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## THE ATTACK ON MULTIPLE CORPORATIONS

There are those who separate their business on a functional basis and employ more than one corporation for legitimate business reasons. Others may contemplate multiple incorporation of an existing integrated business, or the use of several corporations in a new venture largely as a means of effecting tax savings. It is to the latter group in particular that this cautionary note is addressed as it is apparent that the Internal Revenue Service is engaged in an all out attack on multiple corporations.

In view of progressive income tax rates an obvious means of minimizing Federal taxes is by spreading income among several tax paying entities with the result that income in each separate entity is subjected to a lower rate. There is an element of progression in corporate taxes in that income under \$25,000 is taxed at 30 per cent, while income over that amount is subjected to a 22 per cent surtax. By using multiple corporations less income is exposed to the surtax. Multiple corporations are a group of separate related entities which fit generally into two categories: (1) in a parent subsidiary relationship, or (2) as affiliated "sister" corporations, separate from each other but subject to common control through stock ownership. This system of organization may be advantageous in that it offers a means of neutralizing the impact of the corporate surtax; it makes available several accumulated earnings credits; in a situation in which sale of a portion of the business is probable it offers relief from the difficulties usually encountered in spin-offs and partial liquidations; and, it can be of help in avoiding the rigors of the collapsible corporation provisions. However, in the absence of a subsidiary relationship, losses sustained by one corporation within the group cannot be taken into account in the returns of those corporations that are earning a profit; but, the principal disadvantage in multiple incorporation is that tax savings expected may be illusory. The Commissioner is armed with several means of attack, for instance, within the complex of corporations some may be found "shams" and disregarded for tax purposes; all income may be allocated to one corporation;<sup>1</sup> corporations within the group may be denied credits, exemptions and allowances if the principal purpose of their creation or acquisition was tax avoidance;<sup>2</sup> or, if a major purpose of transferring property to a

1. § 482: 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.  
Source: § 45, 1939 Code, substantially unchanged.
2. § 269(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,

newly formed corporation was to secure additional exemptions and credits, these may be denied.<sup>3</sup> Before turning attention to prohibitions against multiple incorporation let us review in some detail the possible advantages.

*Corporate Surtax Exemption and Accumulated Earnings Credit*

Corporate earnings are taxed at a normal rate of 30 per cent and additionally a surtax equal to 22 per cent of the amount by which earnings exceed \$25,000 is imposed.<sup>4</sup> By spreading income among several corporations the surtax burden can be minimized or avoided. This effect is achieved by distributing income among corporations so that the income in each is near or below \$25,000. Tax savings are significant. For example, if income of \$100,000 were reported by a single corporation the amount of tax payable would be \$46,500.<sup>5</sup> However, if this same amount of income were divided equally among four corporations, each would pay only \$7,500 in taxes, and the total tax would be \$30,000. The reason for the substantial difference in taxes (\$16,500) is that in the case in which \$100,000 is reported by a single corporation, \$75,000 is subjected to the surtax. As may be expected where there are obvious means of achieving substantial tax savings, Congress acts to close what is often referred to as a "loophole," and this area has not been forgotten. Congress and the courts have responded with legislation and interpretations which curb multi-incorporation. Section 1551 of the Internal Revenue Code of 1954 is designed specifically to restrain the fragmentation of existing corporations to gain added surtax exemptions. This provision may also disallow another advantage achieved in the multi-corporate form, namely, several accumu-

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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 combined 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.

Source: § 129 (a), 1939 Code, substantially unchanged.

3. § 1551: 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.

Source: as originally enacted in the 1954 Code: § 15 (c), 1939 Code.

4. § 11, Internal Revenue Code of 1954.

5.  $30\% \times \$100,000 + 22\% \times \$75,000 = \$46,500.$

lated earnings credits. In this context section 535 (c) provides for a credit of \$100,000, which is permitted irrespective of the stockholders intent, before application of the accumulated earnings tax.<sup>6</sup> However, after the \$100,000 limit is exceeded, the accumulated earnings tax, which reaches 38½ per cent may be asserted by the Commissioner, and, the first \$100,000 may be taken into account in determining whether accumulations exceeding that amount are compatible with the reasonable needs of the business.

The accumulated earnings credit is a valuable tool which may be availed of to minimize the effect of individual effective rates on distributions made by a corporation in the form of dividends. The individual rates progress rapidly from a minimum of 20 per cent to a maximum of 91 per cent on income in excess of \$200,000; therefore, it may be wise to accumulate corporate earnings within the corporation with a view to retrieving them at bargain rate, long-term capital gain rates. In many instances the accumulated earnings credit is available only in the early life of a corporation. If for instance taxable income were \$25,000 per year, the corporation would have \$17,500 left to accumulate after taxes. If all income after taxes were accumulated the \$100,000 limit would be exceeded within six years. Here multiple corporations are helpful in that considerably more can be accumulated over a longer span of years.

As mentioned above this sort of tax planning envisions retrieving corporate earnings at capital gains rates. In this regard, careful consideration must be given the collapsible corporation provisions set out in section 341. These provisions are designed to prevent the conversion of what otherwise would be ordinary income into capital gain by premature liquidation of a corporation. For example, a group incorporates, buys lots, and builds houses on the lots. Before any sales are made the corporation is liquidated, and the individual members of the group take assets in exchange for their stock. The basis for the assets received in the exchange is the fair market value of the assets at the time of the liquidation. To the extent that the value of the property exceeded construction costs, such excess would have been ordinary income in the hands of the corporation; however, through liquidation it is converted into capital gain by the distribution of the property to the shareholders. The collapsible provisions, prevent the conversion of ordinary income into capital gain in analogous situations.

If collapsible corporation problems are anticipated, multiple corporations could be helpful in taking advantage of the exceptions to section 341.<sup>7</sup> For instance, if a particular project will be in construction over a

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6. § 531, Internal Revenue Code of 1954.

