternatives to DISC's, yet subject to none of the latter's restrictions. Solving this problem of incorporating DISC restrictions into any allocation formula provisions appears more a legislative than an administrative task.

Any allocation formula that is based upon compensation and other deductions attributable to each controlled taxpayer must also provide rules for determining to which taxpayer such deductions are attributable. For example, under the present regulations the reallocation to foreign subsidiaries of a portion of the executive salaries paid by the parent corporation has become a prime source of controversy.²⁶³ Under an allocation formula the incentive would be for the Service to reallocate deductions to the domestic parent since the taxable income would follow correspondingly. Under the present regulations this question

²⁶³ Jenks, *supra* note 88, at 297. Similarly, for the purposes of the Federal Insurance Contributions Act (INT. REV. CODE of 1954, §§ 3101-26), the Service maintains that a portion of the salaries of executives of a parent corporation is deemed to be paid by subsidiaries, if such executives are officers of both the parent and subsidiaries, and perform substantial services for both in such capacity. Rev. Rul. 69-316, 1969-1 CUM. BULL. 263. In an integrated multi-corporate enterprise, this position conflicts with the *Marc's Big Boy* rationale.

of allocation of management services is the subject of the "intended benefits" test. Services undertaken for the joint benefit of members of a controlled group, but primarily intended to benefit one member, are to be allocated according to the relative benefit intended, unless the probable benefits to the other members were so indirect or remote that unrelated parties would not have been charged for such services or the service is a mere duplication of services which the related party has independently performed or is performing for itself.²⁶⁴ On the other hand, the court decisions draw an additional distinction between "supervisory controls" for the parent and "specific management" services for the subsidiaries.²⁶⁵ This distinction has been read as a primary benefit test—whether the primary benefit is to protect or advance the overall business of the parent, thereby precluding an allocation.²⁶⁶ Utilization of an allocation formula and a functional test would obviate some of the difficulties in the present benefit test in determining to which taxpayer a deduction is attributable. Management services, whether supervisory controls or specific management controls, would be attributed to the service corporation. Difficulties would no doubt arise in enterprises that were not cleanly divided along functional lines. In any event this area would have to be carefully explored if a formula allocation approach were adopted.²⁶⁷

In summary, the absence of support for, and the inconsistencies resulting from, the generation of income doctrine as applied in *Marc's Big Boy* dictate that the Service abandon this approach in making allocations under section 482. As an immediate solution to intercorporate abuse the Commissioner should limit his attack to section 269 and the specific intercompany transactional regulations under section 482. As an ultimate solution to the problem of allocation among the entities of an integrated business enterprise, a formula method of allocation based upon the ratio of assets, compensation of employees, and business expenses attributable to each component of the enterprise should be adopted.

²⁶⁴ Treas. Reg. § 1.482-2(b)(2) (1968). See generally Jenks, *supra* note 48, at 296-97.

²⁶⁵ *Young & Rubicam, Inc. v. United States*, 410 F. 2d 1223 (Ct. Cl. 1969); see *Columbian Rope Co.*, 42 T.C. 800, 814 (1964).

²⁶⁶ Kalish & Bodner, *supra* note 111, at 7. It has been suggested that the "benefit test" of the regulations should be modified to include this prior development. See Miller, *Proposals for Amelioration of Section 482 Allocations Affecting U.S. Taxpayers with Foreign Affiliations*, 44 TAXES 209, 270-73 (1966).

²⁶⁷ One approach would be to allocate costs which are not easily attributable to a specific member of the controlled group in the same proportion as readily attributable deductions are allocated. Cf. Treas. Reg. § 1.613-3(d)(1)(iii) (1968).

THE DISPOSITION OF *Marc's Big Boy* ON APPEAL: AN ADDENDUM

The Seventh Circuit has recently affirmed *Marc's Big Boy*.²⁶⁸ On the surface the importance of its opinion is limited to the incidence of burden of proof with the added fillip that reconstructing the course of dealings among a highly integrated group of taxpayers to comply with the arm's length standard is probably neither realistic nor feasible. However, a close reading reveals that the generation of income doctrine is still a factor.

On appeal the taxpayers argued that since each separately incorporated restaurant operation must have contributed in some degree to the overall net income of the integrated enterprise and, therefore, generated some of the net income, a total allocation was unreasonable, arbitrary, and capricious. Accordingly, they argued the Commissioner had failed to prove in the Tax Court any less extreme allocation, and no allocation should be allowed. The Commissioner countered with the argument that the Tax Court decision was correct since "faced with clear evidence that some allocation was necessary, taxpayers refrained from introducing any real proof supporting a lesser allocation."²⁶⁹

The circuit court, as the Tax Court before it, chose to limit itself to the extreme positions staked out by the parties. It held that the issue on appeal boiled down to the incidence of burden of proof and that the Tax Court had fairly placed that burden on the taxpayers. The appellate court agreed with the Tax Court below that the taxpayers had failed to show that the Commissioner's allocation was arbitrary based on the following factors: [1] the segments of the highly integrated group were so interdependent that any attempt at reconstruction of their course of dealings to approximate the arm's length standard would be fanciful and unreal, [2] *as the Tax Court saw it*,²⁷⁰ the management entity generated the entire income, and [3] the taxpayers failed to demonstrate a more favorable allocation consistent with the arm's length standard.

