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THE TREATMENT OF INCOME AND DEDUCTIONS IN THE CASE OF CONTROLLED OR RELATED ENTITIES

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INTRODUCTION

In no field of activity is the power of government more sweeping and uninhibited by conventional legal barriers than in federal income taxation. The tax law on occasion leaps corporate boundaries, throws the income of separate enterprises together, reallocates and reapportions income between taxpayers, disallows as improper and incorrect the charges between entities, arbitrarily disallows a corporate loss if the purpose of the corporate acquisition was primarily to make the loss available, and sometimes ignores the very existence of a corporation insofar as the tax effect of its organization is concerned. A power so all pervasive as this would be regarded as utterly tyrannical if it should exist in another area of government concern. In income taxation, it has been gradually developed and grudgingly accepted because the experience of decades of tax administration has demonstrated the need to provide such authority as a defense against manipulations of income that are otherwise thoroughly legal.

The reason for the passage of such laws becomes apparent when one considers that an elementary method of reducing federal taxation on income is its apportionment over a number of related entities, each having its own tax rate, thus preventing the accumulation of this income in any one enterprise, and accordingly reducing the tax brackets that may be applicable. Since this is a matter that may be completely within the control of a group of taxpayers, maneuvers of this type are very troublesome to combat. The question of just what limitations may be applied to this procedure is difficult, yet fascinating, particularly in the light of the American tendency to create corporations for every conceivable purpose. It gives rise to many questions such as:

Does the establishment of a valid corporation automatically carry with it the assurance that income received by it will be taxed at the rate applicable to the entity?

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May the Government entirely ignore a corporate entity?

May the Government shift income and deductions from one related taxpayer to another at will?

In proper cases, the tax incidents of operations may be shifted by the Internal Revenue Service from one entity to another, either by ignoring the existence of the entity on a form versus substance basis, or through the application of statutes providing the Commissioner with this specific power under given circumstances.

This article will trace briefly the development of the doctrines and statutes relating to this problem, and point up the similarities and distinctions between these various laws as they have evolved, under the pressure of economic events, over a period of more than fifty years.

DISREGARDING THE CORPORATE ENTITY—FORM VERSUS SUBSTANCE

The most widely known penetration of the corporate veil and disregard of the separate entity for tax purposes is found in *Gregory v. Helvering*,¹ which placed the issue of form versus substance before the Supreme Court of the United States. The doctrine enunciated in *Gregory* has constituted the basis for many other attempts to ignore separate taxable entities. It represents the background of the form versus substance cases that are attacked by the Internal Revenue Service under the provisions of Section 61 of the Internal Revenue Code. In this historic case, the mechanics of what purported to be a reorganization were disregarded on the ground that there was no sound business purpose to justify the transaction. Accordingly, the corporate entity may be ignored when it can be demonstrated that it is a mere conduit without substance or real meaning, or that it is only an agent for another corporation. Generally speaking, a corporation merely holding the bare legal title to property, and performing no function, is likely to be disregarded.² On the other hand, if there is some activity seeming to qualify as doing business, the corporate entity will probably be respected.³

In dealing with any problem involving income tax law, it behooves the taxpayer to dot his *i*'s and cross his *t*'s meticulously. Yet even after

1. *Moline Properties Inc. v. Commissioner*, 319 U.S. 743 (1943); *Gregory v. Helvering*, 293 U.S. 465 (1935).

2. *Moro Realty Holding Corp. v. Commissioner*, 65 F.2d 1013 (2nd Cir. 1933).

3. *Love v. United States*, 96 F. Supp. 919 (Ct. Cl. 1951).

this is done, there still remains the possibility of ignoring the form in which a transaction is so carefully cast in favor of the substance when its complete artificiality is apparent.

The passage of specific statutes dealing with the question of allocation of income or disallowance of deductions in a related group of entities has obviated the necessity, in most circumstances, of reliance only on case law and judicially established doctrines. Those sections of the 1954 Internal Revenue Code that are particularly germane to the issues under consideration are:

Section 482, involving reallocation of income and deductions between controlled entities, which has evolved from Section 240 of the Revenue Act of 1921.

Section 269, relating to acquisitions for the principal purpose of obtaining a deduction, credit or allowance for income tax determination, originally passed in 1943 as Section 129 of the 1939 Internal Revenue Code.

Section 1551, with respect to the formation of corporate entities to gain the advantage of additional surtax and accumulated earnings exemptions, originally passed in 1951 as Section 15(c) of the 1939 Internal Revenue Code.

These statutes possess certain common characteristics. On occasion, they may all be applied to one case, and frequently this is done by the Government for protective reasons; nevertheless, they are clearly distinguishable. A purpose of this discussion is to point up similarities as well as to differentiate between them.

SECTION 482—AUTHORIZING ALLOCATION AND APPORTIONMENT BY THE COMMISSIONER

The law granting sweeping authority to shift income and expenses is Section 482 of the 1954 Internal Revenue Code. This reads:

In any case of two or more organizations, trades or businesses, (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated), owned or controlled directly or indirectly by the same interests, the Secretary or his delegate may distribute, apportion or allocate gross income, deductions, credits or allowances between or among such organizations, trades or businesses, if he determines that such

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

The history of this law is long and rather tortuous. It first appears in the Revenue Act of 1921 in a section relating to consolidated returns and corporations.⁴ This provided that "in any case of two or more related trades or businesses (whether unincorporated or incorporated and whether organized in the United States or not), owned or controlled directly or indirectly by the same interests, the Commissioner may consolidate the accounts of such related trades and businesses, in any proper case, for the purpose of making an accurate distribution or apportionment of gains, profits, income, deductions or capital between or among such trades or businesses." It was continued in the same form in the 1924 Internal Revenue Act.⁵ It appears again in the 1926 Revenue Act.⁶ The applicable regulation was in substance a repetition of the statute itself.

The statute attained substantially its present form in the 1928 Revenue Act,⁷ which provided that:

In any case of two or more trades or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated), owned or controlled directly or indirectly by the same interests, the Commissioner is authorized to distribute, apportion, or allocate gross income or deductions between or among the trades or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such trades or businesses.