7. Section 341 (b) defines a collapsible corporation. A "collapsible corporation" is a "corporation formed or availed of principally for the manufacture, construction, or production" of any property, or for the purchase of certain kinds of property, "with a view to" the disposition of the stock by the shareholders (whether in liquidation or otherwise) before the corporation has realized "a substantial part of the taxable income to be derived from such property." Section 341 (d) limits the application of the section in three situations. The section does not apply to gain realized by a shareholder with respect to his stock in a collapsible corporation if (1) the share-

long period of time, it may be done in phases. If a separate corporation is used for the separate phases the three year rule can begin to run as each phase is completed. This avoids the problem arising out of the fact that the three years does not commence to run until the entire project undertaken by a corporation is completed. Thus multiple corporations could be helpful, in this manner, in the construction of a shopping center, or the development of an oil and gas leasehold.

#### *Other Tax Advantages*

Operating in the multi-corporate form may avoid the necessity of filing a declaration of estimated tax, and of making advance tax payments. This frees funds for use by the corporations for a longer period, and secondly eliminates the cost of preparing the declaration. Section 6016 (a)<sup>8</sup> provides that every corporation which reasonably expects its income to exceed \$100,000 shall make a declaration of estimated tax. If the expected income of each corporation within the multi-corporate group was kept below this amount for this and other reasons the estimating requirement would not have to be met. This type of organization also makes available selection of different accounting methods and the use of different taxable years for various corporations within the group. One corporation might use the cash method of reporting income while another uses the accrual method or percentage of completion. Also, we see that different elections may be made, one corporation may elect to expense or deduct intangible drilling or development costs, or exploratory mining costs while another capitalizes. And, in view of the \$400,000 limitation on exploratory deductions, multiple corporations suggest a method of securing deductions in excess of that limitation.<sup>9</sup>

This vehicle may also alleviate some difficulties encountered in sale of a part of a business. In situations in which the partial liquidation provisions of section 346, or the spin-off provisions of section 355 are inapplicable, a distribution to the shareholders of a part of the business

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holder did not own more than five percent of the outstanding stock, (2) if no more than seventy percent of the gain recognized is attributable to the collapsible property, (3) if the gain is realized after three years following completion of the manufacture, construction or purchase of the collapsible property. In addition if a corporation has realized a substantial amount of the income from the property, gain recognized by the shareholder will not be subject to the ordinary rates. For some time the Service considered 50 percent of the income to constitute a substantial part; however, a substantial part may be something less, James B. Kelley, 32 T.C. 135 (1959), but see G. A. Heft and Edna S. Heft, 34 T.C. 9 (1960). By carefully observing these exceptions collapsible treatment can be avoided. Additionally, section 341 (e) provides a negative definition of a collapsible corporation. If that definition applies, gain received by a shareholder on the sale or exchange of his stock is not ordinary income. Section 341 (e) applies if the net unrealized appreciation in ordinary income assets does not exceed 15 percent of the corporations net worth. Ordinary income assets are defined at 341 (e) (5). In determining whether or not a particular asset is an ordinary income asset as opposed to a capital gain asset the determination is based not only what its status would be in the corporation, but also by reference to what its status would be in the hands of a principal shareholder. If the particular property would be stock in trade, inventory, or other property held primarily for sale to customers, in the hands of a principal shareholder, the shareholders status as a dealer is imputed to the corporation. Hambrick, *Collapsible Corporations in Oil and Gas*, 28 G. Wash. L. Rev. 815.

8. Internal Revenue Code of 1954.

9. § 615, Internal Revenue Code of 1954.

in the form of assets or stock constitutes a taxable dividend to the shareholders to the extent of earnings and profits of the distributing corporation. The danger is that a capital gains tax would apply at the corporate level on assets sold, and additionally a tax to shareholders upon distribution of the proceeds as dividends; however, if several corporations are employed any on may sold at the cost of only a capital gain on the disposed of property.<sup>10</sup>

Other advantages lie in that a multi-corporate structure may facilitate the estate plan of a principal shareholder; offer greater insulation against contractual and tort liability; ease the handling of mechanics liens; alleviate allocation problems if multiple state income taxes are a problem; permit flexibility in capital structure; and, offer greater attraction to prospective investors because of lower taxes.<sup>11</sup> However, a serious disadvantages arises out of the fact that losses in one corporation may not be offset against the income of those corporations making a profit. If losses become significant in one corporation and are being wasted, merger is one solution. Another means of escape from this type of tax waste is combination of loss corporations with those earning a profit in a consolidated return. Consolidation can be effected by transfer of shares to a single corporation or to a holding company which will then file a consolidated return for the group.<sup>12</sup> However, this solution is limited in that losses of a separate company sustained prior to the consolidation cannot be set off against the profits of other corporations.<sup>13</sup>

#### *Means of Multiplication*

A business may be divided functionally according to activities performed, as in the case of real estate development the following functional division may be made:

- (1) A construction company
- (2) A sales company
- (3) One or more companies which will hold title to land.

A business may be divided geographically, for example, a marketing concern operating over a wide area may create separate companies for each state.<sup>14</sup>

10. The statement presumes complete liquidation within a twelve month period in accordance with the provisions of section 337.

11. For a detailed discussion of the advantages and disadvantages inherent in multiple incorporation, see Driscoll, *Incorporating In Multi-Corporate Form an Existing Business*, N.Y.U. 16th Inst. on Fed. Tax 243.

12. An affiliated group of corporations has the privilege of making a consolidated return in lieu of separate returns. An affiliated group of corporations, within the meaning of section 1504, is formed at the time the common parent corporation, which is an includible corporation, becomes the owner directly of stock possessing at least 80 per cent of the voting power of all classes of stock (not including non-voting stock which is limited and preferred as to dividends) of another includible corporation; a corporation becomes a member of such an affiliated group at the time that one or more members of such group become the owners directly of stock possessing at least 80 per cent of the voting power of all classes of its stock and at least 80 per cent of each class of its nonvoting stock, Reg. § 1.1502-2 (4).

