Louisiana Law Review

Volume 20 | Number 4
June 1960

Income Taxation - Problems of Multiple Corporations

C. A. King II

INCOME TAXATION — PROBLEMS OF MULTIPLE CORPORATIONS

Two recent cases focus attention on some of the tax problems of multiple corporations. In the first case the corporate taxpayer brought an action to recover an alleged overpayment of income taxes which were paid after disallowance of its corporate surtax exemption and minimum excess profits credit. The taxpayer and eight other corporations had been formed "to acquire, improve, and develop real property." The individual who controlled these corporations had previously formed two others, one to construct houses on land transferred to the taxpayer and the other to sell the homes after they were constructed. The Tax Commissioner disallowed the corporate surtax exemption and excess credit by application of Section 129(a)(1) (Section 269 of the 1954 Code)[1] which authorizes a disallowance of any "deduction, credit or other allowance" resulting from acquisition of control of a corporation, when the *principal purpose* of such acquisition is avoidance of income taxes. The taxpayer made two contentions: (1) that Section 269 is applicable only to *acquisition* of corporations, and not to their *creation*, and (2) that this section is authority for denying deductions and credits only to *acquiring* corporations, and not to the corporation which has been acquired. The federal district court *held* for the commissioner. Section 269 is applicable to either acquisition or creation of corporations and to acquiring as well as acquired corporations. The principal purpose for creating the corporation being tax avoidance, the section was properly applied. *James Realty Company v. United States*, 176 F. Supp. 306 (D. Minn. 1959).

In the second case the corporate taxpayer was organized for the purpose of acquiring property, executing loans and having houses built. Its total authorized capital stock was purchased by three individuals designated as the management group. Immediately thereafter a group designated as the investors advanced funds to the taxpayer in the form of a loan, which was used to acquire a tract of land. Subsequently sixteen corporations, designated as the alphabet corporations, were formed by the management group, and the taxpayer transferred its land to these corporations in return for their unsecured notes. After the tract was completely developed the management and investment groups effected an equal division of the profits from development of the tract by liquidation of all the corporations in-

1. INT. REV. CODE OF 1954, § 269, formerly Int. Rev. Code of 1939, § 129(a)(1).

volved. The commissioner made a deficiency assessment against the taxpayer, disregarding all of the alphabet corporations as "shams" and imputing their total net income to the taxpayer under Section 22(a) (Section 61 of the 1954 Code)[2] which contains a general definition of gross income. Alternatively the assessment was based upon Section 45 (Section 482 of the 1954 Code)[3] which authorizes a redistribution of income between corporations controlled by the same interests. The commissioner also disallowed the surtax exemption to each of the alphabet corporations, one of which filed a petition in the Tax Court simultaneously with the taxpayer. The Tax Court consolidated the cases and *held* for the commissioner. Where a group of corporations are formed solely for the purpose of tax avoidance and thereafter engage in no substantial business activity, they will be disregarded as "unreal" or "shams." The entire net income from the development of the tract is properly includible in the gross income of the taxpayer. *Aldon Homes Inc. v. Commissioner*; *Barca Corporation v. Commissioner*, 33 T.C. 65 (1959).

As a general rule corporations are taxed as separate entities.[4] Early in the history of corporate taxation, the commissioner began to attack the standing of certain corporations as separate taxable entities by application of Section 22(a) (Section 61 of the 1954 Code) which defines gross income.[5] The theory behind the attacks was that income should be attributed to the person or corporation who actually earned it. Therefore, if it is found that a certain block of income was earned by an individual but included in the gross income of a corporation, the substance rather than the form[6] would be controlling and the income would be included in the gross income of the individual. Section 45 (Section 482 of the 1954 Code)[7] was enacted to aid the commissioner in attacks on multiple corporations by authorizing redis-

2. *Id.* § 61, formerly Int. Rev. Code of 1939, § 22(a).
3. *Id.* § 482, formerly Int. Rev. Code of 1939, § 45.
4. C.I.R. v. Moline Properties, Inc., 319 U.S. 436 (1943); Burnet v. Commonwealth Improvement Co., 287 U.S. 415 (1932); Dalton v. Bowers, 287 U.S. 404 (1932); C.I.R. v. Montgomery, 144 F.2d 313 (5th Cir. 1944); Glenn v. Courier-Journal Job Printing, 127 F.2d 820 (6th Cir. 1942); Page v. Haverty, 129 F.2d 512 (5th Cir. 1942); Menihan v. Commissioner, 79 F.2d 304 (2d Cir. 1935). INT. REV. CODE OF 1954, § 11, provides for taxation of corporations; subsection (b) imposes a 30% normal tax on corporate income, this to be reduced to 25% beginning June 30, 1960; subsection (c) imposes a surtax of 22% on all taxable income in excess of $25,000.
5. INT. REV. CODE OF 1954, § 61: "Except as otherwise provided in this subtitle, gross income means all income from whatever source derived. . . ."
6. Higgins v. Smith, 308 U.S. 473 (1940); Gregory v. Helvering, 293 U.S. 465 (1935).
7. INT. REV. CODE OF 1954, § 482, formerly Int. Rev. Code of 1939, § 45.

