

January 1974

## **Creation or Reallocation of Income under Section 482: A Continuing Controversy**

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### **Recommended Citation**

Robert R. Veach, Comment, *Creation or Reallocation of Income under Section 482: A Continuing Controversy*, 28 Sw L.J. 766 (1974)  
<https://scholar.smu.edu/smulr/vol28/iss3/2>

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# COMMENT

## CREATION OR REALLOCATION OF INCOME UNDER SECTION 482: A CONTINUING CONTROVERSY

by Robert R. Veach, Jr.

Businesses and taxpayers alike are entitled to organize their affairs so as to expose themselves to the least potential tax liability. One method of tax-planning in a business enterprise might involve the use of functionally or vertically integrated corporate structures, which would enable a parent corporation controlling all aspects of a business from manufacturing to distribution to shift its income among its separate subsidiary corporations, thus availing itself of the multiple surtax exemptions.<sup>1</sup> Or a corporation may form a foreign subsidiary and shift income to that corporation to be taxed at a lower foreign corporate tax rate.<sup>2</sup> While the business and tax advantages of conducting an enterprise in a multi-corporate form are numerous,<sup>3</sup> as taxpayers find new methods of disguising their earnings Congress develops new perimeters to the definition of income under the tax laws. It is one of these concepts of income which has created the controversy under section 482 of the Internal Revenue Code.<sup>4</sup>

Under section 482, reallocations of income and deductions can be made by the Commissioner where, in his discretion, such are determined to be necessary in order to reflect clearly the income of related businesses or prevent the evasion of taxes through intercompany transactions within a multiple corporate structure. This section, along with others,<sup>5</sup> constitutes the Commissioner's arsenal against the multitude of tax advantages available through multiple corporate enterprises. In recent years, however, section 482 has stepped to the forefront because the discretion allowed the Commissioner under it is wide, and other more definitive sections have been avoided by careful tax planning.<sup>6</sup> Implementation of the section is contemplated where

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1. See B. BITTKER & J. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* ¶ 15.01 (3d ed. 1971) [hereinafter cited as BITTKER & EUSTICE].

2. The tax rates of foreign jurisdictions are generally much lower than under the United States tax laws. See Lee, *Section 482 and the Integrated Business Enterprise*, 57 VA. L. REV. 1376 (1971). Tax advantages are also available in the form of a special deduction granted to Western Hemisphere Trade Corporations under INT. REV. CODE OF 1954, §§ 921-22, and a special exclusion for the foreign-source income of a possessions corporation under INT. REV. CODE OF 1954, § 931.

3. See BITTKER & EUSTICE ¶¶ 15.01, 15.05; Eustice, *Tax Problems Arising From Transactions Between Affiliated or Controlled Corporations*, 23 TAX L. REV. 451 (1968).

4. INT. REV. CODE OF 1954, § 482.

5. A corporation may have its surtax exemption or its accumulated earnings credit disallowed under INT. REV. CODE OF 1954, § 1551 where the Commissioner determines that such corporation was created and its assets were transferred to it for purposes of tax avoidance. *Id.* § 269 is also applicable to corporations acquired for tax avoidance reasons, and credits or deductions realized by the acquisition can be disallowed under its provisions. Further potential attacks on the multiple corporate structure can be found in BITTKER & EUSTICE ¶¶ 15.01-.04.

6. See Asbill, *The Application of Section 482 to Domestic Taxpayers—Current*

a taxpayer has shifted some of its income to another taxpayer where it presumably will be taxed at a lower rate or not at all. An actual shifting must occur however; mere ability to do so by reason of a commonly controlled group is not sufficient to call the section into operation.<sup>7</sup>

An important issue which arises in such circumstances is whether income which is never realized can be shifted. When a parent corporation sells an appreciated asset to a controlled subsidiary at cost, and the subsidiary resells the asset to an uncontrolled third party at its appreciated value, the profit realized by the subsidiary has clearly been shifted out of the parent corporation. But if the subsidiary puts the appreciated asset to use within its own business, it is questionable whether any *income* has been shifted between the companies. The regulations under section 482 exhibit an affirmative position on the issue, despite considerable precedent to the contrary, discussed in Part I of this Comment. To obtain a clear reflection of the income of each individual entity within the controlled group and to arrive at their true taxable incomes, the regulations require application of an arm's length standard to intercompany transactions.<sup>8</sup> When a bargain sale or interest-free loan is made between related parties which would not have occurred had the parties dealt with each other as they would with uncontrolled parties, such transactions will be regarded as income-generating events. Thus, when acting under section 482's authority, regulation section 1.482-1(d)(4) in effect allows the Commissioner to create income for purposes of allocating it to a particular enterprise in order clearly to reflect its income.<sup>9</sup> This concept did not arise in the usual manner through enactment by Congress; rather, it developed in the regulations issued in 1968 under circumstances which may not have warranted such an encompassing construction of the section by the Treasury in light of past judicial interpretations. This Comment will examine the legislative background of the section; its early interpretation by the courts; the circumstances which prompted the promulgation of the 1968 regulations; and their effect on today's tax law and judicial decisions thereunder.

## I. SECTION 482: ITS INCEPTION IN THE LAW

Under a deceptively short section of the Internal Revenue Code, the Treasury has promulgated expansive regulations. While lengthy and detailed, the regulations are essential to the administration of the vague authority conferred in the one-sentence section, which states:

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*Status and Trends*, U.S.C. 19TH INST. ON TAXATION 673 (1967); Johnson, *Current Scope of Commissioner's Power To Reallocate Income Under Section 482*, 11 TAXATION FOR ACCOUNTANTS 204 (Oct. 1973); Lee, *supra* note 2.

7. The Tax Court in *Pauline W. Ach*, 42 T.C. 114 (1964), *aff'd*, 358 F.2d 342 (6th Cir.), *cert. denied*, 385 U.S. 899 (1966), said that in addition to common control and the ability to shift income between the related members of the group, "there must be . . . a distortion of income, and the Commissioner's power under the statute is limited to correct that distortion." 42 T.C. at 126. See note 66 *infra*.

8. Treas. Reg. § 1.482-1(b) (1968).

9. Language which creates this authority is found in the regulations, which provide that "if one member of a group lends money to a second member of the group in a taxable year, the district director may make an appropriate allocation to reflect an arm's length charge for interest during such taxable year even if the second member does not realize income during such year." Treas. Reg. § 1.482-1(d)(4) (1968).

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.<sup>10</sup>

To understand this section clearly, its legislative history, as well as the early regulations under its predecessors, must be carefully examined.