13. Reg. § 1.1502-31 (b) (3).

14. Driscoll, supra note 11, defines methods of dividing a business with more refinement. In real estate developments the management group may avail themselves of "vertical" or "horizontal" entities. If a separate corporation performs each function necessary for the development as land acquisition, construction of foundations,

In either case multiple corporations evolve which exist in a parent-subsidiary relationship, or as "sister corporations" separate from each other but related for the reason that their stock is owned by common interests. The "sister" group is created by individuals causing corporations to be formed, to which they transfer individual property in exchange for stock. This pattern has been used in real estate development wherein separable functions are undertaken by separate corporations as suggested above. Parent-subsidiary groups evolve through the transfer of corporate property to other corporations organized for the purpose of receiving part of the business, or the relationship may result from corporate consolidation.

The chief advantage of sister corporations lies in the fact that they may be safely disposed of, whereas disposal of a corporation in the parent-subsidiary relationship introduces spin-off or partial liquidation problems. However, in the "sister" organization operating losses in one corporation may slip away. On the other hand, the consolidated return is readily available to corporations in a parent-subsidiary relationship. Thus we see that "sister" corporations may be more desirable if sale of a part of a business is probable, and a parent-subsidiary relationship is more suitable if one corporation is likely to sustain substantial losses.

Those who seek tax savings through multiple incorporation cannot proceed indiscriminately. Usually the savings sought after are relief from the surtax, and the advantage of several accumulated earnings credits. Section 269 may deny an "acquired" corporation the surtax exemption and accumulated earnings credit if the principal purpose of its acquisition was avoidance of taxes. The words "acquired" and "acquisition" appearing in section 269 encompass organization or creation of a corporation.<sup>15</sup> Additionally, section 482 allows the Commissioner to distribute or allocate gross income, deductions, credits, or allowances among organizations controlled by the same interests, if he determines that such distribution is necessary to prevent evasion of taxes. Section 7701 (a) (3)<sup>16</sup> which includes within the definition of a corporation an "association," may be applied. If in real estate development separate corporations are employed to perform each phase, as acquisition of land, building of frames, finishing work and so forth; and, if these corporations are under contract to an owning company for the performance of the various functions, the arrangements among the corporations may have the effect of creating a new entity which is an "association" taxable as a corporation.<sup>17</sup> Notice the disastrous triple tax-

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construction of frames, etc., the entities are "horizontal." Problems of allocation of income and deductions among "horizontal" entities may become substantial. Problems of this type are not encountered in "vertical" entities. The latter arrangement differs in that each corporation acquires certain lots within a development, then arranges for the construction and sale of individual dwelling units. Thus each "vertical" entity carries out all phases of the development. Finally, a combination of "vertical" and "horizontal" entities could be employed by the same management group.

15. See discussion of § 269 *infra*.

16. Internal Revenue Code of 1954.

17. *Morrissey v. Commissioner*, 296 U.S. 344, 56 S.Ct. 289, 80 L.Ed. 263. See 7 Mertens, *Federal Income Taxation*, ch. 38A (1956); Note, *Multiple Corporations to Obtain Additional Accumulated Earnings Credits and Surtax Exemptions*, 44 Minn. L. Rev. 485. For an application of the theory see *Stierwalt v. United States* (D.C. Wyo. 1960) 181 F.Supp. 770 which also discusses the criteria. See Reg. § 301.7701-2.

tion effect which would follow if multiple corporations are held to be an "association" taxable as a corporation, the association would be taxed on the combined net earnings of the entire group; the component shareholder-corporations would then be taxed, and in addition to these taxes the individual shareholders would be taxed on distributions made by the corporations within the group.<sup>18</sup> And, there is yet another weapon within the Commissioner's arsenal, namely the "sham" theory. The courts look to substance rather than form in determining whether or not that which appears to be a separate entity for tax purposes is in fact entitled to such recognition.

The prohibitions against multiple incorporation briefly stated above are real obstacles in the path of the practitioner who may wish to suggest this form of organization. It is therefore appropriate to turn to a more particular discussion of the obstacles mentioned.

#### *Substance versus Form*

It is axiomatic that a taxpayer may choose whatever form he wishes to conduct a business, even if his choice is motivated solely by a desire to minimize Federal taxes.<sup>19</sup> Although one has a legal right to minimize taxes, he must accomplish this by means which the law permits. Thus if several corporations exist solely for the purpose of avoiding taxes, they are mere shells and will be disregarded and their income attributed to the entity that in fact earned it.<sup>20</sup> The corporate form must have substance if it is to be respected, and substance is furnished by business purpose. This principle is aptly stated by Judge Learned Hand in *National Investors v. Hoey*:<sup>21</sup>

. . . 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 term "corporation" will be interpreted to mean a corporation which does some "business" in the ordinary meaning; and escaping taxation is not "business" in the ordinary meaning.

*National Investors* holds that if a corporation engages in some activity other than avoiding taxation, the Commissioner may not disregard its separate entity for tax purposes.<sup>22</sup> However, if this activity is minute in relation to a dominant purpose of tax avoidance a corporation may nevertheless be a "sham."