Thus, the appellate court seemingly held that to establish the arbitrariness of a section 482 allocation the taxpayer must show a more favorable allocation. And the Commissioner is sure to read this as re-

²⁶⁸ Nos. 18470-71 (7th Cir., Nov. 23, 1971).

²⁶⁹ *Id.* at 5.

²⁷⁰ The circuit court did not directly hold that the parent generated the entire income of the enterprise. Rather it pointed out that the Tax Court had so held and in another portion of its opinion stated that the Tax Court's findings of fact were not clearly erroneous. Under the clearly erroneous principle, an appellate court will upset a trial court's decision only if there was no evidence to support that decision. *Commissioner v. Duberstein*, 363 U.S. 278 (1960).

quiring a showing of the correct allocation. Yet, heretofore, it had been thought, under the aegis of *Helvering v. Taylor*,²⁷¹ that a taxpayer proceeding in the Tax Court was required merely to prove that the Commissioner's allocation was arbitrary (for example, that the taxpayer earned some part of the income which it had reported but which had been allocated to a related entity²⁷²); he need not establish the correct amount of the tax as is required in a refund case.²⁷³ That would be established upon the remanding and reopening of the case for additional evidence to determine a partial allocation.

Although neither party argued for this middle ground, the Seventh Circuit did discuss the solution of remanding for a determination of a partial allocation as it had done in a recent decision.²⁷⁴ It did not elect that solution in *Marc's Big Boy* because in its view [1] an arm's length standard reconstruction was probably neither realistic nor feasible, [2] the taxpayers did not attempt to make such a reconstruction or to establish its feasibility, and [3] "the findings of the trier of facts were adverse to the taxpayers, and not clearly erroneous."²⁷⁵ The last factor may well be the keystone of the appellate decision. For it follows from this conclusion that the Tax Court's finding that the management entity generated the entire income of the integrated enterprise was not disturbed. Consequently, the essential premise of the taxpayers' case, that each restaurant corporation earned some part of this entire income, was implicitly rejected by the Seventh Circuit. Thus, the burden of proof discussion was not necessarily directed to the situation in which the taxpayer can prove that the very basis of the Commissioner's allocation was arbitrary, but can not establish the correct distribution of income and deductions. The Seventh Circuit's disposition may accordingly be viewed in this context as merely repeating the error of the Tax Court in not recognizing that the restaurant subsidiaries did generate some portion of the income that they reported. If, however, it requires more than a taxpayer's showing that the entity reporting income earned some

²⁷¹ 293 U.S. 507 (1935).

²⁷² *W. Braun Co. v. Commissioner*, 396 F.2d 264 (2d Cir. 1968).

²⁷³ See *Plumb & Kapp*, *supra* note 85, at 830. Although the Commissioner argued on brief that *Helvering v. Taylor* did not involve section 482 and its special rule of proof, Brief for Commissioner, pp. 41-2 (7th Cir. 1971). in fact, it had been applied (as had the *Cohan* rule, of which *Taylor* may be viewed as the appellate cousin) in section 482 cases, e.g., *Campbell County State Bank v. Commissioner*, 311 F.2d 374, 379 (8th Cir. 1963).

²⁷⁴ *Baldwin-Lima-Hamilton Corp. v. United States*, 435 F.2d 182 (7th Cir. 1970).

²⁷⁵ Nos. 18470-71 at 6 (7th Cir., Nov. 23, 1971).

portion thereof to establish the arbitrariness of the Commissioner's re-allocation of the taxpayer's entire income, the appellate decision is in conflict with prior precedent and is erroneous.

The conclusion of the Seventh Circuit that any attempt to reconstruct the *Big Boy* course of dealings to approximate the arm's length standard would not be feasible is probably correct, at least to the extent the court was limiting its conclusion to a reconstruction by merely adjusting the fee structure.²⁷⁶ This conclusion highlights the immediate necessity for implementation of a fair division of profits approach where highly integrated groups of taxpayers are involved. If such an approach is not administratively adopted, it is to be hoped that the courts will fashion an approach along the lines suggested in this article. Otherwise, tax controversies are certain to arise where the Government, in reliance upon broad readings of the two *Big Boy* opinions, will launch a three-pronged attack: [1] the management entity in a highly integrated group of related taxpayers earns the entire income of the group, [2] the burden is on the taxpayer to establish a more favorable (correct) allocation consistent with the arm's length standard, and [3] any such reconstruction attempted by the hapless taxpayer is fanciful and unreal. In short the *Big Boy* development illustrates the sterility of application of the legal abstraction of the arm's length standard, particularly in the case of an integrated group, and mandates a reexamination of the concept of division of net income among related parties.²⁷⁷

²⁷⁶ The court's first reference to the difficulty of reconstructing the integrated group's dealings to conform with the arm's length standard was expressly limited to reconstructions through mere adjustments to the fee structure. Its reasoning would probably also apply to reconstructions through adjustments to other specific intercompany transaction pricing arrangements.

²⁷⁷ See Jenks, *supra* note 88, at 312-13.