#### A. *The Antecedent of the Commissioner's Allocation Authority*

The power of the Commissioner to "distribute, apportion, or allocate gross income" among related enterprises has its genesis in the early Code provisions authorizing the consolidation of returns of related businesses.<sup>11</sup> With the advent of the excess profits tax, which raised the corporation tax rate from six percent in 1917 to a range of from twenty to sixty percent during World War I,<sup>12</sup> the Treasury found the previously followed formalistic approach, which treated each corporation as a separate entity regardless of its relation to any other corporation, to be unrealistic.<sup>13</sup> Intercompany transactions, designed merely to reduce the combined taxes of the related companies, soon lost their appeal after the regulations providing for the filing of consolidated returns were subsequently authorized by the enactment of section 240(d) by Congress in 1921.<sup>14</sup> Under this provision the Commissioner was empowered to consolidate the accounts of related businesses where necessary "for the purpose of making an accurate distribution or apportionment of gains, profits, income, deductions, or capital between or among such related trades or businesses."<sup>15</sup> The 1924 version of section 240(d) was substantially the same except for minor rewording and the addition of authority for invocation of its provisions by the taxpayer.<sup>16</sup> Section 240(d) was reenacted in 1926 as section 240(f) but its substantive provisions remained un-

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10. INT. REV. CODE OF 1954, § 482.

11. The commentators are not in full accord as to whether INT. REV. CODE OF 1954, § 482 had its inception in § 240(d) of the Revenue Act of 1921, ch. 136, § 240(d), 42 Stat. 260 (see, e.g., DeKosmian, *Section 482—Allocation of Income and Deductions Among Controlled Taxpayers*, 14 TULANE TAX INST. 420 (1965); Lewis, *Section 482: An Eminently Amendable Provision*, 25 ALA. L. REV. 23 (1972); Spaeth, *Section 482—Past and Future*, 47 TAXES 45 (1969)), or whether its inception was in § 45 of the Revenue Act of 1928, ch. 852, § 45, 45 Stat. 806 (see, e.g., Asbill, *supra* note 6; Jenks, *Treasury Regulations Under Section 482*, 23 TAX LAW. 279 (1970)).

12. See Spaeth, *supra* note 11.

13. The formalistic approach treated each corporation as a separate entity regardless of its relation to any other corporation.

14. Revenue Act of 1921, ch. 136, 42 Stat. 260. This was the beginning of the single enterprise approach of Congress and the examination of transactions which might cause a parent and subsidiary to be treated together for tax purposes. The regulations issued under the War Revenue Act of 1917, Treas. Reg. 41, arts. 77, 78 (1918), were retroactively approved of by Congress in the 1921 Act. See text accompanying notes 15-17 *infra*.

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

16. Revenue Act of 1924, ch. 234, 43 Stat. 288.

changed.<sup>17</sup>

Confusion then arose as to whether section 240(f) of the 1926 Act permitted controlled organizations to consolidate completely their income and deductions, though they were not actually affiliated within the meaning of the section.<sup>18</sup> To alleviate this confusion, Congress enacted section 45 in the 1928 Act.<sup>19</sup> This section not only deleted the phrase "consolidate the accounts," but also eliminated the taxpayer's right to invoke its provisions.<sup>20</sup> The House Ways and Means Committee in its report on the Revenue Act of 1928 made the purpose behind section 45 clearer in an oft-quoted passage:

Section 45 is based upon section 240(f) of the 1926 Act, broadened considerably in order to afford adequate protection to the Government made necessary by the elimination of the consolidated return provisions of the 1926 Act. The section of the new bill provides that the Commissioner may, in the case of two or more trades or businesses owned or controlled by the same interests, apportion, allocate, or distribute the income or deductions between or among them, as may be necessary in order to prevent evasion (by the shifting of profits, the making of fictitious sales, and other methods frequently adopted for the purpose of 'milking'), and in order clearly to reflect their true tax liability.<sup>21</sup>

Although minor amendments were made to section 45 in subsequent re-enactments, it was substantially incorporated as section 482 of the Internal Revenue Code of 1954.<sup>22</sup>

### B. *The Treasury Regulations*

The regulations initially issued interpreting section 45 contained only general terms framing the basic policy behind the section.<sup>23</sup> There were few

17. Revenue Act of 1926, ch. 27, 44 Stat. 46.

18. This interpretation was expressly disapproved of by the House Ways and Means Committee. See H.R. REP. NO. 2, 70th Cong., 1st Sess. (1927), reprinted in 1939-1 (pt. 2) CUM. BULL. 384.

19. Section 45 of the Revenue Act of 1928, ch. 852, § 45, 45 Stat. 806, provided: In any case of two or more trades or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Commissioner is authorized to distribute, apportion, or allocate gross income or deductions between or among such 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 such trades or business.

20. Revenue Act of 1928, ch. 148, 45 Stat. 806. The House Ways and Means Committee report on the 1928 Act stated: "It has been contended that section 240(f) of the 1926 Act permits what is in effect the filing of a consolidated return by two or more trades or businesses, even though they are not affiliated within the meaning of the section. Section 45 of the bill prevents this erroneous interpretation by eliminating the phrase 'consolidate the accounts.'" H.R. REP. NO. 2, 70th Cong., 1st Sess. (1927), reprinted in 1939-1 (pt. 2) CUM. BULL. 384, 395.

21. H.R. REP. NO. 2, 70th Cong., 1st Sess. (1927), reprinted in 1939-1 (pt. 2) CUM. BULL. 384, 395.

22. In the Revenue Act of 1934, ch. 277, 48 Stat. 695, the term "organizations" was added by Congress to "remove any doubt as to the application of this section to all kinds of business activity." H.R. REP. NO. 704, 73d Cong., 2d Sess. (1934), reprinted in 1939-1 (pt. 2) CUM. BULL. 554, 572. Also in the Revenue Act of 1943, ch. 63, 58 Stat. 48, Congress added the words "credits, or allowances" to the section.