*Aldon Homes v. Commissioner*<sup>23</sup> is a case of recent vintage that makes

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18. Sharp, Multiple Tax Benefits Through Multiple Incorporation: Some Thoughts On The Law As It Is, And As It Ought To Be, XL Boston U. Law Rev. 375, 382.
  19. Gregory v. Helvering, 293 U.S. 465, 55 S.Ct. 266, 79 L.Ed. 596; Davis v. United States (10th Cir. 1960) 282 F.2d 623, 627.
  20. Higgins v. Smith, 308 U.S. 473, 60 S.Ct. 355, 84 L.Ed. 406. The Court disallowed Smith's deduction of a loss taken upon a sale of securities to a corporation in which Smith owned all the stock.
  21. 144 F.2d 466, 468.
  22. See, Moline Properties, Inc. v. Commissioner, 319 U.S. 436, 63 S.Ct. 1132, 87 L.Ed. 1499; National Carbide Corporation v. Commissioner, 336 U.S. 422, footnote 20, 69 S.Ct. 766, 93 L.Ed. 779; Mertens, Law of Federal Taxation, Vol. 7, Ch. 28, ph. B.
  23. 33 T.C. 582 (1959).



this clear. It appeared that three individuals with reputations in real estate development wished to subdivide and develop a tract in Downey, California. These individuals, called the management group, organized Aldon Homes, Inc. Other persons, called the investor group, advanced \$300,000 to Aldon with the understanding that they would receive 50 per cent of the profits from the venture. The money advanced was used to acquire land and initiate the development. A partnership composed of the management group secured approval of local authorities and negotiated necessary financing. Another controlled corporation was formed by the management group to construct the homes. Subsequently sixteen "alphabet" corporations were organized and Aldon transferred several lots to each alphabet taking in return unsecured notes. Every lot was sold to the alphabets for the same price although they varied in size considerably. One member of the management group signed sixteen separate construction agreements between the alphabet corporations and the construction corporation although he was not an officer, director, or stockholder in six of the corporations. An independent realtor advertised the entire tract as an "Aldon" project with no mention of the alphabet corporations, although each of these corporations held and conveyed legal title to their separate properties. The stock in each alphabet was owned almost exclusively by a member of the management group. During the development all corporations were located in the same office.

Observe that a group of eighteen corporations was availed of by the same persons for the development of a single tract. Notice also that all of the corporations were financed and operated as a single entity. The only business activity engaged in by the alphabet corporations was that separate bookkeeping was done, each had a separate bank account, they separately employed a general contractor to build homes on their lots, and conveyed title to purchasers of their developed lots. The Commissioner asserted that all of the income of the alphabet corporations should be attributed to Aldon Homes, since the former existed only to avoid taxes. The taxpayer attempted to show that the alphabets were real, viable corporations organized for substantial business reasons, other than tax saving, in that they provided a means of avoiding a general claim against the entire project in case any part became insolvent, limited tort liability, eased the handling of mechanic's liens, and helped to attract capital by reducing corporate taxes. The court treated the foregoing as mere recitals and held that there was no *substantial* business purpose for the organization of the alphabet corporations, and that since they had not engaged in any business activity worthy of recognition for tax purposes their income was attributable to Aldon which directly or through its controlling stockholders took all the major steps necessary to create the income in question.<sup>23a</sup>

23a. Observe a serious non-tax problem arising wherein stock ownership varies and the income of a corporate group is attributed to a single corporation. Thus a disproportionate share, or the whole tax burden, is shouldered by particular stockholders. This result leaves the burdened stockholders with the difficult task of attempting a proportionate distribution of tax among the other individual stockholders.

Section 22 (a) <sup>24</sup> Internal Revenue Code of 1939 is the provision under which the "sham" cases have been decided. In this context the question is, whose income is it? It may be that of the corporation under attack if a substantial business purpose for its creation can be shown, or that it has been engaged in some activity worthy of recognition for tax purposes. *Aldon Homes* makes clear that the business purpose asserted must be real and present, not merely a recitation of purposes that exist only in the realm of possible use to individual stockholders and their corporations. If the principal stockholders treat the multi-corporate group as a single entity in financing and operation, and if the individuals disregard the separate corporate entities, the corporations so managed may well be found to lack substance and be disregarded as "shams."

#### *Application of Section 482*

This section is substantially unchanged from section 45 of the 1939 Code.<sup>25</sup> Section 482 permits the Commissioner to allocate gross income, deductions and credits among organizations controlled by the same interests if such allocation is necessary to prevent tax avoidance or to clearly reflect the income of the organizations. This provision would appear to be a powerful weapon against multi-corporate schemes; however, the courts have to some extent disemboweled section 482 and relegated it to the role of policing transactions between related entities. Still this section may have some vitality in the multiple incorporation area. In *Advance Machinery Exchange, Inc. v. Commissioner*<sup>26</sup> the Court of Appeals for the Second Circuit approved of the allocation of all income to one of a group of controlled corporations under the authority of section 45 (now 482) where it appeared that there was no real purpose for the existence of the other corporations. It appeared that an individual organized the taxpayer to deal in used machinery. Subsequently two other corporations were formed to engage in the same business. All of the stock in these corporations was owned by members of the same family who were also the officers and directors of all the corporations. All used the same office, the same personnel, and sold to the same customers. The evidence disclosed that one of these corporations though inactive in the year in question had 47 separate sales.

There was evidence that large numbers of purchase invoices had been altered to attribute them to one or another of these taxpayers, and that these changes were made without any set policy to indicate that there was any motive in doing so other than to divert income from the petitioner.

The force of this decision was watered down by *Commissioner v. Chelsea Products*<sup>27</sup> decided later in the same year. In this case the three stockholders of the taxpayer decided to separate the manufacturing and sales functions of the business. The asserted purpose for this separation was

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24. § 61 (a) Internal Revenue Code of 1954.

25. See footnote 1.

26. 196 F.2d 1006 (1952), cert. den. 394 U.S. 835.

27. 197 F.2d 620 (1952), affirming 16 T.C. 840.

to limit tort liability and increase sales by having them handled through a local concern in each locality. In fulfilling this plan the taxpayer split into four corporations by organizing three additional corporations, the petitioner being the manufacturing concern, and the other corporations being sales companies organized in each of three states. Under section 45 (now 482) the Commissioner allocated all the income of the sales corporations to the taxpayer.