The wording of the section in the 1932 Revenue Act⁸ and in the 1934 Revenue Act⁹ is the same. A carefully developed section relating to this statute appears for the first time in regulations applicable to the 1934 Revenue Act,¹⁰ in which it is stated that the purpose of the law is to place the controlled taxpayer on a "tax parity with an uncontrolled

4. Revenue Act of 1921, ch. 136 § 240(d), 42 Stat. 260.

5. Revenue Act of 1924, ch. 234 § 240(d), 43 Stat. 288.

6. Revenue Act of 1926, ch. 27 § 240(f), 44 Stat. 46.

7. Revenue Act of 1928, ch. 852 § 45, Stat. 806.

8. Revenue Act of 1932, ch. 209 § 45, 47 Stat. 186.

9. Revenue Act of 1934, ch. 277 § 45, 48 Stat. 695.

10. Regulation 86 of Art. 45-1 of 1934 Code.

taxpayer by determining, according to the standards of an uncontrolled taxpayer, the true net income from the property and the business of a controlled taxpayer." The term "true net income" means, so the regulations say, "the net income which would have resulted to the controlled taxpayer had it in the conduct of its affairs (or as the case may be, in the particular contract, transaction, arrangement or other act) dealt with the other member or members of the group at arms length." This was carried forward in substantially the same form through the 1939 Internal Revenue Code¹¹ and finally into Section 482 of the 1954 Internal Revenue Code.¹² The purpose of the statute is not to extract the maximum amount of tax that might be possible from a given situation or under particular circumstances. The income tax is to be imposed on the basis of the result that would have been attained if the transaction between the enterprises had not been controlled.

The section may be applied whether the taxpayer makes a separate return or a consolidated return. The Regulations provide that "if a controlled taxpayer makes a separate return, the determination is of its true taxable net income. If a controlled taxpayer is a party to a consolidated return, the true consolidated taxable income of the affiliated group and the true separate taxable income of the controlled taxpayer are determined consistently with the principles of a consolidated return."¹³

The same regulation provides the test of whether a transaction is fraudulent, colorable or a sham, or is a device designed to reduce or avoid tax by shifting or distorting income, deductions, credits or allowances. The result to be achieved by the application of the section is the reflection of the income that would have resulted had the taxpayer been uncontrolled and dealing at arms length with another uncontrolled taxpayer.¹⁴

If the requisite control exists, Section 482 may be used for allocations and reapportionments between individuals, partnerships, domestic and foreign corporations, estates, trusts, and tax exempt organizations. It is apparent, therefore, that the section may be applied to income arrangements between taxable and non-taxable entities. It may be invoked only by the Government and not by the taxpayer.

11. Int. Rev. Code of 1939, § 45, 53 Stat. 25.

12. INT. REV. CODE OF 1954 § 482.

13. Treas. Reg. § 1.482-1(b)(2) (1963).

14. Treas. Reg. § 1.482-1(c) (1962).

Control is Necessary

The definition of control is important to a consideration of this section. There are no objective standards in the statute indicating the meaning of this term. The actuality of control is the crucial question, and its existence may be inferred from the course of conduct of the parties. Are the taxpayers in the group of enterprises interrelated in such a manner that it is possible to exercise a control that will be used purely to create a contrived and unreasonable income for any of the various entities in the group? Seemingly capricious adjustments between various taxpayers may create a presumption of control, although not necessarily indicating its improper exercise.¹⁵

In one case, all of the partners in a partnership were stockholders of a corporation from which the partnership leased operating equipment. Although 35% of the corporate stock was held by persons who were not partners, because of family relationships and certain practical economic factors, the partnership and the lessor corporation were considered to be controlled by the same interests.¹⁶

Another case deals with a corporation in which certain members of a partnership owned 100% of the capital stock. One of the members of the partnership was president of the corporation and exercised administrative control, while he was the business manager of the partnership. In this case, the court found that the control required by Section 482 was present.¹⁷

On the other hand, when 46% of a corporation's stock was held by persons not members of a partnership, and a 30% partner had no interest in the corporation, the court considered it doubtful that the necessary control was present to justify the application of this section.¹⁸

Some Situations in Which the Statute May Be Applied

The section has been applied to prevent the shifting of income from one entity to another.¹⁹ Likewise, it has been used to prevent loss of

15. *Grenada Industries v. Commissioner* 17 T.C. 231 (1951), 202 F.2d 873 (5th Cir. 1953), *cert. denied* 346 U.S. 819 (1953); *Advance Machinery Exchange v. Commissioner*, 196 F.2d 1006 (2d Cir. 1952); G.C.M. 2856, VII-1 CUM. BULL. 128 (1933); Rev. Rul. 59-247, 1952-2 CUM. BULL. 112.

16. *South Texas Rice Warehouse Co. v. Commissioner*, 41 T.C. 540 (1966), 366 F.2d 890 (5th Cir. 1966) *cert. denied* 386 U.S. 1016 (1967).

17. *Friedlander Corp. v. Commissioner*, 25 T.C. 70 (1955).

18. *Cedar Valley Distillery v. Commissioner*, 16 T.C. 870(A) (1951).

19. *Asiatic Petroleum Co. v. Commissioner*, 79 F.2d 234 (2nd Cir. 1935), *cert. denied* 296 U.S. 645 (1935), *rehearing denied* 296 U.S. 664 (1935).

tax on income because of the liquidation of a corporation prior to realization of income in the case of a completed contract basis accounting method,²⁰ and also when there has been an unjustified shift of a profit to a loss corporation.²¹

It has been held that Section 482 cannot be used to create income where none exists. For example, an organization may not be required to charge rent for the use of property or interest on a loan to another member of the group. Nevertheless, through the shifting of expenses applicable thereto when actually incurred in transactions outside the group, the Commissioner may be able to obtain substantially the same result.²² For more recent thinking on this subject, however, reference is made to proposed new regulations under this section which are discussed later in this presentation.

Section 482 may be applied to eliminate the income and deductions from a member of the controlled group²³ and attribute them to another member if the former member does not perform a valid function. This may result when an attempt is made to separate on an unrealistic basis the various segments of what would otherwise be a unitary operation.²⁴ On the other hand, if the entities in a controlled group are clearly separable and the arrangements between them are reasonable, the law does not justify consolidation of the operations for tax purposes, merely because it would result in a larger income tax.²⁵

The burden is on the taxpayer to prove the incorrectness of the Government's position.²⁶ Therefore, it is important from the taxpayer's standpoint to demonstrate that the enterprises involved in a consideration of this section are self-contained economic units, each of which reports the income properly attributable to its operations. This validity of the

20. *Dillard-Waltermire, Inc. v. Campbell*, 255 F.2d 433 (5th Cir. 1958); *Jud Plumbing & Heating, Inc. v. Commissioner*, 153 F.2d 681 (5th Cir. 1946).