23. Treas. Reg. 86, art. 45-1 (1934).

specific guidelines developed for the application of section 45 or its successor, section 482, in their early years of existence. The regulations did, however, indicate that the standard to be carried forward into section 482's application was that of an "uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer."<sup>24</sup>

In 1962 an effort was made to amend section 482 under the Revenue Act of 1962, by adding a second section which would have set out strict allocation procedures for intercompany sales between related domestic and foreign businesses.<sup>25</sup> The Conference Committee, however, concurred with the Senate Finance Committee and struck out the amendment, indicating that the same objective could be accomplished by amending the existing regulations.<sup>26</sup> The committee referred to the broad authority already existing in the section for the allocation of income and deductions, and directed the Treasury to "explore the possibility of developing and promulgating regulations under [that] authority which would provide additional guidelines and formulas for the allocation of income and deductions in cases involving foreign income."<sup>27</sup>

The Treasury then, in 1966, initiated the extensive revision which eventually produced the regulations under section 482 which are currently in force.<sup>28</sup> At the same time the Internal Revenue Service declared its policy under section 482 to be that "adjustments will be proposed only in those cases where there have been significant deviations from so-called arm's length dealings—that is, dealings that would take place between unrelated companies—or where there has been significant shifting of income."<sup>29</sup> The new regulations not only provided guidelines for allocations of domestic income between commonly controlled domestic and foreign corporations but go well beyond the scope of development envisioned by the Conference Committee when it directed the Treasury to promulgate guidelines for cases involving foreign income.<sup>30</sup> One major innovation in the regulations was a new section setting out several methods of allocation which could be used by the Commissioner depending on "the substance of the particular transactions or arrangements which result in the avoidance of taxes or the failure to clearly reflect income."<sup>31</sup> At the heart of the "creation of income" controversy is one of

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24. Treas. Reg. § 1.482-1(b) (1968).

25. H.R. 10650, 87th Cong., 2d Sess. (1962), H.R. REP. NO. 1447, 87th Cong., 2d Sess. 28-30 (1962), *reprinted in* 1962-3 CUM. BULL. 402.

26. H.R. REP. NO. 2508, 87th Cong., 2d Sess. 19 (1962), *reprinted in* 1962-3 CUM. BULL. 1129.

27. *Id.* at 1147.

28. The preliminary regulations, Proposed Treas. Reg. § 1.482-1(d) dealing with allocation methods, and Proposed Treas. Reg. § 1.482-2 for determining taxable income from loans and advances, performance of services, and the use of tangible property, came out in 1965. 30 Fed. Reg. 4256 (1965). In 1966 these were amplified and repropoed. 31 Fed. Reg. 10394 (1966).

29. Treasury Dept. Release, Aug. 2, 1966, *reprinted in* 7 CCH 1966 STAND. FED. TAX REP. ¶ 6685. The final regulations came out in 1968, 33 Fed. Reg. 5848 (1968), and one section in 1969, 34 Fed. Reg. 933 (1969).

30. Several commentators on § 482 have advanced this opinion. *See, e.g.*, Jenks, *supra* note 11, at 280; Spaeth, *supra* note 11, at 46; and Comment, *Recent "Extensions" of Section 482 of the Internal Revenue Code*, 3 MEMPHIS STATE L. REV. 106, 109 (1972).

31. Treas. Reg. § 1.482-1(d)(1) (1968). The basic methods are set out as five

these methods of allocation. The Commissioner is empowered by it to make allocations in the case of related parties, where they are not dealing at arm's length with each other, despite the fact that the income being allocated is not realized during the taxable year in question or at any future time.<sup>32</sup>

However, before looking at the added provisions of the current regulations in more depth, it is necessary to examine the judicial interpretation of the congressional intent behind section 45 and section 482 in the intervening years between their inception and the promulgation of these regulations by the Treasury.

### C. Initial Interpretation of Sections 45 and 482

The broad language utilized by Congress in section 45 required the courts to give definitive boundaries to the terms of the statute and the scope of the Commissioner's discretion thereunder. In *Asiatic Petroleum Co. v. Commissioner*<sup>33</sup> the court found that tax avoidance transactions in which taxable income was transferred from a domestic subsidiary of a foreign parent to a foreign subsidiary of the parent fell within the Commissioner's authority to allocate income in order to prevent "evasion of taxes." The question also arose as to whether the terms of the statute could authorize an allocation of the net income from transactions between related entities when the Commissioner's authority was to allocate gross income.<sup>34</sup> The cases initially refused to authorize the allocation of net income by the Commissioner.<sup>35</sup> However, in *Ballentine Motor Co.*<sup>36</sup> the Tax Court held that in a proper case net income could be allocated by the Commissioner as a shortcut approach to allocating gross income. The court rejected the *Chelsea Products, Inc.*<sup>37</sup> rationale which did not allow such allocations of net income, reasoning

general subsections of *id.* § 1.482-1(d). Under *id.* § 1.482-1(d)(2) the Commissioner must make correlative adjustments to the other members of the group from which any allocation is made, "[t]hus, if the district director makes an allocation of income, he shall not only increase the income of one member of the group, but shall decrease the income of the other member if such adjustment would have an effect on the United States income tax liability of the other member for any pending taxable year." Consideration must also be given to other offsetting transactions between the parties, *id.* § 1.482-1(d)(3). Adjustments can be made regardless of whether the income being allocated has been realized, *id.* § 1.482-1(d)(4). Section 482 may be applied in circumstances where there otherwise would be no recognized gain or loss, *id.* § 1.482-1(d)(5). And *id.* § 1.482-1(d)(6) provides, for a taxpayer electing the deferred income method of accounting, the option of treating allocations, with respect to transactions where the payment was not made due to restrictions of a foreign country, as deferrable income. For a perceptive analysis of each of these methods, see Jenks, *supra* note 11, at 281-92.

In addition, guidelines were established in Treas. Reg. § 1.482-2 (1968) for determining an organization's taxable income in five specific areas: loans or advances; performance of services; use of tangible property; transfer or use of intangible property; and sales of tangible property. See Hammer, *Section 482—Apportionment and Allocation Guidelines*, N.Y.U. 26TH INST. ON FED. TAX. 693 (1968).

32. Treas. Reg. § 1.482-1(d)(4) (1968); see note 9 *supra*, and note 56 *infra*.

33. 79 F.2d 234, 236 (2d Cir.), *cert. denied*, 296 U.S. 645 (1935). The court also noted at one point the Commissioner's authority to allocate gross income, and that "[i]f there is no gross income, there is nothing to allocate." *Id.* at 237.

34. See Hewitt, *Section 482—Reallocation of Income and Deductions Between Related Persons—Up to Date*, N.Y.U. 22D INST. ON FED. TAX. 381, 388 (1964).

35. The leading case was *Chelsea Prods., Inc.*, 16 T.C. 840 (1951), *aff'd*, 197 F.2d 620 (3d Cir. 1952). See also *T.V.D. Co.*, 27 T.C. 879 (1957).

36. 39 T.C. 348 (1962), *aff'd*, 321 F.2d 796 (4th Cir. 1963).

37. 16 T.C. 840 (1951).

that an allocation of net income is merely the allocation of gross income and deductions.<sup>38</sup>

The fundamental question in this article which has been at issue for more than thirty years is whether the Commissioner can "create income" for purposes of allocating it to a related business where it does not exist or has not been realized outside of the related group.<sup>39</sup> In several early cases, the courts were faced with this issue in a number of different situations, including the rent-free use of equipment; a gratuitous transfer of oil payments; interest-free loans; and the sale of supplies at cost.