tribution of income between related corporations in order to more clearly reflect income actually earned by each. Believing that further powers were required to deal with multiple corporations, Congress supplied the commissioner with two additional weapons. The first was Section 129 (Section 269 of the 1954 Code),[8] which was aimed at acquisition of corporations by either individuals or other corporations whose *principal purpose* was tax avoidance. To supplement this section, Section 15(c) (Section 1551 of the 1954 Code)[9] was enacted to authorize the commissioner to disallow the surtax exemption to transferee corporations when the *major purpose* of the transfer of property was tax avoidance. Each of these sections will be discussed individually.

The present Section 61 was originally enacted merely as a general definition of what must be included in an individual's gross income, with no reference to corporations. However, the commissioner soon began using it to redistribute corporate income. The jurisprudence under this section seems to have developed the rule that the commissioner must show that the *sole* purpose for the formation of the corporation was tax avoidance and that the corporation has carried on no business which produced income.[10] Therefore, if the taxpayer can prove that the corporation was either organized for some business purpose or thereafter has carried on some business, Section 61 will be inapplicable. Some of the business purposes which have been allowed to defeat application of this section are to avoid unlimited liability,[11] to gain advantage under the law of the state of incorporation,[12] to secure a loan,[13] and to protect a building from attachment.[14] Section 482[15] was enacted to authorize the commissioner to "distribute, apportion, or allocate gross income, deduc-

8. *Id.* § 269, formerly Int. Rev. Code of 1939, § 129(a)(1).
9. *Id.* § 1551, formerly Int. Rev. Code of 1939, § 15(c).
10. Moline Properties, Inc. v. Commissioner, 319 U.S. 436 (1943); Sanford Corp. v. Commissioner, 309 U.S. 659 (1940); Higgins v. Smith, 308 U.S. 473 (1940); Rota-Cone Oil Field Operating Co. v. C.I.R., 171 F.2d 219 (10th Cir. 1948); National Investors Corp. v. Hoey, 144 F.2d 466 (2d Cir. 1944); Commonwealth Title Co. of Philadelphia v. Rothensies, 124 F. Supp. 274 (Pa. 1954); Herbert v. Riddell, 103 F. Supp. 369 (Cal. 1952). See also Marshall, *Income Status of the Wholly Owned Subsidiary Corporation*, 29 TEX. L. REV. 87 (1950); Holzmay, *Moline Properties Inc., May the Taxpayer Ignore the Corporate Equity*, 26 TAXES 858 (1948); Cleary, *The Corporate Entity in Tax Cases*, 1 TAX L. REV. 3 (1945).
11. Commissioner v. Chelsea Products Inc., 187 F.2d 620 (3d Cir. 1952).
12. Moline Properties, Inc. v. Commissioner, 319 U.S. 436 (1942).
13. Paymer v. Commissioner, 150 F.2d 334 (2d Cir. 1945).
14. Sheldon Bldg. Corp. v. Commissioner, 118 F.2d 835 (7th Cir. 1941).
15. INT. REV. CODE OF 1954, § 482. See also National Securities Corp. v. C.I.R., 137 F.2d 600 (3d Cir. 1943), cert. denied, 320 U.S. 794 (1944).

tions, credit or allowances" between owned or controlled entities if he finds it necessary in order to more clearly reflect actual income. Thus, although the taxpayer could establish some business purpose, the commissioner might still reallocate income. In the majority of cases, however, the taxpayer has been able to avoid the application of this section by showing that the transactions were made at arms' length and therefore were transactions generally found in the ordinary course of business with no special advantage being given to the related corporation.[16] It has also been held that Section 482 does not authorize the disallowance of "deductions, credits, or allowances" but merely a redistribution thereof.[17] It would seem that both sections, 61 and 482, are applicable only where related corporations have indiscriminately distributed income among themselves in order to secure tax benefits.[18]

The next two sections of the Code used by the commissioner to attack affiliated corporations deal with acquiring or transferring property to secure tax benefits. Section 269[19] deals with the acquisition of corporations or other property for the principal purpose of securing tax benefits not otherwise available. The regulations indicate that this section was designed to prevent acquisition of corporations or property in order to take advantage of loss carry-overs and to prevent corporate division motivated principally by a desire to obtain surtax exemptions. Thus, if the *principal purpose* of the acquisitions is tax avoidance, Section 269 is applicable.[20] Among the purposes accepted as principal purposes by the courts have been limited tort liability,[21] local ownership avoiding prejudice,[22] better bargaining