The Tax Court held that under these facts section 45 could not be applied to allocate the income to one corporation within the controlled group, finding as ultimate facts that: Each sales corporation was a business enterprise separate and distinct from the taxpayer; that no part of the income to the sales corporations constituted income to the taxpayer; that the principal purpose for their organization was to carry on business, not tax avoidance. Five judges dissented. The Court of Appeals for the Third Circuit affirmed, holding that the Commissioner had exceeded his statutory authority in allocating the net income of the sales corporations to the taxpayer. The court pointed out that the plain language of section 482 does not permit the Commissioner to disregard valid corporate entities.

In *Advance Machinery* controlled corporations were disregarded just as the "alphabets" were in *Aldon Homes*. In *Chelsea* the income of the sales corporations could not be allocated to the manufacturing company since they were found to be valid corporate entities organized to carry on business. The division made in the *Chelsea Products* case was on a functional basis, the separation of manufacturing and marketing. The manufacturing corporation was located in a northern city, and the sales corporations were organized in three separate southern states. It further appeared that these sales corporations were active, and it did not appear that the controlling stockholders themselves disregarded the separate entities of the controlled corporations. These facts would seem to distinguish the case from *Aldon Homes* and *Advance Machinery v. Commissioner* wherein the only business conducted by the disregarded corporations was that separate accounts were maintained for them. Concurring in the result reached in *Aldon Homes*, Judge Opper was of the opinion that the same result could have obtained under section 45.<sup>28</sup> The majority opinion did not reach the question of the applicability of section 45 since the Commissioner's allocation was held proper under section 22 (a) and the majority stopped there.

The *Chelsea* case holds the Commissioner cannot disregard valid corporate entities, hence, unless corporations within a multi-corporate group are mere "shams" their gross income cannot be allocated to another controlled corporation. Thus the business purpose criteria is, under this construction, implicit in section 482.<sup>29</sup> If the business purpose test

28. Internal Revenue Code of 1939.

29. For cases in which "some" business purpose prevented section 45 from applying see *Polack's Fruit Works, Inc.*, 21 T.C. 953 (1954); *L. W. Tilden, Inc. v. Commissioner*, 192 F.2d 704; *Stevens Bros. and The Miller-Hutchinson Company, Inc.*, 24

can be met the section is relegated to the role of overseeing transactions between controlled corporations to insure "arms length" dealing.<sup>30</sup>

*The Application of Section 269 (a)*

This section is substantially unchanged from section 129(a) of the 1939 Code.<sup>31</sup> It provides generally that if any person acquires control of a corporation and the principal purpose of the acquisition was tax avoidance then credits and exemptions will be disallowed. Section 269(c) creates a presumption of tax avoidance in a case in which the acquired corporation assets were acquired for substantially less than their adjusted basis, plus the tax benefit, meaning the loss carry forward, to the acquiring corporation. Legislative history indicates that the provision came into the Code to prevent trading in loss corporations, and to give the Commissioner broader powers than he had under section 45 of the 1939 Code.<sup>32</sup>

Dictum appearing in the *Alprosa Watch* case<sup>33</sup> suggested that the provision was inapplicable in the event that the loss corporation survived, ". . . section 129(a) would seem to prohibit the use of a deduction or credit, or allowance only by the acquiring corporation and not their use by the corporation whose control was acquired." This construction was followed and permitted reorganization and acquisitions in which the loss corporation was the surviving or acquiring corporation and set off its losses against new profits following corporate combination or acquisition.<sup>34</sup> For some time the Tax Court adhered to this interpretation as evidenced

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T.C. 953 (1955); *Twin Oakes Company v. Commissioner*, 183 F.2d 385; *Idaho Livestock Auction, Inc. v. United States*, 187 F.Supp. 875 (1960) held that the Commissioner erred in combining the income of a partnership with that of a corporation where both were controlled by the same persons, and occupied the same offices. The partnership traded in livestock in the country and often sold through the auction owned by the corporation. The court found that these were separate entities, and that they represented a "natural" division in the livestock industry, and that the dealings between them were at "arms length." But see *Grinada Industries, Inc. v. Commissioner*, 202 F.2d 873, cert. den., 346 U.S. 819.

*Hypotheek Land Company v. Commissioner*, 200 F.2d 390 (9th Cir., 1952) held, Commissioner erroneously disallowed as a deduction interest paid by the taxpayer to related corporations, because section 45 nowhere permits disallowance of a deduction. However, section 45 may be invoked where a corporation at the close of a year makes allocations of income to its subsidiaries, *Birmingham Ice & Cold Storage Company v. Davis*, 112 F.2d 453.

For recent cases see *Aiken Drive In Theatre Corporation v. United States* (4th Cir., 1960) 281 F.2d 7; *Haberman Farms, Inc. v. United States* (D.C. Neb., 1960) 182 F.Supp. 829.

30. The Court of Appeals in the *Chelesea Products* case, supra footnote 27, defined the application of § 482 to individual transactions: "His (the Commissioners) object is to arrive at the true net income of each controlled taxpayer and the technique used is the application of the standard of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer. Whenever the lack of an arm's length relationship produces a different economic result from that which would ensue in the case of two uncontrolled taxpayers dealing at arm's length, the Commissioner is authorized to allocate gross income and deductions."

31. See footnote 2.

32. Senate Report 627, Seventy-eighth Congress, First Session (1943); Rudick, *Acquisitions to Avoid Income or Excess Profits Tax: Section 129 of the Internal Revenue Code*, 58 Harv. L. Rev. 196 (1944).

33. 11 T.C. 240.