*Rent-Free Use of Equipment.* In *Tennessee-Arkansas Gravel Co. v. Commissioner*<sup>40</sup> the taxpayer was a Tennessee corporation originally organized to recover sand and gravel from the Mississippi River; the recovered materials were then sold in part to the highway departments of Arkansas and Louisiana. In 1933, following a policy decision by the Mississippi Highway Department that Mississippi bidders would be favored on the state's new road building contracts, a new corporation owned and controlled by the same interests as the Tennessee corporation was formed in Mississippi. A lease of the taxpayer's river equipment to the Mississippi corporation for 1933 was subsequently arranged at a rental of \$1000 per month, but due to the operating losses of the affiliate, the rental was not paid and by oral agreement none was accrued for that year. Further, because of an expensive location change in the Mississippi corporation's operations, no charge was to be made for the rental of the equipment in 1934. The Commissioner, acting under section 45, assessed a deficiency against the taxpayer for the \$12,000 rental income it was entitled to have charged and received from the Mississippi corporation in 1934.<sup>41</sup>

In reversing the Board of Tax Appeals, the Sixth Circuit Court of Appeals held that the Commissioner's authority extended no further than to "distribute, apportion or allocate gross income" and in this case he had failed to

38. This is still an unsettled question as the cases have come out on both sides since the *Ballentine* decision. The allocation of net income was sustained in *Wisconsin Big Boy Corp. v. Commissioner*, 452 F.2d 137 (7th Cir. 1971), and *Hamburgers York Road, Inc.*, 41 T.C. 821 (1964). But see *W. Braun Co. v. Commissioner*, 396 F.2d 264 (2d Cir. 1968); *Interior Sec. Corp.*, 38 T.C. 330 (1962). See also *Hewitt*, *supra* note 38, at 388-91, and *Lewis*, *supra* note 14, at 52-56. The *Ballentine* decision also seems to indicate a section 482 allocation may be made even in the case of an arm's length transaction if there is a tax-avoidance motive underlying it. Clearly the section applies where there is an obvious distortion of income regardless of the presence of a tax avoidance motive. *Eli Lilly & Co. v. United States*, 372 F.2d 990 (Ct. Cl. 1967); *Dillard-Waltermire, Inc. v. Commissioner*, 255 F.2d 433 (5th Cir. 1958); *Central Cuba Sugar Co. v. Commissioner*, 198 F.2d 214 (2d Cir.), *cert. denied*, 344 U.S. 874 (1952).

39. The question was decided against the Commissioner in 1940 by the Sixth Circuit Court of Appeals in *Tennessee-Arkansas Gravel Co. v. Commissioner*, 112 F.2d 508 (6th Cir. 1940). The release of the Internal Revenue Service List of Prime Issues, July 16, 1973, under the new Freedom of Information Act, included section 482. See 9 CCH 1974 STAND. FED. TAX REP. (1973 Rulings, 71,415) ¶ 6632. A prime issue is one the Service will litigate rather than concede or compromise.

40. 112 F.2d 508 (6th Cir. 1940), *rev'g* a B.T.A. memorandum decision of June 30, 1938, CCH DEC. 10,073-D.

41. It is not clear whether the Mississippi affiliate had either gross or net income for 1934 but it did have gross receipts in excess of the \$12,000 rental charge. The Board of Tax Appeals upheld the Commissioner on the basis that the taxpayer failed to show its gross income was any less than its gross receipts. CCH DEC. 10,073-D.



allocate any of the Mississippi corporation's gross income to the taxpayer. The Sixth Circuit indicated two premises for its decision, one substantially clear on its face and followed by subsequent Tax Court decisions, and another abstracted from the choice of words in the opinion, but advocated now by the Commissioner and promulgated in the regulations. Clearly the court was holding that income not actually realized by a member of the related group from dealings with outside parties stemming from the original inter-company transaction could not be created and allocated to one member of the group. With reference to section 45, the court stated it "did not authorize the Commissioner to set up income where none existed. The principal purpose of the section was to clearly reflect income that did exist."<sup>42</sup> But the Commissioner would contend this decision was merely a result of the failure in this case to actually allocate gross income and grant a corresponding deduction. The Commissioner in the *Tennessee* case had merely concluded that rent should have been charged, and ignored the actual business situation and the effect of a deduction for such expense to the subsidiary.<sup>43</sup>

*Gratuitous Transfer of Oil Payments.* In *E.C. Laster v. Commissioner*<sup>44</sup> the taxpayer owned all of the stock of two corporations. One corporation, Retsal, owned oil leases and the other, Laster, owned certain oil payments burdening the leases of Retsal which it transferred to Retsal without any consideration. Acting under section 45 the Commissioner included the fair market value of the oil payments in the gross income of Laster as a forgiveness of indebtedness. The Board did not agree, however, and held that the gratuitous transfer to the Retsal Drilling Co. of the oil payments did not result in income either to it, or to the transferor, and thus there was no income upon which section 45 could operate.<sup>45</sup> Thus, a clear precedent developed supplementing section 45, which limited the Commissioner's authority to allocate income to cases in which such income actually existed.<sup>46</sup>

*Interest-Free Loans.* The position of the Tax Court was further established in *Smith-Bridgman & Co.*<sup>47</sup> In this case a parent corporation, Continental Dept. Stores, borrowed funds from one of its subsidiaries, Smith-Bridgman, in an amount sufficient to retire its outstanding debenture bonds. The funds

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42. 112 F.2d at 510. The Commissioner originally concurred in this decision. *But see* note 60 *infra*.

43. 112 F.2d at 510. This is thought by some to be an early indication of the necessity of making correlative adjustments. It is on this basis that the Commissioner later explained his concurrence to the case. *See* text accompanying note 60 *infra*. *See also* Cohen, *Section 482: Treasury's Efforts To Teach an Old Dog Some New Tricks*, 43 TAXES 835, 839 (1965); Jenks, *The "Creation of Income" Doctrine: A Comment on the Proposed Section 482 Regulations*, 43 TAXES 486 (1965); Mansfield, *The 482 Proposed Regs: The Problems with Which Practitioners Will Have To Contend*, 28 J. TAX. 66, 70 (1968).

44. 43 B.T.A. 159, 177 (1940), *acquiesced in*, 1941-1 CUM. BULL. 7.

45. *Id.*

46. In another early case, *Epsen Lithographers v. O'Malley*, 67 F. Supp. 181, 190 (D. Neb. 1946), the court, in discussing the application of § 45 to a corporation which was renting equipment to a similarly controlled partnership at allegedly inadequate rates, made reference to "the rule that Section 45 does not authorize the Commissioner to set up or create income where none exists."