21. *Leedy-Glover Realty & Insurance Co., Inc. v. Commissioner*, 13 T.C. 95 (1950). 184 F.2d 833 (5th Cir. 1950).

22. *Smith-Bridgman & Co. v. Commissioner*, 16 T.C. 287(A) (1951); *Texsun Supply Corp. v. Commissioner*, 17 T.C. 433(A) (1951).

23. *Advance Machinery Exchange v. Commissioner*, 196 F.2d 1106 (2nd Cir. 1952); *Forcum James Co. v. Commissioner*, 7 T.C. 1195(A) (1946), 176 F.2d 311 (6th Cir. 1949); *Seminole Flavor Co. v. Commissioner*, 4 T.C. 1215(A) (1945).

24. *Shaw Construction Co. v. Commissioner*, 35 T.C. 1102(A) (1961), 323 F.2d 316 (9th Cir. 1963).

25. *J. I. Byrne Est. v. Commissioner*, 16 T.C. 1234(A) (1951); *Seminole Flavor Co. v. Commissioner*, 4 T.C. 1215(A) (1945).

26. *First Securities Corp. of Memphis, Tenn. v. Commissioner*, 103 F.2d 1011 (6th Cir. 1939).

entity may be attested by many factors, including suitable records separately maintained,²⁷ separate bank accounts, and separate stationery and billheads for each entity. Each enterprise should be held out to the public in every way as a separate entity. It should contract separately, have its own personnel, and file the necessary withholding returns for its employees. However, although this may prove the separation of the enterprises or entities, it does not necessarily establish the reasonableness of the charges between them. These must be fair and equitable for the goods sold or the services rendered.²⁸ A charge that had been made initially on what appeared to be a reasonable basis and later arbitrarily adjusted to accomplish a better tax result would cause suspicion concerning the purpose of the change and might result in the Internal Revenue Service's efforts to effect a revision of the item. Substantial charges made from one entity to another with obviously no effort to determine a suitable basis may cause the invocation of the section.²⁹ The early establishment of a reasonable method of making charges between enterprises at a time when the resulting effects on tax economy cannot be anticipated can be helpful in establishing the propriety of a subsequent charge. The presence of fraud is not necessary for the application of the section.³⁰

Of course, the use of the section does not result in the actual shifting of income from one entity to another, but merely in the transfer of the tax incidents of the income. An excessive charge for services made between the A and B corporations does not make it possible through the use of this section to transfer income from one to the other. It merely permits the two to be taxed as though the excessive charge had not been made. Ordinarily this will not cause double taxation, for in the case of intercompany charges, when the amount deductible by one entity is reduced, the amount taxable to the other entity is reduced also. Section 482 does not permit changing the tax effect of a transaction because a corporation was created primarily for tax savings purposes, provided the income of the corporation is fairly shown.³¹ Such a disal-

27. *W. G. Duncan v. Commissioner*, 6 CCH Tax Ct. Mem. 1292 (1947), 173 F.2d 218 (5th Cir. 1949), *cert. denied*, 337 U.S. 957 (1949).

28. *Oil Base, Inc. v. Commissioner*, 362 F.2d 212 (9th Cir. 1966), *cert. denied*, 385 U.S. 928 (1966).

29. *Asiatic Petroleum Co. v. Commissioner*, 79 F.2d 234 (2nd Cir. 1935), *cert. denied*, 296 U.S. 645 (1935), *rehearing denied*, 296 U.S. 664 (1935).

30. *Simon J. Murphy v. Commissioner*, 22 T.C. 1341 (1954).

31. *Unger v. Campbell*, 7 A.F.T.R. 2d 547 (N.D. Texas 1960).

lowance of the favorable tax effects growing out of the creation of a separate entity may result from the application of either Section 269 or Section 1551, but not necessarily from Section 482.

The principle had long been accepted in regard to this section that there could be no allocation of income unless it actually exists as the result of a transaction with a taxpayer outside of the group. Consider, for example, the situation in which A sells to B at a very low profit. B later sells the same property to an outsider at a much greater profit. The method of sale attributes much more income to B and much less to A than would occur under ordinary circumstances. At one time there could have been no allocation of greater income from B to A. However, under present case law, when the assets sold by A to B have been sold in turn by B to an outsider, the total profit involved can be apportioned between A and B. However, under the decided cases, there would be no allocation of additional profits from B to A when B in turn had not realized profit for the group by a sale to an outside taxpayer. An interesting question arises under this section when a parent company makes a tax free loan to a subsidiary corporation. Under these circumstances, can it be considered that the subsidiary has paid interest to the parent company?³²

Proposed New Regulations and New Concept

These views concerning the creation of income within the group where none had previously existed may conceivably be replaced by a new doctrine. It is significant that regulations proposed August 2, 1966, under Section 482, provide what appears to be a drastic revision in the previous administrative attitude toward this question. Quite possibly this issue will be retested, for although *Smith-Bridgman & Co.*³³ and *Texsun Supply Corp.*³⁴ appear conclusively to have established this principle, the new regulations call for the attribution of a fair sales price and arms length interest charges between parent and subsidiary corporations. This is entirely contrary to the previously accepted principle that income cannot be created when none exists.

The proposed new regulations would require that when one member of a controlled group sells to another member at other than an arms

32. See Note, *Interest-Free Loans and Section 482—Creation of Income?* 9 WM. & MARY L. REV. 509 (1967), [Ed. Note].

33. 16 T.C. 287(A) (1951).

34. 17 T.C. 433(A) (1951).

length price, an allocation may be made between the seller and the buyer to reflect an arms length price for the sale. The arms length price is the price that an unrelated party would have paid under the circumstances for the property involved in the controlled sale. Since unrelated parties ordinarily sell products at a profit, it is presumed that an arms length price would normally involve a profit to the seller. The proposed regulations provide that prices may be determined by (1) the comparable uncontrolled price method,³⁵ (2) the resale price method,³⁶ and (3) the cost plus method.³⁷ This entire approach appears to be an innovation in the application of this section.

