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Note

Multiple Incorporation
To Obtain Additional Accumulated
Earnings Credits and Surtax Exemptions

The Internal Revenue Code allows each corporation an automatic surtax exemption and accumulated earnings credit in the computation of its taxes. A result of this has been a trend toward conducting a single business through several corporations instead of one. The author of this Note analyzes the common law and statutory weapons the Commissioner of Taxation has to prevent multiple incorporation, demonstrating how, until recently, they have been relatively weak. He then discusses various legislative approaches to the problem, concluding that only a subjective test can provide the flexibility necessary to confine the surtax exemption and accumulated earnings credit to the purposes expressed by the drafters of the Internal Revenue Code.

The 1954 Internal Revenue Code contains a temptation to conduct businesses in multiple corporations because it excludes the first $25,000 of corporate income from the twenty-two per cent surtax, and gives each corporation an automatic $100,000 accumulated earnings credit. A business with a taxable income of $250,000 would be able to reduce its income taxes by $49,500 per year by operating through ten corporations instead of one. In addition, the business

1. In addition to the “normal tax” on corporate income, which is now a flat thirty per cent, there is also a surtax of twenty-two per cent of all income in excess of $25,000. Int. Rev. Code of 1954, § 11.
2. Int. Rev. Code of 1954, § 535(c)(2). There is a tax of twenty-seven and one-half per cent of the first $100,000 of accumulated taxable income, and of thirty-eight and one-half per cent in excess of $100,000. Int. Rev. Code of 1954, § 531. “Accumulated Taxable Income” is defined in section 535 as “taxable income, adjusted in the manner provided in subsection 531(b), minus the sum of the dividends paid deduction (as defined in section 561) and the accumulated earnings credit (as defined in subsection (c)).” The minimum accumulated earnings credit provided in section 535(c)(2) is $100,000.
3. Assuming that the $250,000 income was divided equally so that each corporation had only $25,000 taxable income, there would be no surtax on the total income of the group. The tax rate would therefore be only thirty per cent, which would yield a $75,000 tax. If the $250,000 was earned by one corporation there would be a
could accumulate, tax free, up to $1,000,000.\textsuperscript{4} The benefits of the exemption and credit are much sought after,\textsuperscript{5} as evidenced by the number of cases dealing with the use of multiple entities to reduce taxes.\textsuperscript{6}

There are two basic multiple corporation structures: the parent-subsidiary relationship, in which one corporation holds controlling interests in others; and the brother-sister "tie-in," where one individual, or group of individuals, owns the controlling shares in several corporations.\textsuperscript{7} The Commissioner of Internal Revenue has

\textsuperscript{4}This is the result of having ten $100,000 accumulated earnings credits instead of one. Thus, the $49,500 tax savings explained in note 3 supra, can be augmented by savings of twenty-seven and one-half per cent of $100,000 and thirty-eight and one-half per cent of the last $800,000—a total of $335,500. However, the accumulated earnings tax is not a significant factor in debt financed corporations since accumulating earnings of the corporation to retire the debt will satisfy the "reasonable needs of the business" test of section 535(c)(1). See Asch, Tax Consideration in Real Estate Syndication, 3 VILL. L. REV. 469, 480 (1958).

\textsuperscript{5}There are other tax advantages in conducting a business in multiple corporate form besides the extra surtax exemption and accumulated earnings credit: for example, to avoid the "spin-off problem" of section 355, to permit the selection of different accounting methods for different types of business conducted by the common interests, and to minimize collapsible corporation problems. Driscoll, Incorporating, in Multi-Corporate Form, an Existing Business, N.Y.U. 16TH INST. ON FED. TAX 243–53 (1958). See generally id. at 248–60. Also, there are situations where splitting the business into several types of entities, such as partnerships and sole proprietorships, might be advantageous. For example, during the period of excess profits tax, the temptation was to split into partnerships to avoid the heavy tax on excess corporate earnings. Because of the obvious similarity between multiple incorporation to obtain additional deductions and organization into several different types of entities to avoid excess profits tax, the "multiple entity" cases are used interchangeably in this Note with multiple incorporation cases in discussing business purpose and tax evasion.

\textsuperscript{6}See, e.g., cases listed in CCH 1959 STAND. FED. TAX REP. §§ 2266, 2993, 4914.

\textsuperscript{7}Each type of structure has several species. A multiple group can be divided on a functional basis, so that corporation A handles manufacturing and corporation B handles sales. Or, there can be a geographic division, with each corporation handling both sales and manufacturing in different sections of the country. Two more technical terms used by some writers, are "vertical" and "horizontal" organization. In vertical organization, each related corporation is complete in its operations and conducts a separate business. For example, a real estate tract may be developed by several corporations, each developing one section of the tract. In horizontal organization of a real estate development, one corporation would hold title to the land, another build it, and a third sell it. See Driscoll, supra note 3; Mortenson, The Multiple Attack on Multiple Corporations, 35 TAXES 647 (1957).

There are several ways to establish either type of multiple corporate structure. For example, an individual may acquire the controlling stock in several corporations or he may acquire stock of one corporation and split its assets among three newly-created corporations. A corporation may acquire stock of existing corporations, or can split off assets into new corporate subsidiaries. For a general discussion of the various methods, see McCandless, Acquisition of Corporate Business with a View to Subsequent Operations in Two or More Corporations, N.Y.U. 16TH INST. ON FED. TAX
many weapons, both statutory and common law, to use against multiple incorporation. Until recently, however, these weapons have been relatively weak due to restrictive judicial interpretation. The purpose of this Note is to demonstrate the need for legislative strengthening of the Commissioner’s position. The Note will analyze the present strength of the various devices available to the Commissioner and suggest legislative improvements.

I. THEORIES USED TO PREVENT MULTIPLE INCORPORATION

The weapons used against multiple incorporation are: 1) The sham theory. Under this common law theory the Commissioner seeks to prove that in substance the corporation is a sham; he then argues that it should be disregarded as a taxable entity even though its form is recognized by local law. 2) Section 482. This section gives the Commissioner discretion to allocate income, deductions, credits or allowances among commonly controlled organizations if he determines it is necessary to prevent tax evasion, or to reflect clearly the income of each of the related businesses. 3) Section 61. The Commissioner’s position is that even if the corporation is a taxable entity, the challenged income was not in reality earned by the taxpayer, but rather by a related entity. This is in effect an allocation of income

261 (1958). Several of these methods give rise to problems under sections of the Code other than those discussed in this Note, particularly sections 351, 354, 355, 366 & 368.

8. The separation and order of presentation of these weapons is arbitrary since they are inextricably intertwined. Together they are more powerful than individually, as illustrated by Professor Landman’s remark:

This situation is ominous. The danger is that a factual position under section 45 may be vulnerable under sections 45, 129 and 23(a) [sections 482, 269 and 61(a) of the 1954 Code], and the principle of substance versus form, as well as the new sections 112(b)(11) and 15(c) [sections 355 and 1551 of the 1954 Code], jointly and severally.

Landman, Multiplying Business Corporations and Acquiring Tax Losses, 8 Tax L. Rev. 81, 87 (1952). The Commissioner is well aware of this effect and often brings all weapons to bear on a single case. See, e.g., John P. Wagner, 17 CCH Tax Ct. Mem. 569 (1958).

9. SEC. 482. ALLOCATION OF INCOME AND DEDUCTIONS AMONG TAXPAYERS.

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.

This section is substantially similar to section 45 of the 1939 Code.

10. “Except as otherwise provided in this subtitle, gross income means all income from whatever source derived. . . .” Int. Rev. Code of 1954, § 61(a). This is the same definition as contained in section 22(a) of the 1939 Code.
among related taxpayers. 4) Section 269(a)(1).11 By this section the Commissioner is empowered to deny deductions, credits or allowances obtained as a result of the acquisition of control of a corporation, if the acquiring person or corporation is in control after the

11. SEC. 269. ACQUISITIONS MADE TO EVADE OR AVOID INCOME TAX.

[Sec. 269(a)]

(a) In General.—If—

(1) any person or persons acquire, or acquired on or after October 8, 1940, directly or indirectly, control of a corporation, or

(2) any corporation acquires, or acquired on or after October 8, 1940, directly or indirectly, property of another corporation, not controlled, directly or indirectly, immediately before such acquisition, by such acquiring corporation or its stockholders, the basis of which property, in the hands of the acquiring corporation, is determined by reference to the basis in the hands of the transferor corporation,

and the principal purpose for which such acquisition was made is evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit, or other allowance which such person or corporation would not otherwise enjoy, then such deduction, credit, or other allowance shall not be allowed. For purposes of paragraphs (1) and (2), control means the ownership of stock possessing at least 50 percent of the total combining voting power of all classes of stock entitled to vote or at least 50 percent of the total value of shares of all classes of stock of the corporation.