34. *In A. & E. Container Corporation*, 14 T.C. 842 (1952) the Tax Court allowed the net loss carryover of an old business to be applied against the income from a new business where all of the stock of a corporation was sold, its name changed, and a profitable business previously operated by the purchasers was taken over. Also see, *Wage Inc.*, 19 T.C. 249 (1952).

by its decision in *British Motor Car Distributors Ltd. v. Commissioner*.<sup>35</sup> It appeared that Empire Home Equipment Company, Inc., had incurred losses amounting to \$374,406 in the home appliance business, and in 1951 reported its assets as "nil." British Motor Car Company was a partnership profitably engaged in the business of importing and distributing foreign automobiles. In 1951 the partnership offered to buy all the outstanding stock in Empire for \$21,254, Empire's tax loss being the single feature which gave its stock a market value. The partnership acquired all the outstanding stock in Empire, changed its name, and transferred the net assets of the partnership to the corporation for additional stock. During the following years the corporation operated profitably in the automobile business and carried forward the losses sustained in the appliance business against the automobile profits.

The Commissioner disallowed the deduction under section 129 (now 269); however, the Tax Court held that the section did not apply for the reason that here the acquired corporation—which survived—was seeking to make use of its own previous loss, and that the corporation secures the benefit of the deduction, not its new stockholders. The Ninth Circuit Court of Appeals reversed construing section 129 (a) as follows:<sup>36</sup>

We do not read the language of the section, "securing the benefit of a deduction," as applying only to the actual taking of such deduction by the taxpayer. We should be closing our eyes to the realities of the situation were we to refuse to recognize that the persons who have acquired the corporation did so to secure *for themselves* a very real tax benefit to be realized by them *through* the acquired corporation and which they could not otherwise have realized.

This is not, as the corporation protests, a disregard of its corporate entity. Since section 129 (a) is expressly concerned with the persons acquiring control of a corporation, we must recognize such persons as, *themselves*, having a significant existence or entity apart from the corporation they have acquired. To ignore such independent entity simply because such persons are also the stockholders of their acquisition is to ignore the clear demands of section 129 (a). It is not the fact that they are stockholders which subjected them to scrutiny. Rather, it is the fact that they are the persons specified by the section: those who have acquired control of the corporation. They may not escape the scrutiny which the section demands by attempting to merge their identity with that of their acquisition.<sup>37</sup>

This language has particular significance in that the Tax Court has recently followed in this construction in *Thomas E. Snyder Sons Co. v. Commissioner*<sup>38</sup> in which the court affirmed the Commissioner denial of an operating loss carryover to an "acquired" corporation, remarking, "In this we are now convinced we were in error, and we will no longer follow *British Motor*

35. 31 T.C. 437.

36. 278 F.2d 392 (1960). Other courts of appeals have taken the same view, see *Coastal Oil Storage Co. v. Commissioner* (4th Cir., 1957) 242 F.2d 392; *Mill Ridge Coal Co. v. Patterson* (5th Cir. 1959) 264 F.2d 713; *James Realty Company v. United States* (8th Cir., 1960) 280 F.2d 394.

37. 278 F.2d 392, 394.

38. 34 T.C. 39 (1960), also see *Urban Redevelopment Corporation*, 34 T.C. 87.

*Car Distributors Ltd.*" (their decision).<sup>39</sup> Conceivably the Tax Court would now hold that section 269 denies "acquired" corporations within a multi-corporate structure surtax exemptions and accumulated earnings credits if the principal purpose of their acquisition was tax avoidance. This is particularly significant for the reason section 269 is construed to apply in the event a person organizes a corporation and the principal purpose of the organization is tax avoidance.<sup>40</sup> Thus section 269 is available to deny corporations within a multi-corporate group exemptions and credits if they cannot satisfy the business purpose criteria.

Because application of the provision is conditioned upon failure to meet a subjective standard, section 269 is not particularly destructive. *Commodores Point Terminal Corporation v. Commissioner*<sup>41</sup> says that tax avoidance must exceed in importance any other purpose for the acquisition to constitute the principal purpose. The *Alcorn Wholesale Company* case clarifies the foregoing statement and sheds light on the application of 269 to corporate multiplication.<sup>42</sup> As we have seen, the provision may be avoided by showing some real business purpose. It appeared in this case that Bing Grocery Company operated five wholesale grocery houses in five separate counties. It reorganized and each of the houses became a corporation named after the county in which it did business. Each new corporation claimed a separate excess profits exemption, which the Commissioner denied relying on section 129. The court found that multiple incorporation was for the following purposes: to increase borrowing capacity; permit the handling of competitive lines of merchandise; limit liability and prejudice against absentee ownership, and held that the principal purpose of the reorganization was not tax avoidance, hence section 129 did not apply. The petitioners contended that section 129 did not apply to this type of factual situation; however, the court did not direct attention to that argument.<sup>43</sup>

Respecting its application to multi-incorporation, a 1951 Senate report on proposed amendments to the corporate surtax exemption provisions indicates that section 129 was aimed at the practice of creating multiple corporations so as to obtain extra exemptions:

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39. The Snyder case overrules *British Motor Car Distributors Ltd.*, 31 T.C. 437 (1958); *Coastal Oil Storage Co.*, 25 T.C. 1304 (1956). In these cases the Court has held that section 129 applied only where the person acquiring control of a corporation was the taxpayer seeking the benefit of a loss carryover and that the section did not apply where the taxpayer was the corporation whose control was acquired. In Snyder the court distinguished *Virginia Metal Products, Inc.*, 33 T.C. 788, where it found that the acquisition by Virginia was for a bona fide business purpose.
40. *Coastal Oil Storage Company v. Commissioner* (4th Cir., 1957) 242 F.2d 396; *James Realty Company v. United States* (8th Cir., 1960) 280 F.2d 394.
41. 11 T.C. 411 (1948).
42. 16 T.C. 75 (1951). In this context see *Berland's Inc. of South Bend*, 16 T.C. 182 (1951) which held § 129 (a) inapplicable in a case in which 22 retail stores, formerly under common ownership, were incorporated separately.
43. *American Pipe & Steel Corporation*, 25 T.C. 351, has some bearing on the multiple incorporation problem. The taxpayer, a successful corporation in the steel fabricating business, acquired a real estate corporation having high basis low value property. Subsequently, the low value real estate was sold and the loss offset against the taxpayers income in a consolidated return. Held, section 129 was applicable. At a cost of \$11,248.96 to the taxpayer, it acquired a loss of \$400,393.91.