47. 16 T.C. 287 (1951), *acquiesced in*, 1951-1 CUM. BULL. 3. *But see* text accompanying note 60 *infra* as to this acquiescence.

were provided by the taxpayer for its parent corporation's non-interest bearing demand notes. These loans were made at a time when the parent was receiving interest income itself on a loan by it to another subsidiary. Thus, Continental received interest-free loans from Smith-Bridgman enabling it to redeem its outstanding interest-bearing bonds, while at the same time another subsidiary was paying interest to it on a previous loan. The Commissioner added interest to Smith-Bridgman Co.'s income under section 45, in an amount representing a four percent interest rate on the moneys loaned by it to its parent corporation. The Commissioner argued that in order to prevent the evasion of taxes and to reflect clearly the income of the related businesses such allocation was necessary. Not only was Continental relieved of the interest expense on its former outstanding bonds, but also it could have loaned these funds to others at four percent interest. Nevertheless, the Tax Court held the Commissioner's action improper and, relying on several earlier cases, said:

The decisions involving section 45 make it clear that its principal purpose is to prevent the manipulation of or improper shifting of gross income and deductions between two or more organizations, trades or businesses. Its application is predicated on the existence of income. The courts have consistently refused to interpret section 45 as authorizing the creation of income out of a transaction where no income was realized by any of the commonly controlled businesses.<sup>48</sup>

The court indicated further that the record clearly established the Commissioner's failure to make any allocation of existing income.<sup>49</sup> The Commissioner had made no adjustment to the income or deductions of the parent when the interest income was allocated to its subsidiary. The Commissioner contended the adjustment was unnecessary since during the taxable year in question the parent corporation had no net income. The court noted that as net income was received by the parent in the following year, a net operating loss carry forward could have been utilized. Therefore, for the court to allow an allocation, an adjustment must be made to the party from whom the income is being shifted, either decreasing its taxable income or increasing its operating loss which could be utilized to offset the income of other tax years.<sup>50</sup>

*Sale of Supplies at Cost.* Under entirely different factual circumstances in *Texsun Supply Corp.*,<sup>51</sup> the Commissioner again allocated income under his authority in section 45, from a parent to its subsidiary. In this case the parent was a nonprofit cooperative supplying its members with materials related to their processing and packing of citrus fruit, and for this purpose acquired a box manufacturing subsidiary. The taxpayer would receive the packing crates manufactured by its new subsidiary, at their actual cost and

48. *Id.* at 293, citing *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); *E.C. Laster*, 43 B.T.A. 159, *modified on other issues*, 128 F.2d 4 (5th Cir. 1942).

49. The court said the Commissioner had actually "created or attributed income where none in fact existed." 16 T.C. at 294.

50. See notes 58-61 *infra*.

51. 17 T.C. 433 (1951), *acquiesced in*, 1952-1 CUM. BULL. 4.

then, as required by its bylaws, provide them to its members at the prevailing O.P.A. price at that time. At the end of each fiscal year the cooperative corporation would make a rebate to each member of the excess of the purchase price of its supplies over their cost to the cooperative, in an amount reduced by the member's proportionate share of the total overhead and operating costs of the parent corporation. Thus, under such an arrangement no income was actually derived from the sale of supplies to the members. The Tax Court noted that any gross income to be allocated to the manufacturing subsidiary would have to come from another organization: the cooperative parent. Finding the parent to have no gross income subject to allocation,<sup>52</sup> the court held the Commissioner's action to be unauthorized by section 45.<sup>53</sup>

It is in light of these precedents in the case law that the regulations promulgated by the Treasury, and now being consistently applied by the Commissioner, must be viewed with respect to their validity on the "creation of income" issue.<sup>54</sup>

## II. THE COMMISSIONER AND REGULATION 1.482-1(d)(4) VERSUS THE TAX COURT

While the early cases consistently held the Commissioner's authority under

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52. *Id.* at 445.

53. The court found that the parent cooperative was obligated by law under its bylaws to rebate the gross income, which the Commissioner was attempting to allocate to the manufacturing subsidiary, to its member organizations. For § 45 to authorize an allocation under such circumstance would "require legislation by Congress." *Id.*

54. After the proposed regulations came out, continuing to the present, commentators have felt the regulations were to some extent inconsistent with the statute, that the section itself needed amending, or at least with regard to certain of the regulations that their method of application should be reconsidered.

In his article commenting on the proposed regulations in 1965, Jenks examined the regulation permitting the creation of income, Proposed Treas. Reg. § 1.482-1(d)(4), 30 Fed. Reg. 4256 (1965) and questioned the assumption on which the examples of such allocations, which appeared in the regulations, were based. He also raised the question of whether the taxation of imputed income was constitutionally valid as a taxation of income under the sixteenth amendment, or as an excise tax. It is also questionable whether support for such a tax could be found under the legislative history of the section. See Jenks, *supra* note 43, 490-93. Mansfield examined the effect of the proposed regulations on practitioners in a 1968 article and said with regard to the creation of income authorized therein: "Indeed, the proposed Regulations might be taken to indicate that an allocation, if it can be called that, of gross income can be effected even where the recipient has no gross income from any source. If the proposed Regulations do purport to go this far, they would seem, in this respect at least, to have gone beyond the authority granted by the statute." See Mansfield, *supra* note 43, at 71.

In an examination of the proposed regulations in the 19th U.S.C. Institute on Taxation, Asbill found the case law on the creation of income issue prior to the promulgation of the regulations sufficiently convincing, to state: "It seems doubtful whether the approach taken by the Proposed Regulations will stand the test of litigation." Asbill, *supra* note 6, at 696. He felt the regulations in this regard were a "legislative extension of the scope of Section 482." *Id.* at 696-97.