[Sec. 269(b)]

(b) Power of Secretary or His Delegate To Allow Deduction, Etc., in Part. — In any case to which subsection (a) applies the Secretary or his delegate is authorized—

(1) to allow as a deduction, credit, or allowance any part of any amount disallowed by such subsection, if he determines that such allowance will not result in the evasion or avoidance of Federal income tax for which the acquisition was made; or

(2) to distribute, apportion, or allocate gross income, and distribute, apportion, or allocate the deductions, credits, or allowances the benefit of which was sought to be secured, between or among the corporations, or properties, or parts thereof, involved, and to allow such deductions, credits, or allowances so distributed, apportioned, or allocated, but to give effect to such allowance only to such extent as he determines will not result in the evasion or avoidance of Federal income tax for which the acquisition was made; or

(3) to exercise his powers in part under paragraph (1) and in part under paragraph (2).

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

This section is the same as section 129 of the 1939 Code, with the exception of subsection (c), which was added by the 1954 Code.
acquisition and the principal purpose for the acquisition was tax evasion by securing the benefit of the deductions, credits or allowances. 5) Section 269(a)(2).12 This section allows denial of deductions, credits or allowances emanating from assets acquired from another corporation, not controlled by the acquiring corporation, if the basis of the assets “in the hands of the acquiring corporation is determined by reference to the basis in the hands of the transferor corporation,” and the principal purpose for acquiring the assets was tax evasion. 6) Section 1551.13 If a corporation transfers assets, other than cash, to a newly-formed corporation, or to a corporation not actively engaged in business, the transferee corporation will be denied the accumulated earnings credit and the surtax exemption unless it can prove it is not controlled by the transferor or can prove by a clear preponderance of the evidence that securing the exemption or credit was not the major purpose of the transfer. 7) Section 7701(a)(3). By this definitional section “the term ‘corporation’ includes associations, joint stock companies and insurance companies.” Relying on judicial definition of what constitutes an association taxable as a corporation,14 the Commissioner argues that the relationships, agreements and contracts between the component corporations warrant treatment of the group as a single corporation for tax purposes.

12. See note 11 supra.
13. SEC. 1551. DISALLOWANCE OF SURTAX EXEMPTION AND ACCUMULATED EARNINGS CREDIT.
If any corporation transfers, on or after January 1, 1951, all or part of its property (other than money) to another corporation which was created for the purpose of acquiring such property or which was not actively engaged in business at the time of such acquisition, and if after such transfer the transferor corporation or its stockholders, or both, are in control of such transferee corporation during any part of the taxable year of such transferee corporation, then such transferee corporation shall not for such taxable year (except as may be otherwise determined under section 269(b)) be allowed either the $25,000 exemption from surtax provided in section 11(c) or the $100,000 accumulated earnings credit provided in paragraph (2) or (3) of section 535(c), unless such transferee corporation shall establish by the clear preponderance of the evidence that the securing of such exemption or credit was not a major purpose of such transfer. For purposes of this section, control means the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote or at least 80 percent of the total value of shares of all classes of stock of the corporation. In determining the ownership of stock for the purpose of this section, the ownership of stock shall be determined in accordance with the provisions of section 544, except that constructive ownership under section 544(a)(2) shall be determined only with respect to the individual's spouse and minor children. The provisions of section 269(b), and the authority of the Secretary under such section, shall, to the extent not inconsistent with the provisions of this section, be applicable to this section.

This section is the same as section 15(c) of the 1939 Code.
14. The word “association” has never been defined in the Code. Its definition has been left to the regulations and the courts. The landmark case in this area is Morrissey v. Commissioner, 286 U.S. 344 (1935).
A. The Sham Theory

Running through the law of taxation are two propositions: a taxpayer has a right to minimize his potential tax burden by lawful means;15 and a person may select any form for the conduct of business consistent with local law.16 Any attempt to declare that an entity is a sham, and therefore should be disregarded as a taxable entity, runs contrary to these two traditional concepts. Initially courts refused to adopt a theory that would disregard the corporate entity. This is illustrated by *Klein v. Board of Supervisors*,17 where the Supreme Court said, "The corporation is a person and its ownership is a nonconductor that makes it impossible to attribute an interest in its property to its members."18

Five years later, however, in *Gregory v. Helvering*,19 the Court took the first step in adopting the sham theory. There, a taxpayer who had manipulated securities through two of his controlled corporations was denied capital gains treatment in the exchanges on the theory that the law will pierce sham transactions and ascertain their real character. Then, in *Higgins v. Smith*,20 the Court held against a taxpayer who sold securities to his controlled corporation and claimed a loss on the sale. Finally, in *Moline Properties, Inc. v. Commissioner*,21 the Court constructed a test for the application of the sham theory, saying "so long as that purpose [for formation of the corporation] is the equivalent of business activities or is followed by the carrying on of business by the corporation, the corporation remains a separate taxable entity."22 Judge Learned Hand has said the "business purpose test" outlined in *Gregory, Higgins* and *Moline* has sometimes been understood to contradict the doctrine that the motive to avoid taxation is never, as such, relevant. In fact it does not trench upon that doctrine; it merely declares that to be a separate jural person for purposes of taxation, a corporation must engage in some industrial, commercial, or other activity besides avoiding taxation: in other words, that the term "corporation" will be interpreted to mean a corporation which does some "business" in the ordinary meaning; and that escaping taxation is not 'business' in the ordinary meaning.23

Thus, so long as a corporation is actually performing some business activity, it probably will be regarded as a taxable entity.24 This makes

18. Id. at 24.
22. Id. at 439.
23. National Investors Corp. v. Hoey, 144 F.2d 466, 468 (2d Cir. 1944).
24. The business purpose test for sham entities is often described as a subjective
the application of the sham theory difficult and infrequent, since usually it is possible for a taxpayer to show that some business was carried on by the corporation.

However, in a case decided this past December, Aldon Homes, Inc.,25 the Tax Court struck down as sham sixteen real estate development corporations. The court recognized that each of the corporations held directors' meetings, adopted by-laws, issued stock and prepared for the carrying on of business, but said that, in light of all the circumstances present, these activities "were not the substantive business activities which produced the income."26 The court also disposed of several business purpose arguments of the taxpayer by saying that they were "little more than mere recitals" by the witness for the taxpayers. Thus, the court seems to be looking to the actual functioning of the sixteen corporations, rather than the reasons for their creation. And, the court, in requiring that the business activities carried on by the corporations in question must be substantial business activities,27 has changed the criterion of the sham theory. The taxpayer must show more than one item of business activity to defeat an accusation of being a sham entity.

If other decisions follow the reasoning of Aldon Homes, the sham theory may be turned into an effective weapon against multiple incorporation. Even if this does not occur, however, the sham theory still has vitality in the attack on multiple incorporations since its test, as a test of the motives for forming the entity, or the purposes for which it was formed. See, e.g., L. W. Tilden, Inc. v. Commissioner, 192 F.2d 704 (5th Cir. 1951); Twin Oaks Co. v. Commissioner, 183 F.2d 385 (9th Cir. 1950); John L. Denning & Co. v. Commissioner, 180 F.2d 288 (10th Cir. 1950); Estate of Julius I. Byrnes, 16 T.C. 1234 (1951), acq., 1952–1 Cum. Bull. 1; Miles-Conley Co., 10 T.C. 754 (1948), acq., 1948–2 Cum. Bull., aff'd on other grounds, Miles-Conley Co. v. Commissioner, 173 F.2d 958 (4th Cir. 1949); Buffalo Meter Co., 10 T.C. 83 (1948), acq., 1948–1 Cum. Bull. 1; Seminole Flavor Co., 4 T.C. 1215 (1945), acq., 1945 Cum. Bull. 6; John P. Wagner, 17 CCH Tax Ct. Mem. 569 (1953); Brost Motors, Inc., 7 CCH Tax Ct. Mem. 806 (1948).