Uncontrolled sales take place when at least one party to the sale is not a member of the controlled group. They may occur when a sale is made by the seller to an unrelated party, when a sale is made to the buyer by an unrelated party, and when a sale is made where neither party is a member of the controlled group. The regulations explain that these uncontrolled sales do not include sales at unrealistic prices, "as for example where a member makes uncontrolled sales in small quantities at a price designed to justify a non-arms length price on a large volume of controlled sales."³⁸ In general, uncontrolled sales are considered comparable to controlled sales if the physical property and circumstances involved are identical or if the properties and circumstances are so nearly identical that any differences either have no effect on the price or can readily be reflected by a reasonable number of adjustments to the price of the uncontrolled sales. It is proposed that when significant differences exist these can be corrected by proper adjustments.

The resale price method is possible when there has been a sale from one member of the controlled group to the other and the purchaser resells the merchandise outside the group. The proper price for the buyer (reseller) is determined by taking his uncontrolled sale price of the goods and reducing it to a theoretically proper cost by applying the percentage of markup earned by this buyer (reseller) on uncontrolled sales during the period. The resale price must be used to compute an arms length price of a controlled sale if all of the following circumstances exist:

35. Proposed Treas. Reg. § 1.482-2(e)(2), 31 Fed. Reg. 10394 (1966).

36. Proposed Treas. Reg. § 1.482-2(e)(3), 31 Fed. Reg. 10394 (1966).

37. Proposed Treas. Reg. § 1.482-2(e)(4), 31 Fed. Reg. 10394 (1966).

38. Proposed Treas. Reg. § 1.482-2(e)(2), 31 Fed. Reg. 10394 (1966).

- (a) There are no comparable uncontrolled sales.
- (b) An applicable resale price is available with respect to resales made within a reasonable time before or after the time of the controlled sale.
- (c) The buyer (reseller) has not added more than an insubstantial amount to the value of the property by physically altering the product before resale. For this purpose, packaging, repackaging, labeling or minor assembly of property do not constitute physical alteration.
- (d) The buyer (reseller) has not added more than an insubstantial amount to the value of the property by the use of its intangible property.

If there are no comparable uncontrolled sales, the resale price method must be utilized. If all the standards for the mandatory application of the resale price are not satisfied, then either that method or the cost-plus method will be used depending upon which is more feasible and likely to result in a more accurate estimate of an arms length price. When the cost plus method is used the arms length price of a controlled sale is computed by adding to the cost of producing the property an amount equal to the cost multiplied by the appropriate gross profit percentage plus or minus certain necessary adjustments. For the purposes of this subsection of the proposed regulation, the appropriate gross percentage is the gross profit percentage (expressed as a percentage of cost) earned by the seller or another party during the taxable year on the uncontrolled sale or sales of property which are most similar to the controlled sale in question with respect to the following characteristics:

- (a) The type of property involved in the sales. For example, machine tools, men's furnishings, small household appliances.
- (b) The functions performed by the seller with respect to the property sold. For example, contract manufacturing, product assembly, selling activity, processing, servicing, delivering.
- (c) The effect of any intangible property of the seller associated with the property sold. For example, patents, trademarks, tradenames.
- (d) The geographic market in which the functions are performed by the seller.

If the taxpayer wishes to use some method other than the comparable uncontrolled price method, the resale price method, or the cost plus method, the regulations would require that the District Director be

satisfied that considering all the facts and circumstances this other method of pricing would clearly be more appropriate.

It appears that to some degree the proposals of the Treasury will constitute a radical departure from past practice. This is an embarkation on hitherto uncharted seas and the judicial reaction to the Government's position will be interesting indeed. These proposals require not only that income actually realized through transactions outside the group be appropriately apportioned, but that income might be created as to one member of the group for income tax purposes with a corresponding adjustment as to another member of the group on transactions that remain entirely within the group.

It is proposed that this be done in the case of interest on loans or advances³⁹ and charges for the performance of services, for the use of tangible property, for the use or transfer of intangible property, and for sale of tangible properties. Of course, the regulations have consistently required that for every adjustment made to one member of the group, there must be a correlative adjustment to another member. The implications of these new proposals, however, are quite striking and dramatic.

Certainly an interest adjustment between parent and subsidiary, when none had actually been charged, should be clearly justified by the need either to prevent evasion of tax or clearly to reflect the income of the enterprises. The statute refers to allocating "gross income" to prevent distortion or evasion, and the granting of an interest free loan by a parent to a subsidiary that is taxed at a lower rate in a foreign country or to a domestic corporation in a lower tax bracket may constitute a certain type of evasion. The same would be true of a sale to a subsidiary in a tax haven at an excessively low price, for the income realized on its resale would flow into an entity having little or no tax, thus effectively evading the American income tax. Therefore, the new proposed regulation will be very sweeping in the scope of its application to foreign operations, spelling out as it does with particularity the manner in which transactions should be apportioned between the United States and foreign nations to assure the equitable reporting of profit under the circumstances.

The danger of a law such as this grows apparent when one considers the uncertainty of the taxpayer's position and the fear that any transaction may be recast for tax purposes by the tax administrator to attain

39. Proposed Treas. Reg. § 1.482-2(a)(2), 31 Fed. Reg. 10394 (1966).

what he regards as a fair, proper or uncontrolled result. This may give rise to the application of standards that seem reasonable in the light of hindsight, but were not necessarily apparent at the time the course of conduct took place. The judgment of a critical examiner intent on protection of the revenue at all costs can be substituted belatedly for decisions made under the pressure of immediate business conditions, and a taxpayer can be required to justify the position reflected in the tax returns in the arena of the courtroom, carrying the proof of burden as he does so.

The taxpayer in such a conflict has the advantage of an intimate knowledge of his own business affairs, and the comprehension of the techniques of his trade makes it possible for him to argue his case convincingly. The Government, on the other hand, has the sweeping authority conveyed by the statute and the ability to thrust the burden of proof on the taxpayer to sustain his position. There is no other section of the statute which requires more administrative prudence and taxpayer integrity if a fair result is to be achieved. The proper application of this law is more likely to be assured by a harmonious conference around a table than through a trial by combat in open court, and every effort should be made to deal with these questions in this manner.