Eustice's view of the creation of income under the proposed regulations was that the tax imposed after reallocation but before the income was actually realized through a transaction with a party outside of the related group resulted in the acceleration of income as well as its reallocation. "Perhaps the most equitable solution to this problem of timing would be to suspend application of the section 482 adjustment until such time as the related group finally generates the particular gross income or loss from its activities through dealing with outsiders." Eustice, *supra* note 3, at 490-91. A recent article called for a broad reform of the section having found "[v]irtually every major aspect of section 482 [to contain] an inherent inadequacy." See Lewis, *Section 482: An Eminently Amendable Provision*, 25 ALA. L. REV. 23, 72 (1972).

section 45 did not extend to the "creation of income,"<sup>55</sup> the Treasury clearly wrote such authority into regulation 1.482-1(d)(4), which allows allocations "notwithstanding the fact that the ultimate income anticipated from a series of transactions may not be realized or is realized during a later period."<sup>56</sup> Thus, if in an economic sense some benefit can be ascribed to any transaction between related businesses which would not have arisen if they were dealing at arm's length, the Commissioner may add an appropriate amount of income to the party benefiting therefrom whether or not there ever is any actual income in an accounting sense realized by the other business, from which the allocation could be made.<sup>57</sup>

### A. The 1968 Regulations

By way of compromise, the Treasury added the concept of making correlative adjustments. Where income is to be allocated under section 482 from one member of the group to another, the Commissioner must make a corresponding adjustment to the party from which the income is derived.<sup>58</sup> This addition to the regulations would seem the most logical of any in light of the terms of the section itself. Obviously a reallocation of income has a mutual effect, as the Tax Court has noted.<sup>59</sup> It was on this basis that the Commissioner explained his long-standing acquiescence to the *Smith-Bridgman* case and his concurrence to the *Tennessee-Arkansas* case.<sup>60</sup> Whether the court in *Smith-Bridgman* relied on the absence of such corresponding adjustments in making its decision is questionable, particularly with the emphasis placed by the court on the lack of authority in the section for the "creation

55. See Aland, *Section 482: 1971 Version*, 49 TAXES 815 (1971); Cooper, "Section 45," 4 TAX L. REV. 131 (1948); Holzman, "Arm's Length Transactions and 45," 25 TAXES 389 (1947); Sherman, "A Case History of Section 45," 29 TAXES 13 (1951).

56. Treas. Reg. § 1.482-1(d)(4) (1968). The section continues giving an example regarding a sale at less than an arm's length price between related parties and the authority to make an "appropriate allocation to reflect an arm's length price for the sale of the product in the first taxable year, notwithstanding that the second member of the group had not realized any gross income from the resale of the product in the first year." *Id.* A second example is given regarding the allocation of interest income. The section concludes with, "[t]he provisions of this subparagraph apply even if the gross income contemplated from a series of transactions is never, in fact, realized by the other members." *Id.*

57. Such action would seem to ignore the accounting realities of the situation by recognizing income for taxation prior to its realization. But taxation of such economic benefits under § 482 does have support outside the regulations. See, e.g., Hewitt, *supra* note 34, at 398-400; Eustice, *supra* note 3, at 469.

58. Treas. Reg. § 1.482-1(d)(2) (1968) states, "[w]henever the district director makes [primary] adjustments to the income of one member of a group of controlled taxpayers . . . he shall also make appropriate correlative adjustments to the income of any other member of the group involved in the allocation."

59. See *Smith-Bridgman & Co.*, 16 T.C. 287 (1951), *acquiesced in*, 1951-1 CUM. BULL. 3, and text accompanying note 49 *supra*.

60. In Rev. Rul 67-79, 1967-1 CUM. BULL. 117, also released as T.I.R. 838, Aug. 2, 1966, the Commissioner, in conjunction with the release of the proposed regulations under section 482, restated his position on his acquiescence and concurrence to two cases seemingly diametrically opposed to the new regulations. "The acquiescence in *Smith-Bridgman & Co.* was intended only to concur in the proposition that appropriate adjustments are to be made to the incomes of both members of the group affected to reflect the allocation." 1967-1 CUM. BULL. at 118. The concurrence to *Tennessee-Arkansas Gravel Co.* was explained similarly. The Tax Court would not be bound by this explanation of its decisions however. See text accompanying notes 70-75 *infra*.

of income.”<sup>61</sup>

The purpose of section 482 as indicated in the regulations is:

[T]o place a controlled taxpayer on a tax parity with an uncontrolled taxpayer, by determining, according to the standard of an uncontrolled taxpayer, the true taxable income from the property and business of a controlled taxpayer. . . . The standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer.<sup>62</sup>

At this point it might be questioned whether Congress intended that a corporation be forced to deal with a related corporation on the same basis it would deal with its competitors.<sup>63</sup> The long line of cases denying the Commissioner's authority to create income between related corporations and the Commissioner's acquiescence thereto should not be overlooked in view of the inaction of Congress on this issue.<sup>64</sup>

In addition, the regulations indicate that transactions between related tax-

61. The Tax Court in *Huber Homes*, 55 T.C. 598 (1971), see text accompanying notes 70-75 *infra*, examined the basis of the Commissioner's explanation in Rev. Rul. 67-79. As to the *Tennessee-Arkansas Gravel Co.* case, the court said:

The Commissioner seeks to distinguish the *Tennessee-Arkansas* case on the ground that the decision was based on the Commissioner's failure to make a correlative adjustment to the income or deductions of the related entity. We think, however, that the Sixth Circuit's decision rests on a broader ground: that the allocation under section 482 must be of income actually realized by a member of the controlled group.

55 T.C. at 608. The Commissioner in *Huber Homes* also contended as in Rev. Rul. 67-79 that the court in *Smith-Bridgman* noted the absence of a correlative adjustment to the related party in that case, and the decision was premised on that fact. But the Tax Court in *Huber* disagreed and said, “[w]e view this factor as no more than a possible supporting ground for the decision and not the controlling reason.” *Id.* at 610. See also *Jenks*, *supra* note 43, at 489.

62. Treas. Reg. § 1.482-1(b)(1) (1968). See also *Central Cuba Sugar Co. v. Commissioner*, 198 F.2d 214 (2d Cir. 1952). The idea of finding the “true taxable income” of a taxpayer is hardly meaningful in an accounting sense as there is no one “true income” figure. See *Nicholson, Intercompany Accounting Among Related Companies: Maintaining Proper Records to Meet Section 482*, N.Y.U. 26TH INST. ON FED. TAX. 665 (1968).

63. The Commissioner made this absolute arm's length standard clear in an article on how the proposed regulations would be administered. Therein he stated, “[a]ll we ask of taxpayers is that they set prices with their affiliates as if they were dealing with a stranger.” Cohen, *How the I.R.S. Intends to Administer the New Regulations Under Section 482*, 28 J. TAX. 73, 74 (1968). In the Eighth Annual Tax Conference of the University of Pennsylvania, Spaeth examined the “arm's length” standard under section 482 and the nature of its effect on the business community. Following an examination of the section and its early regulations leading up to the 1968 regulations, he said “the idea of requiring related corporations to deal with each other on the same basis as unrelated companies (which almost necessarily means competing companies) seems to go far beyond the intentions of Congress and also seems to be completely removed from the facts of life.” Spaeth, *supra* note 11, at 49. An application of the regulations in a factual situation such as that in *Texsun*, see text accompanying notes 51-53 *supra*, would require allocating a manufacturing profit from the parent cooperative corporation to the newly acquired manufacturing subsidiary. “This result, of course, does not clearly reflect income; it distorts it. It also defies common sense.” *Jenks*, *supra* note 43, at 490.