However, a close examination of these cases reveals that more often than not courts are really using an objective test — did the entity perform any business activity? In Buffalo Meter it was said, "the partners had what in their opinion were sound business reasons for organizing the partnership. The important consideration is that the partnership was real for all purposes and that it has at all times functioned as an entirely separate economic entity."10 T.C. at 89. (Emphasis added.) In Friedlander Corp. v. Commissioner, 216 F.2d 757 (5th Cir. 1954), the court said that a sham case cannot be decided on motives, it must be decided on whether its function is sham. Friedlander is therefore consistent with National Carbide Corp. v. Commissioner, 336 U.S. 422, 431–32 (1949), where the Supreme Court made it clear that the business purpose test is satisfied if the corporation actually engages in business activity. In Herbert v. Riddell, 103 F. Supp. 369 (S.D. Cal. 1952), National Carbide was interpreted to mean that as long as an entity has transacted one item of business it cannot be disregarded.

26. Id. at 352. (Emphasis added.)
27. Id. at 350.
business purpose test, in varying degrees, has been incorporated into sections 482, 269 and 1551.28

B. SECTION 482

Section 482 appears on its face to be the most powerful of the weapons available to the Commissioner.29 It gives him discretion to allocate gross income, deductions, credits or allowances among related entities, and the relation between the entities necessary to invoke this discretionary power is simply that the entities are "controlled directly or indirectly by the same interests. . . ."30 Thus, actual, rather than legally enforceable, control is the criterion.31

28. The three Code sections, 482, 269 and 1551, are all framed in terms of "tax evasion"; if the entity was formed or acquired to evade taxes, it will suffer certain results. Section 482 allows the Commissioner to determine when there has been tax evasion, but a defense to his tax evasion determination is the existence of a valid business purpose for the transaction. See notes 32–37 infra and accompanying text. Section 269, on the other hand, says if the "principal purpose" of an acquisition is tax evasion then the taxpayer loses benefits. Once again, business purpose has been considered a defense. However, under the language of section 269 the taxpayer probably must show more business purpose than under section 482. See notes 57–58 infra and accompanying text. Section 1551 has a "major purpose" tax evasion standard. This is quite clearly a more difficult test for the taxpayer to overcome—he must show that business purposes were the only major purposes. See notes 78–79 infra and accompanying text. In addition, the sham theory has been used successfully in support of section 482 or 61. See, e.g., Advance Mach. Exch., Inc. v. Commissioner, 196 F.2d 1006, cert. denied, 344 U.S. 835 (1952); Commissioner v. Chelsea Prods., Inc., 197 F.2d 620 (3d Cir. 1952); Alpha Tank & Sheet Metal Mfg. Co. v. United States, 126 Ct. Cl. 878, 116 F. Supp. 721 (1953).

29. See note 9 supra.


"Actual control" is not easily defined, but its probable meaning is that type of control which stems from a close relationship, either by family or friendship. If stock in two corporations is divided among cousins and one of them is the dominant executive in the operation of the business there probably would be no difficulty in finding actual common control. In Grenada Industries, the same people were owners of four entities, each in the same proportion, and the court held that the actual control requirement of section 482 was met, even though the owners were not related.

But where a principal shareholder of a corporation formed a partnership with his son and a third party, the tax court expressed doubt that actual control of the entities was present. Cedar Valley Distillery, Inc. 16 T.C. 870 (1951), acq., 1951–2 CUM. B U L L. 2. And, where a man owned half interest in an automobile dealership, a half interest in one truck rental business and a third interest in another, the court said the three organizations were not commonly controlled. Q. I. Roberts, 8 CCH Tax Ct. Mem. 60 (1949) (dictum).

In Lake Erie & Pitt. Ry., 5 T.C. 558 (1945), acq., 1945 CUM. B U L L. 5, the court, relying on regulations under the 1939 Code, reasoned that if two corporations each are fifty per cent shareholders in a third corporation neither has control and therefore section 482 could not be applied to allocate gross income to the subsidiary from the two parent corporations. The question raised by this decision is: Would it be possible to avoid section 482 by an interlocking system of parents and subsidiaries in which each subsidiary is half owned by two of the parents?
In spite of its literal scope, section 482 has been narrowly construed by the courts. First, the sham theory, with its business purpose test,32 has been read into the section. If the taxpayer establishes that its existence is not a sham, the Commissioner cannot use section 482 to allocate the entire gross income of the taxpayer to the related entity, since to do so would be the equivalent of striking down the entity as being sham.33 Because of the relative ease with which the business purpose test may be met,34 the situations in which the Commissioner can successfully allocate all the gross income of an entity are few. The courts have also been explicit in saying that net income may not be allocated among related entities because this would be using section 482 to effect a consolidation.35 Added to these are two other restrictions: the Commissioner cannot disallow deduction of one entity, he must allocate them to the entities so entitled,36 and there can be no creation of income in transactions between related entities.37

32. See note 24 supra.
34. See note 24 supra.

Although the general theory is that section 482 cannot be used to disallow deductions, the section has been successfully used by the Commissioner to reduce the basis of an asset received from a related entity, which in effect disallows a loss on the subsequent sale of the asset. National Sec. Corp. v. Commissioner, 137 F.2d 600 (5th Cir. 1943); G.U.R. Co. v. Commissioner, 117 F.2d 187 (7th Cir. 1941). It is suggested that these cases are examples of the use of section 482 to strike down fictitiously created deductions, whereas in the cases cited above the deductions were of the arm's length type, were not sham, and therefore could only be allocated and not disallowed.
37. Tennessee-Arkansas Gravel Co. v. Commissioner, 112 F.2d 508 (6th Cir. 1940); Epsen Lithographers, Inc. v. O'Malley, 67 F. Supp. 181 (D. Neb. 1946); Texsun Sup-
The result of these judicial restrictions is that section 482 has been relegated to the role of a policeman of transactions and arrangements between related entities. Its sole function is to keep these transactions equivalent to dealings between unrelated parties. Therefore, section 482 cannot be used to sweep through a multiple corporation group and remove the total benefit of the extra exemptions and credits. Instead, it can only be used to minimize the benefit by confining earnings and income deductions to the entities that properly deserve them.

This is not to say that section 482 may be disregarded as a weapon against multiple incorporation. The discretionary power of the Commissioner to determine what allocations are necessary to keep things on an arm's length basis means that, once such a determination is made, the taxpayer has the burden of proving that the Commissioner


Subsequent cases have explicitly stated the purpose of section 482 to be the maintenance of parity between controlled and uncontrolled entities. See, e.g., Central Cuba Sugar Co. v. Commissioner, 198 F.2d 214 (2d Cir.), cert. denied, 344 U.S. 674 (1952); Epsen Lithographers, Inc. v. O'Malley, 67 F. Supp. 181 (D. Neb. 1946); Lake Erie & Pitt. Ry., 5 T.C. 555 (1945), acq., 1945 Cum. Bull. 5.


The business purpose test again comes into play when the Commissioner claims that a certain expense or deduction should be shifted, the taxpayer arguing that the expense or deduction was justified by business reasons. See, e.g., Hypotheek Land Co. v. Commissioner, 200 F.2d 390 (9th Cir. 1952); Essex Broadcasters, Inc., 2 T.C. 523 (1949), acq., 1943 Cum. Bull. 7.

Similarly, impossibility can be a defense to section 482. See L. E. Shunk Latex Prods., Inc., 18 T.C. 940 (1952), nonacq., 1953-1 Cum. Bull. 7, where a manufacturing corporation selling to a related partnership had to keep its prices at wartime price ceilings, but the partnership had no price ceiling on its resale of the goods. The court held that the Commissioner could not allocate any of the partnership's extraordinarily high profits to the corporation on the theory that the price paid by the partnership to the corporation, though below market value due to the ceiling, was a fair price because it was set by the government. It would have been impossible to sell to the partnership at any other price and therefore it would be unfair to make the corporation report any part of the profit realized by the partnership.

One area in which the business purpose argument is of no avail to the taxpayer is
was arbitrary and unreasonable in his determination. This makes the section effective in its job of policeman and at least insures that the entities are conducted as truly distinct units by their controlling interests. Not only does this deter fictitious shifting of income, expenses or deductions but also it causes higher expenses in the maintenance of a multiple group, since separate accounting records, minute books, production records and payroll records must be kept. Thus, section 482 contributes significantly to the establishment of a point of diminishing returns from the multiplication of corporations.