It is not intended, however, that the exemption of the first \$25,000 of a corporation's surtax net income from the surtax shall be abused by the splitting up, directly or indirectly, of a business enterprise into two or more corporations or the forming of two or more corporations to carry on an integrated business enterprise. It is believed that sections 45 and 129 will prevent this form of tax avoidance.<sup>44</sup>

This Congressional opinion was affirmed in *James Realty Company v. United States*<sup>45</sup> in which tax avoidance was held to be the principal purpose of forming the petitioner, which was one corporation within a "sister" group, formed by an individual who created the corporations and transferred his property to them in exchange for stock. This section may also apply in the event an existing business is fragmented into multiple corporations in a parent-subsidiary relationship; however, respecting this practice section 1551 is more directly applicable. We may conclude that section 269 is an available weapon against multiple incorporation, but that its effectiveness is limited because of the subjective standard upon which its application is predicated.

*Section 1551: Section 15(c) of the 1939 Code*<sup>46</sup>

This section provides generally: if any corporation transfers part of its property (other than money) to another corporation, (1) created for that purpose, or (2) not engaged in business prior to the acquisition, and (3) if after the transfer the transferor and, or its stockholders are in control of the transferee, the transferee shall be disallowed the surtax exemption and the accumulated earnings credit, unless the transferee shows by a clear preponderance of the evidence that the securing of such exemption or credit was not a major purpose of the transfer,<sup>47</sup> or the Commissioner allows such exemption or credit pursuant to the authority provided in this section and section 269 (b).<sup>48</sup> It appears that the section would not apply if money alone is transferred to a newly formed corporation; secondly, transfers of property to existing active corporations are excluded because of the express language, "corporation . . . created for the purpose of acquiring," and transfers by individuals to corporations are excluded. Further, 1551 would not prohibit expansion of existing business by formation of new corporations in the ordinary case; however, consideration would have to be given the major purpose criterion. And, it would seem that the scope of the provision is limited to those situations in which a parent subsidiary relationship evolves and would have no application in formation of "sister" groups.<sup>49</sup>

44. S. Rep. No. 2375, 81st Cong., 2d Sess. 70.

45. *Supra*, footnote 40.

46. See footnote 3.

47. Mortenson, *The Multiple Attack on Multiple Corporations*, 35 *Taxes* 647, 654 reviews the legislative history of the provision.

48. The Commissioner may allocate or apportion gross income or deductions and credits among the controlled corporations or allow the latter to an extent which will not result in the avoidance of Federal taxes. Respecting control, this means ownership of the value of 80 per cent of all classes of stock or 80 per cent of the total combined voting power of all classes of stock. Ownership of stock is determined in accordance with the provisions of § 544.

49. Regarding the limitations on § 1551 see, Sharp, *Multiple Tax Benefits Through Multiple Incorporation: Some Thoughts On The Law As It Is, And As It Ought To Be*, XL *Boston U. Law Rev.* 375, 390.

*Coastal Oil Storage Company v. Commissioner*<sup>50</sup> is a late case which may chart the course for application of section 1551. Coastal Terminals Inc. was engaged in the business of storing and supplying petroleum products. It caused the taxpayer to be organized and transferred to it seven oil storage tanks in exchange for the capital stock in the newly formed corporations and a note. This debt was quickly retired by the new corporation. The Commissioner disallowed this company's \$25,000 surtax exemption relying on sections 15 (c) and 129 (now 1551 and 269, respectively) on the ground that the acquisition of the assets enabled the new corporation to secure a deduction, the \$25,000 surtax exemption, which it would not otherwise have enjoyed. Separation of government contracts from the other business of Coastal Terminals was given as the reason for the transfer; however, "tax consciousness" was admitted. The Tax Court held that petitioner had failed to establish by a clear preponderance of the evidence that securing the extra exemption was not a major purpose of the acquisition. The court noted specifically that petitioner gave no adequate explanation as to why separation of government contracts could not have been accomplished as well through proper accounting methods. Accordingly the Tax Court affirmed the disallowance under 15 (c). It is suggested that this conclusion sheds light on the major purpose standard in that the taxpayer may have to show that the asserted purpose for transferring property to it could not have been accomplished as well by another means.

In affirming the Tax Court in the *Coastal Oil Storage* case the Court of Appeals held that section 129 (a) applied as well, which is significant because of the factual situation.<sup>51</sup> Literally the section would only apply to transactions involving existing corporations; however, in this case the "acquired" corporation was organized by the "acquiring" corporation, hence section 129 (a) is held to encompass the creation of new corporations. In this context the court remarked: "That section was intended to reach just such schemes for tax evasion or avoidance by the splitting up of a business enterprise clearly appears from the H. Rep. 871, 78th Cong., 1st Sess., p. 49. . . ." This construction broadens the scope of section 269 (a) considerably; however, comparatively 269 would not seem as readily applicable as section 1551 in situations in which the latter may be applied for the reason that the taxpayer's burden of proof is more difficult under 1551. That provision may apply, "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." There may be several major purposes for transferring corporate assets to a new corporation and if any one is avoidance of a type contemplated, section 1551 will apply. Hence the showing of business purpose alone may not be sufficient.<sup>52</sup> In contrast, under the principal purpose criterion of

50. 25 T.C. 1304, affirmed in part (4th Cir., 1957) 242 F.2d 396.