16. Ross v. C.I.R., 129 F.2d 310 (5th Cir. 1942); Trippett v. C.I.R., 118 F.2d 764 (5th Cir. 1941); Friedlander Corp. v. C.I.R, 25 T.C. 70 (1955); Texsun Supply Corp. v. C.I.R., 17 T.C. 433 (1951); Cedar Valley Distillery Inc. v. C.I.R., 16 T.C. 870 (1951). It seems that the court will be most likely to find that the transaction was made at arms length if a sufficient price is paid and such transactions are found in the ordinary course of business between unrelated interests.

17. Hypotheek Land Co. v. Commissioner, 200 F.2d 390 (9th Cir. 1952); Central Cuba Sugar Co. v. Commissioner, 198 F.2d 214 (2d Cir. 1952); C.L.R. v. Chelsea Products, 197 F.2d 620 (3d Cir. 1952); Tennessee-Arkansas Gravel Co. v. Commissioner, 112 F.2d 508 (6th Cir. 1940).

18. Advance Machinery Exchange Inc. v. Commissioner, 196 F.2d 1006 (2d Cir. 1952); Birmingham Ice & Cold Storage Co. v. Davis, 112 F.2d 453 (5th Cir. 1940).

19. INT. REV. CODE OF 1954, § 269.

20. Mill Ridge Coal Co. v. Patterson, 264 F.2d 713 (5th Cir. 1959); American Pipe and Steel Corp. v. C.I.R., 25 T.C. 351 (1955).

21. Alcorn Wholesale Co., 16 T.C. 75 (1951).

22. Commissioner v. Chelsea Products, 197 F.2d 620 (3d Cir. 1952).

power,[23] increased borrowing capacity,[24] and clarification of tax position.[25] The Tax Court[26] and the courts of appeal[27] have given different interpretations to Section 269, with the Tax Court holding that it applies both to the acquiring and the acquired corporations. Further, until recent decisions it was felt that the section applied only to the acquisition of corporations and did not extend to *formation* of corporations. Recent cases, however, have held that the section applies to both situations.[28] As a result of the commissioner's unsuccessful attempts to apply this section, Section 1551[29] was enacted providing for disallowance of the surtax exemption and accumulated earnings credit (1) if one corporation transfers all or part of its property, other than money to another corporation, (2) the transferee either was created for the purpose of acquiring such property or was not actively engaged in business at the time of the transfer, and (3) after such transfer the transferor was in control of the transferee during any part of the transferee's taxable year. After a showing of these conditions, the commissioner is authorized by this section to disallow the surtax exemption and accumulated earnings credit, unless the transferee can avoid application of the section by establishing by a preponderance of the evidence that a *major* purpose of such transfer was not the securing of such exemption or credit.[30] Within this limited area Section 1551 is more valuable to the commisisoner because the taxpayer, in order to avoid its application, must prove that tax avoidance was not even *a major* purpose as opposed to his burden merely to establish that tax avoidance was not *the* principal purpose under Section 269.

It can be seen that the commissioner has a variety of means for attacking multiple corporate structures and generally, as illustrated by the two instant cases, will attempt an application of several of the above discussed rules and sections to the same case. In *James Realty Co. v. United States* the district court recognized the conflict of decisions between the Tax Court and

23. Berland's Inc. of South Bend, 16 T.C. 182 (1951).
24. Alcorn Wholesale Co., 16 T.C. 75 (1951).
25. J. E. Dilworth Co. v. Henslee, 98 F. Supp. 957 (M.D. Tenn. 1951).
26. British Motor Car Distributors Ltd. v. C.I.R., 31 T.C. 437 (1958); Terminal Corp. v. C.I.R., 11 T.C. 411 (1948); Alprosa Watch Corp. v. C.I.R., 11 T.C. 240 (1948).
27. Mill Ridge Coal Co. v. Patterson, 264 F.2d 713 (5th Cir. 1959); Coastal Oil Storage Co. v. Commisioner, 242 F.2d 396 (4th Cir. 1957).
28. Coastal Oil Storage Co. v. Commissioner, 242 F.2d 396 (4th Cir. 1957); Alcorn Wholesale Co., 16 T.C. 75 (1951).
29. INT. REV. CODE OF 1954, § 1551, formerly Int. Rev. Code of 1939, § 15(c).
30. *Ibid.*