At least one court has reasoned that section 482 does, and should, allow the consolidation of commonly controlled entities if they are engaged in related trades or businesses. In *Advance Mach. Exch., Inc. v. Commissioner*, the Court of Appeals for the Second Circuit stated that the purpose of section 482 is to prevent tax evasion by any arbitrary shifting of income, and "there is no exception, nor any reason for excepting, from this purpose the case where such arbitrary allocation of income is among affiliated corporations who could, under section 141, consolidate their respective incomes." The court used the sham theory to buttress its reasoning, saying that only one entity really earned the income, and therefore it all should be allocated to the true income producer. Although this reasoning would seem to be that of a section 61 attack, rather than section 482,

the transfer of partially completed construction contracts to another entity, which on completion of the contract realizes all the profit on the project, claiming this to be proper under a contract completion accounting system. Even though a valid business purpose for the transfer can be shown, the Commissioner has been upheld in allocating the profit on the project between the transferor entity and the transferee. *E.g.*, Dillard-Waltermire, Inc. v. Campbell, 255 F.2d 433 (5th Cir. 1958); Standard Paving Co. v. Commissioner, 190 F.2d 330 (10th Cir.), *cert. denied*, 342 U.S. 860 (1951); Jud Plumbing & Heating, Inc. v. Commissioner, 153 F.2d 681 (5th Cir. 1946).


40. The expenses involved in maintaining separate records can be significant, especially in the maintenance of separate payrolls. In states where there is an unemployment compensation fund, with employer contributions based on an experience rating, new corporations automatically take the highest rate for one or more years. This could mean an added expense of up to 2.7% of the payroll of the new corporation.

41. 196 F.2d 1006 (2d Cir.), *cert. denied*, 344 U.S. 835 (1952).

42. Section 141 has been carried into the 1954 Code in sections 1501–05 (dealing with conditions under which related entities may file consolidated income tax returns).
the court explicitly says it is relying on section 482 alone. The obscurity of the exact nature of the Advance Machinery holding is illustrated by Commissioner v. Chelsea Products, Inc. There the Court of Appeals for the Third Circuit, in holding for the taxpayer, classified the section 482 discussion in Advance Machinery as "essentially dicta," and also said that the Advance Machinery interpretation was not in accord with either the language or the legislative purpose of section 482.

However, in Alpha Tank & Sheet Metal Mfg. Co. v. United States, a later case, the Court of Claims disallowed the rentals paid by a manufacturing corporation to a corporation owning the plant facilities where both corporations were controlled by the same interests. The effect of the disallowance was allocation of the entire gross income of the real estate corporation back to the manufacturing corporation, and the elimination, for all practical purposes, of the real estate corporation. Although section 482 is not explicitly mentioned in the opinion, it would appear that the court used the same combination of section 482 and the sham theory as employed in Advance Machinery.

The theory expressed in Advance Machinery and Alpha Tank seems to be that section 482 should be interpreted in its broadest sense. In the opinion of these two courts, section 482 can be used to disallow transactions among related entities even if they are equivalent to arm's length transactions between unrelated parties, and even though the net effect is to establish one taxable entity. This is the same as giving the Commissioner discretion to determine if and when an entity is a sham, which in turn would place on the taxpayer the burden of proving the Commissioner's determination to be arbitrary and unreasonable. It is manifest that this burden would be more difficult than the meeting of an allegation of sham existence, as would be the procedure if the Commissioner used the common law sham theory. In addition, the Court of Claims in Alpha Tank

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44. Ibid. The Tax Court in Advance Mach. Exch., Inc., 8 CCH Tax Ct. Mem. 84 (1949), held the Commissioner's determination to be proper under section 61. Also, it is clear that the Tax Court viewed all but one of the entities to be sham—that there was only one real entity. Yet, the Court of Appeals affirmed, it said, entirely on the basis of section 482, adding that it was therefore not necessary to discuss section 61.

45. 197 F.2d 620 (3d Cir. 1952).

46. Id. at 623, n.6.


48. Advance Machinery and Alpha Tank are cited with approval in James Realty Co. v. United States, 59–2 U.S. Tax Cas. ¶ 9660 (D. Minn. 1959). However, James Realty is a section 269 case and the citations are only for general support.

49. See note 39 supra and accompanying text.

50. If the Commissioner determines that a taxpayer's tax return is deficient because of siphoning-off income to a sham entity, there is the normal presumption that the Commissioner was correct in his determination. The taxpayer must meet this
characterizes the business purpose test as a subjective inquiry; it would look to the motives for the formation of the separate entity, rather than the activities performed by the entity. Such a subjective criterion would make it even more difficult to show that the Commissioner's determination was arbitrary and unreasonable. It would complete the transformation of section 482 into a broad, powerful weapon against multiple incorporation.

C. SECTION 61

Closely intertwined with the sham theory and section 482 is section 61 and its definition of income. Here, the Commissioner, instead of focusing his attack on splitting or shifting of income to the taxpayer from a related entity, concentrates on whether the taxpayer actually performed the services that earned the income. It is perhaps questionable whether section 61 should be turned to such a task. Nevertheless, the Commissioner has had some recent success with section 61, and this has put some new strength into his position.

It may be that the increasing acceptance of section 61 is an indication of a general willingness by the courts to listen to anti-multiple incorporation arguments. A court may feel it is bound by precedent under the sham theory and section 482 but that it is not so bound in the use of section 61. This section could provide an avenue of escape from prior judicial restrictions on section 482 and the sham theory.

preference, but this is no more than saying the taxpayer has the burden of persuasion. The burden of proving the Commissioner's determination was arbitrary is far more difficult to carry than proving him wrong. See note 39 supra and accompanying text.

51. We find no legitimate corporate business motive was involved in the organization of Delmo. The transfer of the plant to it and the lease back to plaintiff were integral parts of the same transaction. The attempted creation of deductions for rentals of a plant when there was no real change in ownership in the circumstances of this case is not a sufficient business motive. 126 Ct. Cl. at 883, 116 F. Supp. at 724. (Emphasis added.)

52. See note 10 supra.

53. Professor Landman has been critical of the judicial legislation under section 61. Landman, Multiplying Business Corporations and Acquiring Tax Losses, 8 TAX L. REV. 81, 90-92 (1952); Landman, Being Tax-Wise and Otherwise in Multiplying Business Entities, 30 Taxes 893, 903 (1952). He points out that section 61 could not have been intended to do the job of section 482, since section 482 was enacted after section 61 (1921 and 1913, respectively).

Nevertheless, the theory that income is taxable only to him who earns it is well established in the case law. E.g., United States v. Joliet & C. R.R., 315 U.S. 44 (1942); Helvering v. Horst, 311 U.S. 112 (1940). The use of section 61 against multiple incorporation may appear to be illogical from a reading of the section but because of this long established judicial theory it has some reason behind it—it is a logical extension even though the original use of the theory may have been wrong. 54. In Advance Machinery the Tax Court had used section 61 to aggregate all the income into one entity. The court perhaps did this because it felt section 482 was limited by judicial precedent. The Court of Appeals for the Second Circuit chose to
D. Section 269

Like section 482, section 269 has broad language but has been narrowly applied. Subsection (a)(1) was primarily designed to eliminate the acquisition of loss carry-over corporations, whereas subsection (a)(2) was designed to stop the trading in high basis, low value assets that gave desirable excess profit credits and depreciation deductions to the acquiring corporation. The pivotal test of the section is whether the acquisitions were principally motivated by tax evasion purposes. This could be considered a codification of the sham theory, but in its application it is one step further. The statutory language indicates that the business purpose test (for tax evasion) is to be subjective, and that more than a minimal amount of business purpose must be present before the principal purpose is no longer tax evasion. Although this test would seem to require a greater amount of business purpose than under the sham theory and section 482, it has not been difficult to meet. The courts have usually refused to apply section 269 whenever a small amount of business purpose is proved. In an effort to stem this liberal attitude and disregard precedent under section 482 and used that section rather than section 61 to affirm the Tax Court. The Court of Appeals for the Third Circuit, speaking in Chelsea Products, expressed the opinion that the Tax Court approach in Advance Machinery, was the correct one for that fact situation. Thus, one court of appeals and the Tax Court approve of the use of section 61 in at least some cases where section 482 is not applicable due to its judicial restriction. It may be, though, that the Tax Court's view has changed and that it now considers section 61 to have the same limitations as section 482. See John P. Wagner, 17 CCH Tax Ct. Mem. 569, 608-09 (1958).