Although Section 482 is seemingly comprehensive in the extreme, it was unsatisfactory as the basis for dealing with certain classes of tax avoidance and evasion plans. It could not always be effectively applied to the utilization of net operating loss carryovers by means of corporate acquisitions, nor to the surtax advantages gained in some cases by the creation of unnecessary corporations. The limitation of Section 482 grew out of the requirement that income and deductions may be shifted only to the extent necessary to reflect clearly the proper net income of the entities involved. It is not concerned with the purpose for which an entity is created, but only with the reasonableness with which its income is determined. Therefore, Sections 269 and 1551 were added to the arsenal of the Commissioner's legal weapons for dealing with income manipulation.

SECTION 269—ACQUISITIONS TO OBTAIN THE BENEFITS OF DEDUCTIONS AND CREDITS, ETC.

This law came into being in 1943 as Section 129 of the 1939 Internal Revenue Code⁴⁰ primarily to provide a means of ending the acquisition

40. INT. REV. CODE OF 1939, § 129.

of corporate entities entirely for the purpose of making available any loss carryover the acquired corporation might possess. In fact, this practice was becoming so blatant that it was not unusual to see advertisements in business periodicals and papers announcing the availability of such corporations for purchase. Section 129 was substantially the same as it appears today in the 1954 Internal Revenue Code.⁴¹ Its attempted application in the earlier days of its existence was quite limited and there was little effort made to use it for any purpose except the disallowance of a net operating loss carryover obtained as the result of a corporation acquisition. There were a few attempts to apply it in the case of divisive reorganizations on the grounds that the creation of the new corporation had resulted from a desire on the part of members of the group to avail themselves of a favorable surtax position. These initial efforts were rather unsuccessful.⁴² Later the section was used more successfully for this purpose,⁴³ and the regulations now contain specific provisions for this type of case.⁴⁴ However, in those cases where a divisive reorganization had as its predominant purpose the utilization of a tax advantage not otherwise obtainable, an attack on the reorganization exchange itself can well be made by treating it as taxable rather than as non-taxable because of the lack of an overriding sound business purpose. Increasingly, cases of this nature are being approached, if possible, under Section 1551⁴⁵ because, if the objective standards of that section with respect to the stockholdings have been met, it places a heavier burden on the taxpayer to show the reason for the accomplishment of the transaction. Whereas, under Section 269, the taxpayer must prove that the availability of a loss did not constitute *the principal* reason for the acquisition, under Section 1551, he must show that it was not a *major* purpose.

The law grants sweeping authority to the Government to disallow deductions, credits or other allowances if the forbidden purpose is present, or, if it is deemed appropriate, to make this disallowance or adjustment only in part.⁴⁶

Unlike Section 482, Section 269 sets forth certain objective standards

41. *Id.* § 269(a).

42. *Alcorn Wholesale Co. v. Commissioner*, 16 T.C. 75 (1951).

43. *Bonneville Locks Towing Co. v. Commissioner*, 343 F.2d 790 (9th Cir. 1965); *James Realty Co. v. Commissioner*, 280 F.2d 394 (8th Cir. 1960); *Coastal Oil Storage v. Commissioner*, 243 F.2d 97 (4th Cir. 1957).

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

45. *INT. REV. CODE OF 1954*.

46. *Id.* § 269(a)(2).

to determine whether or not it may be applied in the case of particular taxpayers.⁴⁷ First, it deals with those cases where, on or after October 8, 1940, a person or persons acquire or acquired directly or indirectly control of a corporation. Second, it applies to the acquisition on or after October 8, 1940, directly or indirectly of property of another corporation not controlled directly or indirectly immediately before such acquisition by the acquiring corporation or its stockholders, when the basis of the property in the hands of the acquiring corporation is determined by reference to its basis in the hands of the transferor corporation.

For the purposes of Section 269, control means the ownership of stock possessing at least 50% of the total combined voting power of all classes of stock entitled to vote, or at least 50% of the total value of shares of all classes of stock of the corporation. To be applicable, this law requires the presence of the principal purpose to evade or avoid federal income tax by securing the benefit of a deduction, credit or other allowance which the person or corporation would not otherwise enjoy. Obviously, these specifications are different from the very sweeping and generalized requirements of Section 482, which deals with control of any sort existing between any type of enterprise or entity. Section 269 applies to acquisitions with resulting tax benefits between persons or corporations carefully described in the law, and its application depends upon the principal purpose of the acquisition.⁴⁸ Section 482 may be applied in any controlled situation to place the members in the controlled group on a parity with non-controlled taxpayers.

Section 381 provides for the carryover of a net operating loss in the case of a liquidation of a subsidiary when the parent owns 80% or more of the stock, if the stock has been held for two or more years. This section also permits carryovers of such losses in mergers and other types of reorganization.⁴⁹ Section 382(a)⁵⁰ has a provision for the disallowance of such a loss to a corporation when stock of a corporation is acquired by ten or fewer persons, with the result that there is a change of fifty or more percentage points in the holdings of such person or persons, and there is a change in the character of the corporation's business within a certain period of time. Section 382(b)⁵¹ scales down

47. *Id.* § 269(a).

48. *Id.* § 269(b).

49. INT. REV. CODE OF 1954.

50. *Id.*

51. *Id.*

on a percentage basis the net operating loss of the transferor corporation in a reorganization when its stockholders, as a result of the reorganization, obtained less than twenty percent of the fair market value of the acquiring corporation's stock. Section 269 is available for consideration in those cases not covered by Sections 382(a) and (b).⁵² Some cases where the change in character of business did not take place completely within two years after acquisition have been dealt with successfully by the Government under Section 269.⁵³

The application of Section 269 seems rather simple where an acquiring corporation merges a component that possesses a net operating loss and the surrounding circumstances clearly indicate the predominant purpose of the transaction was to make this loss available. In the earlier days of this law, some thought that the taxpayer's position was more secure if the loss was that of the acquiring corporation and a component with a profit was merged into it. Nevertheless, under these conditions, it has been held that Section 269 may be applied so that the continuing corporation's net operating loss may not be utilized for this purpose.⁵⁴