64. In *Emphrey v. United States*, 272 F. Supp. 851 (D. Colo. 1967), the court concluded the Treasury Regulations dealing with the Kintner plan were inconsistent with the statute and the judicial construction thereof, and as they therefore constituted the exercise of a non-delegable legislative function, they were invalid and unenforceable, stating: “There appears to be no case law to the contrary and Congress has not seen fit to take any legislative action to repudiate this uniform and long-standing judicial construction of the statute.” *Id.* at 853.

payers will be subject to "special scrutiny"<sup>65</sup> and the application of the section may be extended even to innocent transactions or those undertaken with a valid business purpose.<sup>66</sup> The regulations promulgated by the Treasury must of course withstand the tests of litigation and initially it seemed regulation 1.482-1(d)(4) might fail.<sup>67</sup>

### B. Post-Regulation Decisions by the Tax Court

The Commissioner tested his new authority in *P.P.G. Industries, Inc.*,<sup>68</sup> wherein he proposed a correlative adjustment in order to reallocate interest income on an interest free loan from a corporation to its wholly-owned foreign subsidiary. One of the Commissioner's problems, however, was the fact that the loan was made in 1940 and the subsidiary did not realize any income until 1960. The Tax Court relied on *Smith-Bridgman* and reinforced the position it had taken before the regulations came out, indicating that there had to be income clearly arising from and related to the transaction for there to be any allocation.<sup>69</sup>

65. Treas. Reg. § 1.482-1(c) (1968). See also *Local Fin. Corp. v. Commissioner*, 407 F.2d 629 (7th Cir.), cert. denied, 396 U.S. 956 (1969).

66. The Commissioner in clarifying the spirit under which § 482 would be applied stated, "[i]t is not a Section which is limited in application to instances of conscious tax avoidance or evasion." See Cohen, *supra* note 63, at 74. The courts have interpreted the section to encompass transactions with tax avoidance motives as well as those for the evasion of taxes. See *Asiatic Petroleum Co. v. Commissioner*, 79 F.2d 234 (2d Cir. 1935). But the extension to transactions entered for a valid business purpose might be questioned for its support in the section itself or legislative support in its history. Many of the cases under this section refer to the requirement of an actual "distortion of income." Pauline W. Ach, 42 T.C. 114, 126 (1964), *aff'd*, 358 F.2d 342 (6th Cir.), cert. denied, 385 U.S. 899 (1966), or to an "actual shifting of income." V.H. Monette & Co., 45 T.C. 15, 37 (1965), *aff'd per curiam*, 374 F.2d 116 (4th Cir. 1967). See also *Bush Hog Mfg. Co.*, 42 T.C. 713 (1964). And in *Simon J. Murphy Co. v. Commissioner*, 231 F.2d 639, 644 (6th Cir. 1956), the court, citing the *Tennessee-Arkansas* case on the creation of income question said:

The foregoing cases point out that the basic purpose of the statute to recognize the normal tax effect of bona fide business transactions between separate organizations, even though controlled by the same interests, but to enable the Commissioner to change the bookkeeping effect of a transaction between controlled taxpayers when, by reason of the relationship, they arbitrarily or improperly shift income or deductions from one organization to the other. . . . The Commissioner is not authorized to transfer income or deductions from one controlled organization to another, unless, by reason of the relationship the original distribution between the two entities, as reflected by the books, is in substance a fictitious one, improperly reflecting form instead of substance.

In this regard the precept noted by the court of appeals in *W. Braun Co. v. Commissioner*, 396 F.2d 264, 266-67 (2d Cir. 1968), would seem relevant: "[A] taxpayer is not required to adopt or continue with that form of organization which results in the maximum tax upon business income and that when a taxpayer chooses to conduct his business in a certain form, the tax collector may not deprive him of the incidental tax benefits flowing therefrom, unless it first be found to be but a fiction or a sham."

67. The Treasury Regulations must be shown to be unreasonable and plainly inconsistent with the revenue statutes to be declared invalid. See *Sanford v. Commissioner*, 412 F.2d 201, 202 (2d Cir.), cert. denied, 396 U.S. 841 (1969). The Tax Court in *Huber Homes* came close to ruling on their validity but found instead that the factual situation presented was outside the scope of section 482. See text accompanying notes 70-75 *infra*.

68. 55 T.C. 928 (1970).

69. This would seem to be the origin of the tracing concept now ascribed to by the tax court. The court in *P.P.G.* stated:

We need not decide whether respondent may, under the authority of section 482, make an allocation of income which is indistinguishable from

In *Huber Homes, Inc.*<sup>70</sup> the Tax Court soundly rejected the allocation of income where none was yet realized, but the court did not rule on the validity of the regulations as it was thought that the factual situation there was outside that contemplated by section 482.<sup>71</sup> The case involved a sale of houses built by the parent corporation, which was engaged in the construction and sale of homes, to a subsidiary engaged in the real estate rental business. The homes were sold to the subsidiary at their actual cost and were then rented out to the general public. The Commissioner allocated as income to the parent the difference between the houses' fair market value and their actual cost, and increased the subsidiary's basis in the homes. In this manner the sale would be on arm's length terms and the income of both corporations would be clearly reflected. The Tax Court, viewing the transaction in its true terms, noted that the houses were not resold by the subsidiary, thus shifting profits normally received by the parent to the subsidiary.<sup>72</sup> Rather the houses were the source of rental income to the subsidiary and the Commissioner did not assert that any of such rental income was attributable to the parent.<sup>73</sup>

This decision, believed by some commentators at the time to be the crippling blow to the Commissioner's position with respect to the creation of income,<sup>74</sup> was not appealed by the Commissioner, probably because it would have been reviewed by the Sixth Circuit and the *Tennessee-Arkansas* decision would likely have been held to be controlling, thus adding further weight to the list of authorities contrary to the Commissioner's position.<sup>75</sup>

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the imputation of an interest charge. Our concern here is whether section 482 can be applied at all under the circumstances of this case. . . . We cannot possibly conceive even the most tenuous connection between this 1940 balance [of loans and advances to the subsidiary and the subsidiary's] income some 20 years later . . . .

55 T.C. at 1009.

70. 55 T.C. 598 (1971).

71. "In deciding that section 482 is inapplicable here we do not reach the question whether the regulations . . . relied upon by the Commissioner are valid. They plainly contemplate a situation where one member of a controlled group sells to another at less than fair market value and where it is expected that the controlled vendee would in turn resell the product to a third party." 55 T.C. at 610. The court determined the *Huber* case to be beyond this as there was no intention on the subsidiary's part to resell the houses after the transfer.