55. See note 11 supra.
56. For a thorough review of the legislative history and original purposes of the section, see Asiatic Petroleum Co. v. Commissioner, 79 F.2d 234 (2d Cir.), cert. denied, 296 U.S. 645, affirming 31 B.T.A. 1152 (1935); 7 MERTENS, FEDERAL INCOME TAXATION § 38.65 (1956); Mandell, Acquisition to Avoid Tax, N.Y.U. 16TH INST. ON FED. TAX 891 (1958); Mortenson, The Multiple Attack on Multiple Corporations, 35 TAXES 647 (1957); Rice, Internal Revenue Code, Section 269: Does the Left Hand Know What the Right Is Doing?, 103 U. PA. L. REV. 579 (1955).

For some early opinions on section 269, before it had judicial interpretation, see Barnard, Acquisitions for Tax Benefit, 34 CALIF. L. REV. 56 (1946); Rudick, Acquisitions to Avoid Income or Excess Profits Tax: Section 129 of the Internal Revenue Code, 58 HARV. L. REV. 196 (1944). Mr. Rudick's article contains a chronological history of section 269, giving the step by step development of the section through the House and Senate. Id. at 200-06. It also has an interesting appendix showing how the final section differed from several earlier versions. Id. at 294.

57. Under section 269, the test is whether there was a business purpose, as opposed to business activity. This differs from the test under the sham theory and section 482. See note 24 supra.
58. As pointed out in note 24 supra, any amount of business activity will defeat an allegation of being a sham entity. Thus, if the function of a corporation is ninety-nine per cent tax evasion and one per cent legitimate business, the sham theory cannot be used to strike down the corporation. But where the test is "principal purpose" it would be logical to assume that only one per cent business function would not be a successful defense to section 269.
59. See Commissioner v. Chelsea Prods., Inc., 197 F.2d 620 (3d Cir. 1952),
revive the effectiveness of the section, Congress in 1954 added subsection (c), which creates prima facie evidence of tax avoidance where the purchase price of the corporation is substantially disproportionate to the sum of the basis of the assets acquired plus the value of the tax benefits received. It is not clear what additional help the presumption could give the Commissioner, since his determinations are always presumed correct; “prima facie” evidence would not strengthen this presumption.

In addition to the limitations imposed on section 269 by the business purpose test, two other judicial inroads have contracted the scope of the section. It has been held that section 269 cannot be used to deny deductions, credits or allowances of the acquired corporation. And, the deduction, credit or allowance sought to be disallowed from the acquiring corporation must have resulted from the acquisition of control; if the taxpayer would have had the deduction regardless of its acquiring another entity the deduction cannot be denied. An application of this theory is that a loss corporation can acquire a profitable corporation and apply its loss carry forwards to the future earnings of the profitable business. A third limitation is


For cases in which the taxpayer failed to establish sufficient business purpose, see Elko Realty, 29 T.C. 1012, aff’d, 260 F.2d 949 (3d Cir. 1958); American Pipe & Steel Corp., 25 T.C. 351 (1955), aff’d, 243 F.2d 125 (9th Cir. 1957).

60. See note 11 supra. Congress also enacted sections 381 and 382 to give the Commissioner some specific weapons against tax loss carry-over acquisitions because section 269 had proven so ineffective. Arent, The Impact of the Coastal Oil Decision Upon Loss Corporations, 8 J. Taxation 14 (1958).

61. See 7 MERTENS, FEDERAL INCOME TAXATION § 38.69, at 156–59 (1956). Also, “the facts which cause the presumption to arise are usually not probative of the prohibited principal purposes” and “this presumption is wholly futile and may be summarily ignored.” Cuddihy, Tax, Legal & Practical Considerations in Acquisition of a Loss Corporation, U. So. Cal. 1958 Tax. Inst. 303, 320. Further, subsection (c) does not apply to corporate split-offs because the subsidiary usually gives all its stock for the assets received, which means the value of the consideration paid is the same as value of the assets. Rice, Internal Revenue Code, Section 269: Does the Left Hand Know What the Right Is Doing?, 103 U. Pa. L. Rev. 579, 586 (1955).


It is manifest from the unambiguous terms of section 129 [section 269 of the 1954 Code] that it applies only to an acquiring corporation and does not apply to an acquired corporation.

27 T.C. at 886.


the theory that section 269 does not apply to the creation of new corporations, and therefore corporate split-ups into new corporations, or launching of a new business in multiple corporate form are not within the purview of section 269.65

These limitations of section 269 could prevent it from being effective against multiple incorporation to obtain additional surtax exemptions and accumulated earnings credits.66 When a corporation acquires nine other corporations, and none is a sham, the extra nine exemptions and credits cannot be denied, since they belong to the acquired corporations, which would have had them regardless of the common control of the group. Furthermore, if a corporation creates

BULL. 1. The argument to allow a loss corporation to acquire a profit making corporation and apply the loss carry forwards to the future profits is that the loss corporation would have had the carry forwards regardless of its acquiring the profit corporation. The Commissioner counter argues that the profits activated the loss carry forwards and therefore the loss corporation acquired the benefit of the loss carry forwards as a result of obtaining the profit corporation. The Tax Court's reply to this is that the loss corporation did not acquire profits, it only acquired the possibility of making a profit, and this "benefit which may flow to the new stockholders is too tenuous a benefit to bring section 139 [section 269 of the 1954 Code] into play." Id. at 440. See generally 7 MERTENS, FEDERAL INCOME TAXATION § 38.67 (1956); Cuddihy, Tax, Legal and Practical Considerations in Acquisition of a Loss Corporation, U. So. CAL. 1958 TAX INST. 303; Mandell, Acquisitions to Avoid Tax, N.Y.U. 16TH INST. ON FED. TAX 891 (1957).

On the other hand, where a profit corporation acquires a loss corporation, section 269 would be in point, since the profit corporation is actually acquiring the loss carry forward. Thus, there is a great difference in result depending on which corporation is the acquiring corporation.

65. This theory was argued by the taxpayer in Berland's Inc. of South Bend, 16 T.C. 182 (1951), acq., 1951–2 CUM. BULL. 1, and in Alcorn Wholesale Co., 16 T.C. 75 (1951), acq., 1951–2 CUM. BULL. 1. However, the point was not discussed in either case because the court found there was no principal purpose of tax evasion, thereby mooting the question of whether section 269 is applicable to creation of new corporations. In J. E. Dilworth v. Henslee, 98 F. Supp. 957, 960 (D. Tenn. 1951) it was said:

Section 129 [section 269 of the 1954 Code] . . . applies only to a situation where one corporation or one individual acquires new assets. Said section was enacted to prevent a corporation that had large earnings from acquiring another corporation that had large capital tax exemptions, thereby reducing the acquiring corporation's excess profits tax. Section 129 does not apply . . . where no new assets are acquired by the plaintiff.

The theory that acquisition does not include creation of a new corporation has been accepted by several writers. E.g., Chase, An Analysis of Section 129 of the Internal Revenue Code, 30 CORNELL L.Q. 421, 434 (1945); Mortenson, The Multiple Attack on Multiple Corporations, 95 TAXES 647, 656 (1957). See also 2 C.C.H. 1960 STAND. FED. TAX REP. ¶ 2268.06.

66. Although section 269 was passed with specific purposes in mind (see note 56 supra and accompanying text), it seems clear from reading the Senate Finance Committee report that the section was to apply to all types of tax avoidance made possible by acquisitions of other corporations. See S. REP. No. 627, 78th Cong., 1st Sess. (1944), 1944 CUM. BULL. 973, 1016–18. See also the authorities cited in note 56 supra.
nine new subsidiaries, then section 269 is inapplicable on two theories—the exemption of an acquired corporation cannot be denied, and section 269 does not apply to creation of a corporation.