Generally speaking, cases involving net operating loss carryovers of an acquiring corporation may be divided into two categories. The first includes the acquisition of a profit corporation by a loss corporation so that the profit corporation may be merged into the loss corporation to obtain the benefit of a net operating loss; the second includes the transfer or shifting of business assets by the stockholders who acquired the loss corporation so that the profit from this enterprise may flow into the loss corporation. This type of acquisition is described in the regulations in the following language:

A corporation or other business enterprise (or the interest controlling such corporation or enterprise) with large profits acquires control of a corporation with current, past or prospective credits, deductions, net operating losses, or other allowances and the acquisition is followed by such transfers or other action as is necessary to bring the deduction, credit or other allowance into conjunction with the income (See further Section 1.269-6). This subparagraph may be illustrated by the following example:

EXAMPLE: Individual A acquires all of the stock of L corporation, which has been engaged in the business of operating retail

52. *Id.*

53. *Brown Dynalube Co. v. Commissioner*, 297 F.2d 915 (4th Cir. 1962); *J. G. Dudley Co. v. Commissioner*, 298 F.2d 750 (4th Cir. 1962).

54. *J. T. Slocomb v. Commissioner*, 334 F.2d 269 (2d Cir. 1964).

drug stores. At the time of the acquisition, L corporation has net operating loss carryovers aggregating \$100,000, and its net worth is \$100,000. After the acquisition, L corporation continues to engage in the business of operating retail drug stores, but the profits attributable to such business after the acquisition are not sufficient to absorb any substantial portion of the net operating loss carryovers. Shortly after the acquisition, individual A causes to be transferred to L corporation the assets of a hardware business previously controlled by A, which business produces profit sufficient to absorb a substantial portion of L corporation's net operating loss carryovers. The transfer of the profitable business, which has the effect of using net operating loss carryovers to offset gains of a business unrelated to that which produces the losses, indicates that the principal purpose for which the acquisition of control was made is evasion or avoidance of Federal income tax.⁵⁵

A troublesome question may arise when the stockholders of a profit corporation individually purchase a loss corporation. Does the fact of this acquisition by the stockholders cause the invocation of Section 269 if, following the purchase, the loss corporation begins to operate at profit? At first blush it would appear reasonable that the net operating loss of the acquired corporation is properly its own deduction, and if a change in management rendering its operation more effective should transform a loss into a profit, there should be no reason why the loss should not be carried over. Nevertheless, in certain cases, it has been held that if following this acquisition there is a diversion of operating income from the stockholders directly or indirectly to this newly acquired corporation, Section 269 may be applied.⁵⁶ Also, consideration is given to the question of whether or not the corporation thus acquired was at the time of its acquisition really worthless except for utilization of the loss.

The Internal Revenue Service has dealt with this question in Revenue Ruling 63-40.⁵⁷ This refers to a case in which the M corporation, with accumulated net operating losses sustained for prior years, acquired the assets of the N corporation, which had a successful history of operating drive-in restaurants. M and N were unrelated corporations and none of the shareholders in M corporation owned directly or indirectly any stock of N corporation. The funds for the cash purchase were derived

55. Treas. Reg. § 1.269-1 (1962).

56. H. F. Ramsey Company, 43 T.C. 500 (1965).

57. Rev. Rul. 63-40, 1963-1 INT. REV. BULL. 46.

in part from N corporation's own business assets and in part from an equal contribution of cash to its capital by its three stockholders. Shortly thereafter, M corporation discontinued its form of business activity, sold the assets connected therewith, and engaged exclusively in the business of operating the chain of drive-in restaurants formerly operated by N corporation. In these circumstances, the Internal Revenue Service ruled that Section 269 had no application to the situation and did not serve to bar the carryover of the net operating losses. Further advice was then sought concerning the attitude of the Service had the M corporation, instead of purchasing the assets of N corporation, acquired its capital stock. In the example given, the M corporation first attempted, in extended negotiations, to purchase the assets of N corporation, but the shareholders of N corporation were unwilling to consummate the transaction except by way of the sale of their stock to M corporation. M corporation therefore purchased the stock of N corporation for cash at market value, solely for the purpose of acquiring its assets, and immediately thereafter liquidated N corporation under such circumstances that the basis of the assets of M corporation would be determined by reference to the amount it paid for the stock of N corporation. In these circumstances, the Internal Revenue Service ruled that Section 269 would not apply to disallow the net operating loss carryover of M corporation.

The purpose of the acquisition is of predominant importance. Of course, in some cases, this seems to be rather obvious, and there are situations in which it is apparent that there would be no justification for such a purchase by a prudent business man except to utilize a net operating loss. The statute, however, provides a rather peculiar criterion for judging this intent: the payment of a disproportionate amount for the properties involved.⁵⁸

58. INT. REV. CODE OF 1954 § 269(c).

(c) PRESUMPTION IN CASE OF DISPROPORTIONATE PURCHASE PRICE.—The fact that the consideration paid upon an acquisition by any person or corporation described in subsection (a) is substantially disproportionate to the aggregate—

(1) of the adjusted basis of the property of the corporation (to the extent attributable to the interest acquired specified in paragraph (1) of subsection (a)), or of the property acquired specified in paragraph (2) of subsection (a); and

(2) of the tax benefits (to the extent not reflected in the adjusted basis of the property) not available to such person or corporation otherwise than as a result of such acquisition,

shall be prima facie evidence of the principal purpose of evasion or avoidance of

The payment of what appears to be a substantially disproportionate amount for the properties involved merely establishes presumptively that the purpose of the acquisition is the evasion or the avoidance of income tax. This presumption is of course entirely rebuttable. This seems a rather odd standard by which to judge intent, for there are many who would think that the purchase for a *substantial* price would be indicative of the tax avoidance purpose. Quite to the contrary, however, the law apparently gives rise to the presumption that the forbidden purpose exists not if the amount paid is too high, but if it is too low in relation to the tax benefits available as the result of the acquisition and the adjusted basis of the property of the corporation. Nevertheless, when a taxpayer was able to show that the principal purpose of acquiring a loss corporation at a low price was to effect a bargain purchase of the properties, the allowance of the corporation's net operating loss was sustained.⁵⁹

Although it has been applied in the disallowance of surtax exemptions growing out of the creation of multiple corporations, it would appear that the primary purpose of Section 269 would be to disallow net operating losses and carryovers of other types in circumstances indicating that the availability of these tax benefits constituted the predominant reason for the acquisition.