courts of appeal and chose to adopt the rule of the latter by holding Section 269 applicable to both acquiring and acquired corporations.[31] The *James* case is supported by at least one previous court of appeals case in its holding that Section 269 is applicable to the formation as well as acquisition of corporations.[32] In *Aldon Homes v. Commissioner* the commissioner relied mainly on his original weapon against multiple corporations by alleging that all the subsidiaries were merely "shams" organized solely for the purpose of tax avoidance. Therefore all of the income was included in the gross income of the taxpayer as the real entity creating the income under Section 61. Although the taxpayer alleged several business purposes which in prior decisions have been held to be sufficient, the court based its decision not on the fact that these were not sufficient business purposes but rather on the finding that they were not the *true reasons* for establishment of the subsidiaries. It would seem that this should be taken as a warning that the court will require more actual proof of the subjective business purpose than has been required in earlier cases, resulting in more frequent applications of both Section 61 and Section 269. In refusing to rule on the applicability of the other sections urged by the commissioner the court aligned itself with prior decisions which indicated that those sections were meant to apply only to certain specified cases in which the general rule of "sham" corporations could not be applied. By refusing to base its decision on more than one section the court seems to be attempting to indicate the specific situations to

31. It would seem that the Supreme Court will eventually have to rule on this question in order that a uniform interpretation can be accomplished. The first case to hold that Section 269 is applicable to the acquired corporation was Coastal Oil Storage Co. v. Commissioner, 242 F.2d 396 (4th Cir. 1957). Even in this case the court stated that the sole benefit of the surtax exemption would accrue to the parent or acquiring corporation. A strict interpretation of the language would seem to support the Tax Court decisions as the statute says: "If any person or persons acquire, . . . control of a 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. . . ." It is true, however, that this strict interpretation severely limits the applicability of the section. Section 1551 to some degree fills the gap, but it only authorizes the disallowance of the surtax exemption and accumulated earnings credit; thus a corporation could transfer property to another corporation with a loss carry over and use that loss carry over to offset income from the transferred property. Section 1551 offers no authority to the commissioner for disallowing this loss carry over. Also, Section 269 requires only 50% control, whereas Section 1551 requires 80% control; therefore many transactions will escape Section 1551 which might have been covered by the broader interpretation of 269 offered by the courts of appeal. See Kirkpatrick, *Section 269 of the 1954 Code — Its Present and Prospective Function in the Commissioner's Arsenal*, 15 TAX L. REV. 137 (1960); Landman, *Being Tax-Wise and Otherwise in Multiplying Business Entities*, 30 TAXES 893 (1952).

32. Coastal Oil Storage Co. v. Commissioner, 242 F.2d 396 (4th Cir. 1957).

which each section will be applicable. It would seem inconsistent first to disregard a group of corporations as "unreal" and then apply a section of the code which authorizes attacks on "real" corporations. To the extent that the *Aldon* decision avoids this inconsistency, it appears to be sound.

C. A. King II

LABOR LAW — THE EFFECT GIVEN TO AN ARBITRATION AWARD BY THE NLRB IN AN UNFAIR LABOR PRACTICE HEARING

Under the National Labor Relations Act as amended a problem exists where an arbitration award deals with the subject matter of conduct which may be an unfair labor practice. It is clear that the Board can entertain jurisdiction when an arbitration award is interposed as a bar to an unfair labor practice proceeding. Section 10(a) provides: "The Board is empowered . . . to prevent any persons from engaging in any unfair labor practice affecting commerce. This power shall not be affected by any other means of adjustment or prevention that has been or may be established by agreement, law or otherwise."[1] However, it is particularly important to notice that the act does not require, with one exception,[2] that the Board always exercise its jurisdictional power; it merely gives the Board exclusive jurisdiction when the Board does decide to exercise it.

Prior to the case of *Spielberg Mfg. Co. & Harold Gruenberg*,[3] the Board apparently had not formulated any comprehensive criteria by which it would determine whether to accept an arbitration award as a binding settlement of the dispute presented as an unfair labor practice. In that case four strikers, discharged for their conduct during the strike, were refused reinstatment by an arbitration award which the union, company, and discharged strikers had agreed was to be binding. The discharged strikers were represented by counsel, and three of the four were present during the arbitration. Subsequently these discharged strikers filed unfair labor practice charges. The Board dismissed the complaint and accepted the arbitration award as binding. In doing this the Board enumerated the criteria to be met before the Board would defer the exercise of its jurisdiction to an arbitration award. The three criteria are:

1. Labor Management Relations Act, 29 U.S.C. § 160(a) (1947).
2. Labor Management Relations Disclosure Act § 701 (1959).
3. 112 N.L.R.B. 1080 (1955).