Although these limiting concepts are embedded in the case law interpreting section 269, several courts have recently refused to accept them. In *Coastal Oil Storage Co. v. Commissioner*67 the Court of Appeals for the Fourth Circuit rejected the argument that the deductions of the acquired corporation cannot be disallowed. The court reasoned that section 269(a)(1) prevents the acquiring corporation from receiving the benefit of the extra deductions, and, unless the acquired corporation is denied the use of its surtax exemption and excess profit credit, the parent would benefit by obtaining extra income from the subsidiary. The court also expressed the view that subsection (a)(2) applies where a parent transfers property to a subsidiary because the property is what makes possible the earning of income by the subsidiary, thus activating the surtax exemption and giving the parent more net income on its assets. Although the reasoning under subsection (a)(2) is subject to a logical attack,68 the interpretation of subsection (a)(1) has compelling force.69 A recent district court case, *James Realty Co. v. Commissioner*,70 follows the *Coastal Oil* reasoning on subsection (a)(1) and also disposes of another limiting theory—that “acquisition” does not include “creation”—by saying “there is no settled view that ‘acquisition of control’ cannot and should not include the organization of a new corporation. . . .”71

The third limiting concept—that to deny the deduction it must have stemmed from the acquisition of control—was dealt an oblique blow by *Mill Ridge Coal Co. v. Patterson*,72 a 1959 case. In *Mill Ridge*, control of a loss corporation was obtained by three individuals who had also acquired a lucrative contract for shipping oil. The individuals turned the contract over to the loss corporation, which had discontinued all former business. When the corporation applied its loss carry forwards to the profits made from this contract, the Commissioner disallowed the deductions, using section 269. In sustaining the Commissioner, the court referred to the use of

67. 242 F.2d 396 (4th Cir. 1957).
68. E.g., 49 Va. L. Rev. 1134, 1138 (1957).
69. Apparently Professors Surrey and Warren believe the *Coastal Oil* reasoning on subsection (a)(1) is correct. See their comment on *James Realty Co. v. United States*, 59–2 U.S. Tax Cas. ¶ 9660 (D. Minn. 1959) in CCH Fed. Tax, Current Law & Practice ¶ 1183 (11–59).
70. 59–2 U.S. Tax Cas. ¶ 9660 (D. Minn. 1959).
71. Id. at 73, 685.
72. 264 F.2d 713 (5th Cir. 1959).
the carry forwards as foreign to the "spirit" of section 269 and to its "clearly expressed over all purpose and intent." It recognized that technically section 269 might be inapplicable but the court would not let such technicality thwart the spirit of the section. However, the court also relied on Libson Shops, Inc. v. Koehler, where it was held that tax loss carry forwards of individual brother-sister corporations could not be used, after they had combined into one corporation, to reduce post-merger profits. If the court had used only section 269, instead of dual grounds for its decision, Mill Ridge would be a landmark case in the development of section 269.

The Coastal Oil, James Realty and Mill Ridge decisions may well be the portent of future judicial reconstruction of section 269. When viewed alongside Advance Machinery and Alpha Tank, and the recent section 61 cases, they make it clear that courts are beginning to lend a more sympathetic ear to the arguments of the Commissioner for halting multiple incorporations. Emerging from these decisions seems to be this line of reasoning: sections 482 and 269 should not be restricted by narrow construction of the statutory language, and the business purpose defense to tax evasion should not be as easily established as prior decisions have permitted.

E. Section 1551

Section 1551 is the only section in the code that deals specifically with multiple incorporation. It was enacted in 1951 to stop corporations from transferring assets, with the accompanying business income, to subsidiary corporations in order to obtain extra surtax exemptions and accumulated earnings credits. Thus, the

73. 353 U.S. 382 (1957).
74. Both in Coastal Oil and James Realty there would appear to be sufficient business purpose present to avoid § 269, at least under the Tax Court case law. In Coastal Oil, the subsidiary corporation was formed to take over government contract business, separating it out from the private rental business of the parent. James Realty involves brother-sister corporations in real estate developments, where limitation of liability and increased ability to borrow money as a result of such limitation are normal business considerations. Professors Surrey and Warren seem to be of the opinion that there is sufficient business purpose present in James Realty to defeat § 269. See their comments following the case in CCH Fed. Tax., Current Law & Practice, § 1183 (11–59). However, in both cases the court quickly found tax evasion to be the principal purpose of the subsidiary, indicating that courts are beginning to require more business purpose.
75. See note 13 supra.
section is narrow in its scope, applying only to parent-subsidiary multiple incorporation, and then only if there is eighty per cent control present. However, within this specific area it is effective because the section requires that a subsidiary which has received assets, other than cash, from its parent must prove by a clear preponderance of the evidence that the acquiring of tax benefits was not a major purpose of the transfer.

The major purpose test and clear preponderance burden impose on the subsidiary an almost impossible task. Since there can be several major purposes for the creation of a subsidiary, a literal reading of the section would require the subsidiary to prove that the transfer was almost entirely motivated by business reasons, and this is to be shown by a clear preponderance of the evidence. The few cases decided under section 1551 show no inclination by the courts to emasculate the major purpose test, as was done with the principal purpose test of section 269.

77. If a parent has only seventy-nine and one-half per cent of the voting stock of another corporation it can transfer assets to the other corporation without fear of section 1551. This is a definite limitation since corporations that own close to eighty per cent control of a subsidiary would probably reduce their control to seventy-nine and one-half per cent before transferring any assets. The percentage level of control at which it would be better for the parent to risk section 1551 liability is dependent on the income potential of the subsidiary, the attitude of the shareholders toward having "outside" owners, and the possibility of a successful defense to section 1551 under the major purpose test.

However, changing the percentage of control could "trap" the parent-subsidiary into section 1551 liability. If the control is below eighty per cent when the assets are transferred but later is increased to eighty per cent, the subsidiary will be denied the surtax exemption and accumulated earnings credit as of the year in which the control reached or surpassed eighty per cent. Kahn, Parent-Subsidiary Corporations, N.Y. U. 16TH INST. ON FED. TAX 315, 320-32 (1958). Another trap lies in the leasing of property by the parent to the subsidiary; this probably will be considered a transfer of assets. Ibid.

A possible way to avoid section 1551 is suggested by Airline Gas Co. v. United States, 58-2 U.S. Tax Cas. ¶ 9805 (W.D. Ky. 1958). There a corporation sold assets to its shareholders, who then transferred them to a new corporation. The court held section 1551 was not applicable.


79. The taxpayer would have to prove that none of the several major purposes was tax evasion. Thus, only a small amount of tax consideration can be involved in establishing a subsidiary.

Note also that the test here, as under section 269, is phrased subjectively. For a general discussion of the business purpose test of section 1551 see Note, 44 VA. L. REV. 443, 446-47 (1958).


Because of the power of section 1551, its indiscriminate use by the Commissioner could deter legitimate business expansion. However, the Senate Finance Committee indicted that section 1551 was not intended to prevent genuine expansion, only split-offs of existing business.81

F. THE ASSOCIATION THEORY

The Commissioner has another argument against multiple incorporation; the "association theory" under section 7701 (a)(3). The association theory, in general, is that if individuals voluntarily associate themselves together and conduct a business enterprise for profit in a manner and in a form resembling that of a corporation, they will be taxed as corporation, regardless of the avowed form they have adopted.82 The basic requirements of the theory—conduct of a business venture for profit and resemblance to corporate activity—were laid down by the Supreme Court in Morrissey v. Commissioner.83 The case involved the formation of a trust for the purpose of the development and operation of a real estate project. In holding that there was an association, the Supreme Court listed the factors to be considered in determining if there is resemblance to a corporation: 1) the purpose of the group or venture; 2) whether there is continuity of the enterprise on death of the beneficial members; 3) the presence of centralized management or direction; 4) limitation of personal liability of the members; 5) ease of transferability of the interests of the members; 6) the holding of title of the assets by the association, rather than by the individuals involved.

Presumably, the Commissioner's argument of the association theory in the context of a multiple corporate structure would be that the related corporations compose a group of "individuals" voluntarily associated in a business venture, and conducting the venture in a form resembling that of a corporation. The Commissioner would point to the agreements and dealings between the related corporations to prove the Morrissey factors are present. According to Professor Surrey, the Commissioner has been using this attack mainly against brother-sister corporations in the real estate field,84 but it


Nevertheless, one writer has concluded that the long range effect of section 1551 is to "curtail specialization along natural business lines and to discourage the voluntary breaking up of large enterprises into smaller entities." Emmanuel, Section 15(c): New Teeth For the Reluctant Dragon?, 8 Tax L. Rev. 457 (1953). The author does not explain how the transfer of assets to a wholly owned subsidiary, or an eighty per cent owned subsidiary, is "voluntary breaking up." Certainly if the Buick Division of General Motors Corporation were turned over to a new corporation wholly owned by General Motors there would be no "breaking up" of the General Motors group.