While this section can be applied to divisive reorganizations, there is another weapon available to the Internal Revenue Service in dealing with these; the fact of the overriding tax benefit purpose can be used to disallow the reorganization as a non-taxable exchange, and under some circumstances to tax the distributions as dividends to the recipient stockholders. It is conceivable that Section 269 might be applied as an alternative to or in conjunction with such an attack on the validity of a spin-off or split-up.

The taxpayer may, however, demonstrate a principal purpose other than tax savings, yet be vulnerable because a major purpose is tax avoidance. Section 1551 is available to the Commissioner to effect a disallowance of a corporate surtax exemption in a more restricted factual situation.

Federal income tax. This subsection shall apply only with respect to acquisitions after March 1, 1954.

59. Kershaw Mfg. Co., 24 T.C. 228 (1965).

SECTION 1551—CREATION OF CORPORATIONS TO OBTAIN SURTAX EXEMPTIONS AND IMPROPER ACCUMULATION OF SURPLUS CREDITS

When a number of corporations are formed to perform the functions that might otherwise be handled by one, the federal income tax savings possibilities are obvious. If the division results in a reasonable apportionment of the operations into appropriate units so that each might be logically regarded as a separate enterprise, the resulting tax economy might be clearly permissible except for the provisions of Section 1551 of the Internal Revenue Code, which in some circumstances would prevent the allowance of an additional \$25,000.00 specific exemption in computing surtax and a \$100,000.00 accumulated earnings credit. This law came into existence in 1951 as a part of the 1939 Internal Revenue Code.⁶⁰ This section provides objective standards for defining a controlled transferee corporation and causes the disallowance of the surtax exemption and accumulated earnings credit to such a taxpayer if "a major purpose" of the transfer is to obtain such an exemption or credit which would not otherwise be allowable.

Section 1551 applies when there has been a transfer by one corporation of all or part of its property (other than money) to another corporation on or after January 1, 1951, and on or before June 12, 1963, when the transferee corporation was created for the purpose of the acquisition, or was not actively in business at that time,⁶¹ provided that the requisite control of the transferee existed.⁶² The same rule applies to such transfers after June 12, 1963, when made directly or indirectly to a controlled transferee corporation.⁶³ The statute extends also to a similar transfer, directly or indirectly, after June 12, 1963, to a controlled transferee corporation, by five or fewer individuals who are in control of the transferor corporation.⁶⁴

Control for the purpose of a transfer by a corporation to another corporation on or after January 1, 1951, is defined as the ownership

60. INT. REV. CODE OF 1939 § 15(c).

61. H.R. Rep. No. 749, 88th Cong., 2d Sess. 123 (1964): Therefore, the amendment does not in any way inhibit the organization of new corporations with money transfers even though the corporation is organized for the purpose of acquiring a surtax exemption or accumulated earnings credit. However, the new corporation may be a component member of a controlled group in which case a single surtax exemption is allocated among the members of the group unless the group elects to file a multiple surtax exemption return.

62. INT. REV. CODE OF 1954, § 1551(a)(1).

63. *Id.* § 1551(a)(2).

64. *Id.* § 1551(a)(3).

by the transferor corporation or its shareholders, or both, of stock possessing at least eighty percent of the total combined voting power of all classes of stock entitled to vote, or at least eighty percent of the total value of shares of all classes of stock.⁶⁵

For the purpose of a transfer after June 12, 1963, by five or fewer individuals, control is (1) at least eighty percent of the combined voting power of all classes of stock entitled to vote and (2) more than fifty percent of the total combined voting power of all classes of stock entitled to vote, or more than fifty percent of the total value of shares of all classes of stock of each corporation, taking into account the stock ownership of each individual only to the extent such stock ownership is identical with respect to each such corporation. Constructive ownership rules specified in Section 1563(e)⁶⁶ apply to transfers after June 12, 1963,⁶⁷ while similar rules reflected in Section 544(a)(2), which are limited to the spouse and minor children, apply to transfers made prior to June 13, 1963.⁶⁸

To avoid the disallowance of the surtax exemption or the accumulated earnings credit, if the objective criteria of the statute are met, the transferee corporation must show by a clear preponderance of evidence that the securing of the exemption or credit was not a major purpose of the transfer.⁶⁹ This again provides a troublesome standard, for it is significant that it does not refer to "the principal purpose" or "the major purpose," but "a major purpose."⁷⁰

Because of the nature of the determination required, and the manner in which men of sound judgment might differ concerning what appears to be a major purpose, it is rather difficult to discern the emergence of a clearly defined pattern from the litigation on the question. A conclusion seems as likely to be reached on an impressionistic basis as through careful evaluation and analysis. Is the issue to be decided by reference to whether or not, somehow or somehow, a new business or an expanded business could just as well be operated by a presently active and operative corporate entity, rather than by a new one? What is to be the measure of proof necessary to show that the operation of a new segment of a business cannot possibly be carried on by a presently

65. *Id.* § 1551(b)(1).

66. *Id.* § 1551(b)(2).

67. *Id.* § 1551(b)(1).

68. *Id.* § 1551(b)(2).

69. *Id.*

70. *Id.* § 1551(a).

operating corporation? In *Coastal Oil Storage Co.*,⁷¹ the Court of Appeals for the Fourth Circuit commented on the attempt of the taxpayer to justify a separate corporation for government business by saying that this could have been accomplished as well by keeping separate records of the government operation.

It has been said that the question is to be determined in the light of the effect which consideration of obtaining an exemption and credit had upon the decision to create or activate a new corporation.⁷² It is primarily one of fact and not of law,⁷³ and the evidence adduced by the taxpayer to demonstrate the absence of tax savings as a major purpose must be persuasive.⁷⁴ It is merely necessary that tax avoidance be a major purpose, and not the predominant purpose, to effect the application of the section.⁷⁵ In one case, the need to create a separate corporation to avoid the loss of a franchise was sufficient justification for the taxpayer's position.⁷⁶ In another case, the division of segments of a unitary business into separate corporations was considered artificial and indicative of the forbidden major purpose.⁷⁷

The very creation of a corporation, if the objective standards in the statute are met with respect to stock ownership, thrusts upon the transferor the burden of showing, by a clear preponderance of evidence, that tax economy was not a major purpose of the transfer. This is a harder test than that required by either Section 482 or Section 269.