51. 242 F.2d 396.

52. Truck Terminals, Inc. 33. 100 P-H T.C. 1960. A recent case in which the court said that to support a disallowance under 15 (c), the obtaining of the exemption needn't be the sole purpose or the principal purpose, so long as it was a major



269, that section will apply only if avoidance exceeds in importance any other purpose of the acquisition. Thus section 1551 will be more effective in preventing the fragmentation of existing integrated businesses into parent-subsidiary groups to obtain additional surtax exemptions and accumulated earnings credits. As mentioned above the section would not seem to apply to a situation in which an individual transfers property to new corporations thus forming a "sister" group of multiple corporations; however, the District Court in the *James Realty* case<sup>53</sup> held the section applicable in such a factual situation. If this construction is adopted section 1551 will truly be a powerful weapon against multiple incorporation.

*The Decision in James Realty Company v. United States*<sup>54</sup>

This case arose because of the multiple incorporation practices used by one Adolph Fine in the conduct of a real estate development business within the group of "sister" corporations were a construction corporation, a sales corporation and nine development companies all of which were controlled and managed by Fine and his wife, who owned stock in the corporations individually or in trust for their children. In 1944 the construction corporation was formed and later in 1949 Fine caused the sales company to be organized whose principal activity was to sell homes built by the construction company. James Realty Co. was one of nine development companies created by Adolph Fine between 1950 and 1954 whose main functions in the enterprise were to own land, contract for construction of homes with the construction company and to sell homes through the Fine sales corporation. James Realty was organized in 1952 with an authorized capital of \$25,000 consisting of ten shares of class A common stock with a par value of \$100 (voting) and two hundred and forty shares of class B common with a par value of \$100 (non-voting). Immediately after its creation Fine conveyed lots to James Realty which were his individual property, in exchange for 2 shares of Class A stock and 34 shares of class B stock, and on the same day transferred 18 of the class B shares to his wife in trust for their sons. James Realty then, through Mr. Fine executed contracts with the other Fine corporations for the construction and sale of home on its lots. The Commissioner disallowed James Realty's surtax exemption and excess profits credit under the authority of sections 15(c) and 129(a). Mr. Fine testified that in forming the taxpayer and the other corporations he had in mind the purposes of spreading and minimizing risks of loss from business reversal or tort liability, and that the multiple corporations implemented his estate plan. He admitted an awareness of the favorable tax consequences inherent in the scheme; however, he testified that tax saving was not his

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purpose, and that, while the term "major" is not defined in the statute, the "major" quality of a "purpose" is to be determined in the light of the effect which consideration of securing the exemption had upon the decision to create or activate the new corporation. Also see Sharp, *supra* footnote 49 at 393 for a discussion of the major purpose standard.

53. 176 F.Supp. 306, 312.

54. 176 F.Supp. 306, affirmed 280 F.2d 394.

principal purpose in organizing the multiple corporations. There was evidence that considerable attention was given to keeping the income in the various corporations below \$25,000, and the evidence showed success in this regard over a period of years. It further appeared that James Realty shared the same offices and employees with the other Fine corporations. The District Court found that the principal purpose in acquiring control of the taxpayer was tax avoidance and affirmed the Commissioner under sections 15 (c) and 129 (a). The Eighth Circuit Court affirmed this finding on appeal and specifically affirmed the lower courts conclusions respecting section 129; however, that court refrained from expressing an opinion on the application of section 15 (c).

#### *Summary*

This note is not intended to be exhaustive, however, it should serve to indicate that multiple incorporation planning is precarious. There are a multitude of cases now pending in which the Commissioner is attacking the use of multiple corporations.<sup>55</sup>

This type of organization should not be considered unless the creation or acquisition of each corporation is motivated by some substantial non-tax reason. If the non-tax motivation is significant those avenues of attack predicated on a failure to meet the business purpose test may be closed off. In this context each corporation should be a distinct entity engaging individually in income producing activity. It would be advisable for each corporation to be separately financed, have stockholders different from those in the other corporations, and have its own employees and facilities. Additionally, managing individuals should not themselves disregard the separate entity of any corporation within the group. By following these suggestions it would seem that a basis would be afforded for showing sufficient business purpose to preclude the application of sections 269, 482, and the "sham" theory. However, a showing of business purpose may not prevent section 1551, which embodies the major purpose test, from applying. Since 1551 does not literally apply to transfers by individuals, thus forming a "sister" group of corporations, this type of transfer should be preferred to those in which a parent-subsidiary relation is created.

The foregoing suggestions may close off every avenue of attack with exception of the "association theory." It is not at all safe to predict the extent to which this theory will be applied. If the theory is accepted it will severely limit multiple incorporation practices. Such a limitation may nevertheless be in the offing, since the practice of using several corporations within the framework of a single business to gain extra exemptions and credits is not in harmony with stated congressional purpose. For example, the credit for accumulations came into the Code to encourage the growth of small businesses<sup>56</sup> and the surtax exemption

55. Mr. Sharp, *supra* note 49, reports 1,000 to 1,500 multiple corporation cases docketed in the Tax Court in 1960.

56. H.R. Rep. No. 1622, 83d Cong., 2d Sess. 71-72 (1954).

was designed to inject an element of progression into corporate tax rates, which is an expression of the theory of taxing according to ability to pay.<sup>57</sup> However, through multiple incorporation these provisions designed to aid small business, are easily availed of by those who seek only to minimize Federal taxes. If this practice cannot be limited under the Code as it now stands we may find that Congress will provide stricter prohibitions.

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57. Sen. Rep. No. 781, 82d Cong., 1st Sess. 13-15 (1951); 83 Cong. Rec. 4926.