83. 296 U.S. 344 (1935).
can be argued that the association theory also could be used in a parent-subsidiary case.\(^{85}\)

Assuming that the association theory can be proved in a multiple corporation situation — and this is a big assumption \(^{86}\) — the resulting income tax paid by the related group could be far greater than that paid by a single corporation. It is clear, of course, that the gross income of the component corporations would be aggregated and against this only one surtax exemption allowed. However, there is the problem of how to treat the component corporations. Should they be disregarded or should they be recognized as taxable entities? If recognized, then presumably their taxable income would be a pro rata share of the net earnings of the association. If this is true, then there would be triple taxation of the income earned by the multiple corporate group; two corporate income taxes plus a personal tax on the dividends received from the component corporations by their shareholders. Under this interpretation, an association of ten component corporations could have a gross of $250,000 reduced to $87,850 before distribution to the shareholders.\(^{87}\)

The triple taxation effect of the association theory could be avoided by either of two approaches. The shareholders of the component corporations could be considered as being directly associated,  

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85. This is probably due to the fact the brother-sister corporate group is often used to work joint projects, such as in real estate developments where each corporation will handle a certain function or phase. One will hold title to the land, one will build the houses, a third will sell the houses, etc. The corporations therefore have agreements between them as to prices, profits, security, limitation of liability, control or management, and so on. These agreements can be such that the six prerequisites of Morrissey, or enough of them, will be present. Apparently, parent-subsidiary groups are not commonly used to work joint projects, though they certainly could be.

86. For instance, how would the Commissioner prove that the title to the assets is held by the association? In proving that a trust is an association, it is relatively easy to do this, since the trust will hold title to the assets and it is the trust that is called the association. Central management could be difficult to prove, unless one corporation is dominant, or one shareholder. And, if the component corporations are considered the members of the association, where is the ease of transferability of their interests? They have no stock certificates, nor property rights such as beneficiaries of a trust have.

87. The association would pay $124,500 in taxes, leaving $125,500 for distribution. Assuming equal distribution, each component corporation would receive $12,550, on which each would pay $3,765 in taxes, a total of $37,650 for the ten corporations. Subtracting this from the $125,500 distributed to the corporations, it means that only $87,850 of the original $250,000 is left for distribution to the shareholders. Thus, almost sixty-five per cent of the income would go for taxes. The harshness of this result could be mitigated, or wholly eliminated, if the taxpayer could prevail with one of two possible attacks. It would be mitigated substantially if the taxpayer successfully argues that each component of the association is entitled to the eighty-five per cent dividend credit provided in section 243(a). The harshness would be eliminated if the taxpayer successfully asserted that payments by the association to the components were for services rendered to the association and the association is therefore entitled to deduct these payments as "trade or business expenses" under section 162. However, the latter point may be wholly or partially thwarted by the Commissioner showing the deductions were excessive.
therefore receiving the income, after taxes, of the association without its going through the component corporations. Or, the Commissioner could simply elect not to require the component corporations to pay tax on the income "received" from the association. By avoiding the harsh effects of taxation, these approaches would make the association theory more acceptable to the courts, but the result of both approaches is the disregarding of the component corporations as taxable entities. Thus, under the guise of the association theory, the sham theory would be applied in a situation where the corporations are actually performing business activity.

II. SOME POSSIBLE APPROACHES TO THE PROBLEM OF MULTIPLE INCORPORATION

With the exception of some of the recent cases, judicial construction of the Commissioner's statutory weapons has left him almost powerless against a cleverly conceived multiple corporation device. As pointed out in the beginning of this Note, the rewards for multiple incorporation are significant, and it would be naive to assume they are not being sought after and obtained. This means that some businesses are obtaining a competitive advantage, and that the Internal Revenue Code is directly influencing that natural competitive struggle basic to our economic system. The policy of allowing a person to reduce taxes by selection of any business form is thus outweighed by the desirability of preventing the tax code from creating, or fostering, such unfair competitive advantages. Furthermore, as indicated below, there is a danger that the surtax exemption and the accumulated earnings credit will be lost because of the extensive use of multiple incorporation. Therefore, the use of the multiple corporate device should be limited. These desired limitations should

88. Section 1551 is effective but its area of application is limited. See note 77 supra.
89. See notes 3 through 6 supra and accompanying text.
90. Multiple incorporation has been termed one of the biggest "leaks" in the Code. Mortenson, The Multiple Attack on Multiple Corporations, 35 Taxes 647, 658 (1957).
91. Mr. Mortenson has indicated that it can be argued it is desirable to allow multiple incorporation as an incentive to split-ups and new businesses. Ibid. This would be consistent with Mr. Emmanuel's theory that section 1551 has a stifling effect on the economy. See note 81 supra. The objection allowing unchecked multiple incorporation is that the original purpose of the surtax exemption, a graduated income tax that favors low-income corporations, would be destroyed. Through multiple incorporations the effective tax on corporations would be almost equal to the "normal tax" imposed by section 11. Thus, not only would there no longer be any "break" given to the small corporations, but also there would be a significant loss of tax revenue.
92. Professor Surrey has said that "the decision whether tax benefits should be accorded small business may depend in considerable part on whether the benefits may really be confined to small business." Surrey, Income Tax Problems of Corporations and Shareholders, 14 Tax L. Rev. 1, 38 (1958).
be legislated, not judicially created. Judicial reconstruction of the present theories and code sections, such as done in *Aldon Homes, Coastal Oil, Advance Machinery, Alpha Tank* and *James Realty*, could perhaps accomplish the desired result, but the change would be too uncertain and too slow. Furthermore, it is questionable whether courts should change well established interpretations of statutory law, especially in an area like taxation where there is constant revision of the statutes and there is a need for integration of changes.

A. Elimination of the Surtax Exemption and Accumulated Earnings Credit.

A solution that is appealing because of its simplicity is to eliminate the accumulated earnings credit and the surtax exemption. Deciding whether this should be done necessitates a balancing of the purposes and effects of the two tax "breaks" against the evils of multiple incorporations.

The accumulated earnings credit was inserted in the Code to encourage expansion by small business.\(^3\) It was thought that the threat of the accumulated earnings tax would inhibit small corporations from accumulating any earnings for expansion purposes. Many small corporations apparently believed they would not be able to justify all the accumulated earnings and therefore might jeopardize the entire accumulation.\(^4\)

The effect of the surtax exemption was to create a progressive corporate tax rate, an expression of the theory of taxing according to ability to pay.\(^5\) This is consistent with taxation of individuals and partnerships, and for this reason alone should be retained. The standard reason given for the surtax exemption, however, is that it aids "small business."\(^6\) Also, the exemption aids the expansion of existing businesses.\(^7\) A prosperous business may wish to diversify,


\(^{94}\) Of Joint Comm. on Internal Revenue Taxation, op. cit. *supra* note 93, at 68.


\(^{96}\) Authorities cited note 95 *supra*. Defining "small business" is difficult. It could be defined in terms of the number of shareholders, or the value of assets, the volume of sales, etc. The Code's approach is in terms of income; every corporation formed for a valid business purpose (of varying degrees) that has less than $25,000 taxable income is a "small business."

\(^{97}\) Your committee believes that the continuance of a free competitive market demands the creation of new, and the growth of existing, small businesses and that this necessitates preferential tax treatment with today's corporate tax burden.

explore new areas, or open up new markets, but might hold back because of the doubtful profits, or the fear of risking its assets. The surtax exemption would aid these new offshoots, just as it is said to aid new corporations. Since the economy benefits equally from "offshoots" and "new starts," it is logical that each should receive equal encouragement.

A possible answer to the argument that the surtax is necessary to encourage new businesses is Subchapter S of the 1954 Code. It allows certain small corporations to elect to be taxed in a manner similar to a partnership. By exercising this option, the businesses that qualify for Subchapter S could obtain a self-imposed graduated tax rate. Overlooked by this Subchapter S theory is the fact many small corporations are owned by too many people to qualify for Subchapter S, and there are several types of corporations that could not qualify for the election. Furthermore, there are other factors to be considered, such as the requirement that the electing corporation may have only one class of stock. These limitations on the application of Subchapter S weaken the argument that small business would not be hurt by the removal of the surtax exemption.