It appears more frequently that a cynical attitude is manifested toward any transaction in which the taxpayer is likely to obtain substantial tax benefits. Yet is it required of a taxpayer first to seek the method of acquisition that will result in the least tax savings to show his purity of intent? Obviously lack of awareness or understanding of tax benefits available, if demonstrated, should constitute a good defense for the taxpayer in any such case as this, and yet it taxes the credulity of anyone dealing with such a question to believe that in an age of widely disseminated tax knowledge and an extensive tax bar, a prudent businessman would approach a substantial transaction with no knowledge of its tax

71. *Theatre Concessions, Inc.*, 29 T.C. 754 (1958); *Coastal Oil Storage*, 243 F.2d 97 (4th Cir. 1957).

72. *Truck Terminals, Inc.*, 33 T.C. 876 (1960), *aff'd*, 314 F.2d 449 (9th Cir. 1963).

73. *Hiawatha Home Builders, Inc.*, 36 T.C. 491 (1961).

74. *Napier Furniture Co.*, 22 CCH Tax Ct. Mem. 575 (1963).

75. *Pre-Mixed Concrete, Inc.*, 21 CCH Tax Ct. Mem. 1601 (1962).

76. *Sno-Frost, Inc.*, 31 T.C. 1058(A) (1959).

77. *Henry S. Alper*, 21 CCH Tax Ct. Mem. 185 (1962).

consequences, present and future. There is no virtue in such ignorance, and I do not believe it should be required of a taxpayer in any circumstances that he attempt to complete a transaction in the manner that is the most expensive to him merely to demonstrate a type of naiveté or good faith. Making oneself oblivious of tax consequences is indicative of imprudence, if not outright stupidity, rather than of civic righteousness.

SUMMARY COMPARISON OF THE STATUTES

Perhaps the following summary comparison of the statutes discussed herein may prove enlightening in pointing up similarities and effecting distinctions between them.

Entity to Whom the Sections May Be Applied

Section 61: To the stockholders or those actually receiving the corporation's income when a corporation has no substance.

Section 482: All organizations, trades or businesses in a controlled group, control being undefined by objective standards.

Section 269: To any of the persons involved in the acquisitions to which the section applies who may, as a result, receive the tax benefit of any deduction or credit not otherwise available.

Section 1551: To the transferee corporation.

When the Sections May Be Applied

Section 61: When the entity has no substance.

Section 482: When the income is not reflected as it would be if the entities were not related.

Section 269: When the principal purpose is to make available a deduction, credit or allowance not otherwise available.

Section 1551: When a major purpose of the transfer is to secure a surtax exemption or an accumulated earnings credit not otherwise available.

How The Section Is Applied

Section 61: Ignoring the entity, taxing the income to the actual recipients.

Section 482: By allocating and apportioning the income, deductions, allowances and credits so that the controlled group will be placed on a parity with a non-controlled group.

Section 269: Disallowing the deduction, credit or allowances that would not otherwise be enjoyed.

Section 1551: Disallowing the surtax exemption and accumulated earnings credit that would not otherwise be enjoyed (that of the transferee corporation).

What the Defense of the Taxpayer Must Be

Section 61: That on a form versus substance basis, the questionable entity is a valid one which should pay the income tax on the income reflected by its records.

Section 482: That the true net income of the group is properly shown, measured by appropriate criteria, or that there is no actuality of control.

Section 269: That the principal purpose of the acquisition was not to obtain a deduction, credit or allowance not otherwise obtainable, but that a sound business purpose, unrelated to federal income tax, was predominant.

Section 1551: That a major purpose of the creation was not to acquire another surtax exemption or an accumulated earnings credit, but that a sound business purpose, unrelated to federal income tax, completely overshadowed any possible tax-saving motive. This must be established by a clear preponderance of evidence.

From this analysis, it becomes apparent that, if the corporate entity must be recognized, distortions of income between controlled taxpayers may be adjusted under Section 482. Nevertheless, even Section 482 may be ineffective in some circumstances, for it is limited to a showing of the true net income of the entities involved, and is not constituted to deal with loss acquisitions for the purpose of making carryovers available, or unnecessary split-ups or spin-offs. It then becomes necessary to rely upon Section 269 when the principal purpose of the acquisition is to make available a loss carryover or a similar deduction or credit. And finally, when the taxpayer can show that the principal purpose of the acquisition was not tax evasion or avoidance, Section

1551 may be operative, which, under carefully limited circumstances, requires merely that tax avoidance be *a* major purpose and not *the* principal purpose.

The view has been expressed that the advent of Section 1561, allowing the election of multiple surtax exemptions, will eliminate much of the activity under Section 1551 and perhaps under Section 269. Whether, as a practical matter, this will prove to be correct, only time will tell. Nevertheless, the passage of Section 1561 did not automatically delete from the statute books the laws discussed herein; we may continue to anticipate a confrontation with the terms of Sections 61, 482, 269 and 1551.

CONCLUSION

A law that provides nebulous criteria such as a requirement that it be invoked "clearly to reflect the income" may readily lend itself to rationalization of a course of administrative conduct leading to the extraction of excessive tax. When a statute calls for a subjective determination of a taxpayer's principal purpose or major purpose, particularly when this is undertaken in retrospect, it can result in gross miscarriage of financial justice. Laws lacking definitive objective standards may very easily, in long periods of aggressive tax administration, lend themselves to an almost imperceptible anti-taxpayer trend, particularly when it is conceived that the primary purpose of such a law is to permit the Commissioner to decide on what a fair tax really is rather than what the legal tax will be. This raises the perennial questions of what is fair and what is just, and sometimes causes a tendency to undertake simplistic solutions to complex problems. It is not advocated that these sections be ignored or repealed, but that they be used sparingly with rare good judgment by the tax administration, realizing that what may seem expedient in a given case may develop into very bad law or administrative practice in another matter. It is believed that the courts must always be vigilant lest the use of these laws be undertaken by the taxing authority not to achieve a reasonable result, but to impose an excessive amount of tax, although the error may be committed with the very best intentions. A series of decisions adverse to the taxpayer may, under any of these sections of the law, bring about, by a process of gradualism, an evolution from a fair and reasonable standard to a harsh and forbidding one that was never intended by the lawmakers.