Thus, the appeal of eliminating the surtax exemption and accumulated earnings credit loses its initial lustre on close inspection. The results of their elimination are too harsh to justify this method as an answer to the multiple incorporation problem.

B. USE OF THE ASSOCIATION THEORY

There are three major objections to codifying the association theory: 1) The association theory is in reality an extension of the sham theory, and it would be better to use a more stringent version of the familiar business purpose test than to strike down entities through application of a new test with uncertain and complicated concepts. 2) If the triple taxation results were incorporated in the Code as part of the association theory, too severe a penalty would be imposed on the shareholders of the component corporations. Even if the association theory could somehow be made concrete and definite so that it could be predicted under what circumstances the Commissioner would be successful, the penalty would be too harsh. 3) The association theory could easily be avoided since there are so many prerequisites to its application.

98. Congress is aware of this, as evidenced by its concern that section 1551 should not be used to deny the exemption and credit in cases of legitimate expansion. See note 81 supra.

C. Objective Tests

Professor Surrey and his American Law Institute group project have expressed doubt that the subjective tax avoidance test is relevant to the prevention of undesirable multiple incorporation. Their position is that the surtax exemption and the accumulated earnings credit should be “limited in accordance with the realities of the situation and in the light of the purposes sought to be served by the benefits involved in the exemption and credit.” Under their view, the purpose of the exemption and credit is to aid “small business.” Accordingly, Professor Surrey and the A.L.I. group have developed in their “working views” objective tests or definitions for “small business.” These tests are:

1. A parent-subsidiary affiliated group should be treated as a unit . . . and the group should be entitled only to a single exemption and credit. The stock-ownership requirements respecting the consolidated return privilege, 80 per cent at present, should apply in determining affiliation.

2. A brother-sister group should also be treated as a unit . . . if there is common shareholder ownership and if the business activities of the corporations are conducted in an integrated manner.

(a) As respects the stock-ownership requirement, it would be satisfied if at least 80 per cent of the common stock of each corporation is owned by not more than five individuals in substantially the same proportion, taking into account reciprocal stock ownership arrangements and rules of stock attribution.

(b) As respects the integration of business-activities requirement, regard should be paid to whether the corporations utilize common management, sources of supply, and facilities, etc.; to whether there are substantial intercorporate dealings, such as mutual financing or credit arrangements; to whether the activities represent substantially a unitary trade or business, and like factors.

Professor Surrey would add these tests to the present weapons of the Commissioner, retaining, for example, section 269 to deal with situations not covered by the new tests.

Professor Surrey’s tests are appealingly precise in their application. If the objective criteria are met, the exemption and credit will be limited accordingly. This is particularly true in the case of the parent-subsidiary relationship, where the credit and exemption are limited automatically after eighty per cent control is obtained. Although the applicable test is not completely objective in the brother-sister relationship, the proposed tests would at least give the Commissioner better legislative standards than presently exist.

101. Id. at 42.
102. Ibid.
103. Ibid.
However, two major objections to Professor Surrey's recommendations may arise from the inflexibility of the proposed objective tests. First, in some respects, these tests do not go far enough and consequently can easily be circumvented. For example, by reducing ownership to 79% per cent a parent-subsidiary group could avoid test number two; and, by having six instead of five common shareholders in a brother-sister group, test number three could be defeated. The A.L.I. answer to this is retention of the present tax evasion sections, which, as demonstrated, are probably powerless against multiple incorporation. The result, therefore, would be continuation of judicial legislation in regard to the present Code sections. Businessmen would circumvent the objective tests, forcing the Commissioner to rely on the present sections and hope for more decisions like James Realty, or for judicial acceptance of the association theory.

Second, in other respects, these A.L.I. proposals go too far and interfere with the encouragement of expansion of business. The tests are too restrictive to allow the surtax exemption and accumulated earnings credit to effect their expansion purpose; this is especially true of the parent-subsidiary test. Congress, in enacting section 1551 to deal with parent-subsidiary multiple incorporation, made it clear that the incentive to genuine expansion (as opposed to split-ups) engendered by the surtax exemption and accumulated earnings credit was not to be destroyed by section 1551. Therefore, it is clear that Congress wants the surtax exemption and accumulated earnings credit to remain as aids to expansion of business, and it is equally demonstrable that the A.L.I. proposal will prevent them from so doing.

D. SUBJECTIVE TESTS

The answer, therefore, is a test that furthers the purposes expressed by Congress for the surtax exemption and the accumulated earnings credit—fostering of new small businesses and encouragement of expansion of existing businesses—and at the same time prevents the use of the exemption and credit for purposes inconsistent with those expressed by Congress. This could best be accomplished by a subjective test, because a subjective test has flexibility, which gives it an ability to adapt to the sophistication of the problem.

104. See notes 93–98 supra and accompanying text.
105. If a parent-subsidiary relationship exists, and there is eighty per cent control, denial of all but one surtax exemption and accumulated earnings credit is automatic.
106. See authority cited note 81 supra.
107. The argument for flexibility in a tax avoidance statute is clearly set forth in this statement:

The line which section 355 draws between corporate separations that qualify and those that do not is a good illustration of the inadequacy of a taxing statute
Accordingly, the definition of what is a multiple corporate group—the definition of the minimum relationship between corporations which must exist before they will be examined for possible denial of exemptions and credit—should be subjective. Such a definition could be supplied by using the "actual control" definition of section 482.108 Professor Surrey's ideas of percentage of control and number of shareholders common to the group could be added to the test as guides to the Commissioner, though care should be exercised to point out that the Surrey tests should not be exclusive.

Once the multiple corporate group has been defined, the denial of the exemptions and credits to some or all of the members of the group should also be based on a subjective test. Congress has long recognized the appropriateness of a subjective test for this purpose, as evidenced by sections 269 and 1551; and the courts have read a subjective test for tax avoidance into section 482.109 It is true that these tests—which balance tax avoidance motives against business purposes—are ineffective against multiple incorporation, but this ineffectiveness is due to two things: the type of business purpose looked to, and the amount required. The business purposes considered under these sections have been all-inclusive. To allow a multiple corporate group to be justified by non-expansion purposes is to allow the use of surtax exemptions and accumulated earnings credits for purposes other than those intended by Congress. To properly effectuate the congressional intent, the purposes looked to should be those associated with the establishing or acquiring of a business unrelated to the businesses of the existing multiple corporate group.

The second reason for ineffectiveness of the present test, the small amount of business purpose that has been allowed to justify multiple incorporation, could be overcome in two ways. First, give the Commissioner discretionary power, as he now has under section 482, to determine when a multiple group has not been established for business expansion purposes. This would result in the taxpayer's having

which is over-specific and inflexible. While rules of thumb are convenient measures for administrative officials and taxpayers, they should not entirely displace standards under which the administrative officials and the courts have enough room to carry into effect the underlying legislative policy.


One writer has concluded that a broad, discretionary tax avoidance section, based on a business purpose test, has worked successfully in Canada, and would probably be the best solution in this country. Rudick, Acquisitions to Avoid Income or Excess Profits Tax: Section 129 of the Internal Revenue Code, 58 Harv. L. Rev. 196, 222-23 (1944). See also Rudick, The Problem of Personal Income Tax Avoidance, 7 Law & Contemp. Probs. 243 (1940).

108. See note 31 supra and accompanying text.
109. See note 32 supra and accompanying text.
the burden of proving the Commissioner's determination of lack of expansion purpose to be arbitrary and unreasonable.

Second, the amount of business expansion purpose required to justify the formation of an additional corporation should be *substantial in relation to the size of the business* presently being conducted by the enterprise. This comparison could be facilitated by estimating in dollar terms the value of business purposes. The answer to an objection that business purpose cannot be monetarily evaluated is that businessmen invariably go through this process before deciding on any change in their business; they *estimate* the net return anticipated from any transaction or undertaking before entering into it.

The result of requiring that business expansion purpose be substantial in relation to the size of the business is that a certain amount of purpose may justify the addition of a corporation by a "small business" but the same amount would not justify a similar addition by a "big business."

If these recommendations were incorporated into a single section of the Code, sections 269 and 1551 would no longer be needed for an attack on multiple incorporation. Of course, section 269 would still be retained and applied to acquisitions of tax benefits, such as tax loss carry forwards and depreciation deductions. Furthermore, section 482 would be retained to maintain arms-length relations between related entities.