72. The Tax Court conceded that if goods or services were transferred to a related party and by their "use or consumption" income was realized by the controlled group, a different question would be presented. In the *Huber* case, however, the homes after their transfer did "not appear to be productive of any net income whatever." *Id.*

73. The Commissioner does not here contend that any of Huber Investment's gross rental income was not earned by it or that any portion of its income should be allocated to Huber Homes. Rather, the Commissioner is purporting to exercise his authority under section 482 to create income, i.e., to charge petitioners with the income it would have realized had its sale to Huber Investment been at arm's length. We hold that this determination is not authorized by section 482.

*Id.* at 607.

74. In analyzing the *Huber Homes* decision, Lewis indicated that the proper course for the Service, when its Code no longer accomplishes the desired purpose, is to seek a new provision from Congress rather than rewriting the present provision to meet its own interpretation. He then said, "[i]t may well be that the *Huber Homes* case will have the beneficial effect of sending the Service back to Congress to present its case for an absolute arm's-length standard." Lewis, *Tax Court in Huber Homes Holds that the IRS May Not Use 482 To Create Income*, 34 J. Tax. 208 (1971).

75. See text accompanying notes 43-46 *supra*.

## III. OVERRIDING OLD PRECEDENTS

A. *The Second Circuit's View*

In *B. Forman Co.*<sup>76</sup> two competing department stores operating in downtown Rochester, New York, were concerned about the growth of outlying stores. In order to stem the tide of shoppers to the suburban shopping centers, the two corporations decided to build and develop jointly a midtown shopping center which would adjoin both of their stores and have a mall in between for smaller shops. The development of the mall was through a new corporation owned by the two department store corporations, Forman and McCurdy. These two corporations each made an interest-free loan of \$1,000,000 to the new corporation. The Commissioner allocated \$50,000 of interest income to Forman and McCurdy for these interest-free loans under the authority of section 482. The Tax Court held the use of section 482 by the Commissioner in this instance was improper, since the new corporation and the taxpayers were not controlled, directly or indirectly, by the same interests. In so holding, the Tax Court never reached the issue of whether the Commissioner could create income by allocating interest income.

The United States Court of Appeals for the Second Circuit,<sup>77</sup> noting the flexibility inherent in the regulation's definition of control,<sup>78</sup> found Forman and McCurdy to be in reality jointly controlling their new corporation, and that section 482's control requirement was met. Having established the technical applicability of section 482 to the taxpayers, the court then had to deal with the creation of income question not faced by the Tax Court. The court referred to the strict scrutiny given to transactions between related taxpayers and the applicability of the section to innocent as well as sham transactions and held the Commissioner's reallocation to be necessary to properly reflect the income of the three corporations.<sup>79</sup> The taxpayers asserted that *Tennessee-Arkansas Gravel Co.*, *Smith-Bridgman & Co.*, and *P.P.G. Industries* all held that no imputation of interest income could be made where no interest was created. However, the court rejected this premise and said in response:

To the extent that the above cases cited by taxpayers may be read as holding that no interest can be allocated under § 482 under the facts of this case, they are not in accord with either economic reality, or with the declared purpose of section 482. They seriously impair the usefulness of § 482. Those cases may be correct from a pure accounting standpoint. Nevertheless, interest income may be added to taxpayers' incomes, as long as a correlative adjustment is made . . . .<sup>80</sup>

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76. 54 T.C. 912 (1970).

77. 453 F.2d 1144 (2d Cir. 1972), *aff'g in part and rev'g in part*, 54 T.C. 912 (1970), *cert. denied*, 407 U.S. 934 (1972).

78. Treas. Reg. § 1.482-1(a)(3) (1968).

79. 453 F.2d at 1155. The court stressed the absolute arm's length requirement of Treas. Reg. § 1.482-1(c) (1968) and stated that a finding that the waiver of interest by Forman and McCurdy on their loans was not in accordance with normal dealings at arm's length between uncontrolled parties was necessary to sustain the Commissioner's allocation.

80. 453 F.2d at 1156.



Thus, the court upheld the Commissioner's allocation<sup>81</sup> upon the rationale that as a matter of economic reality an arm's length loan of this size would certainly involve an interest charge. The court stated that the regulations which allow such an allocation are "entirely consistent with the scope and purpose of section 482."<sup>82</sup>

### B. Rejection of *Forman*

In *Kerry Investment Co.*<sup>83</sup> and *The Kahler Corp.*<sup>84</sup> the Tax Court rejected the Second Circuit's reasoning in the *Forman* case.<sup>85</sup> The Commissioner took two different approaches in the two cases. In *Kerry* the Commissioner followed the tracing theory, previously advanced by the tax court in *P.P.G. Industries* and *Huber Homes*,<sup>86</sup> to establish the use of the interest-free funds loaned to a subsidiary by the Kerry Company. Insofar as the Commissioner argued that an allocation of income should be made where the borrower realizes income from the use of interest-free funds, the Tax Court agreed. Thus, the issue in the case became one of tracing the proceeds of the loan. In certain transactions the use and result was clear, as when the funds loaned to the subsidiary by Kerry bearing no interest were then loaned to a third party at six percent interest.<sup>87</sup> However, in other instances the use to which the funds were put was not clear, and following the normal rule as to the taxpayer's burden of proof,<sup>88</sup> the court sustained the Commissioner's allocation again, because the taxpayer had failed to show a non-income producing use of the funds.<sup>89</sup>

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81. The court also completely rejected the taxpayers' alternative contention that the loans were in fact capital contributions.

82. 453 F.2d at 1156.

83. 58 T.C. 479 (1972).

84. 58 T.C. 496 (1972).

85. See Barnett, *Tax Law Notes*, 46 FLA. B.J. 607 (1972); Crawford, *Tax Court in Two New 482 Decisions Refuses To "Create" Income, but Okays Reallocations*, 37 J. TAX. 277 (1972).

86. See notes 68-75 *supra*.

87. 58 T.C. at 486. This would seem to be the primary type of shifting of income contemplated by § 482. It is analogous to a parent selling property to a subsidiary at a bargain price and the subsidiary then immediately reselling it to an unrelated third party at a profit. The profit clearly belongs to the parent in such case and the Commissioner has the power to reallocate the income realized by the subsidiary. *Asiatic Petroleum Co. v. Commissioner*, 79 F.2d 234 (2d Cir.), *aff'd* 31 B.T.A. 1152, *cert. denied*, 296 U.S. 645 (1935); *Eli Lilly & Co. v. United States*, 372 F.2d 990 (Ct. Cl. 1967). See also J. MERTENS, *LAW OF FEDERAL TAXATION* § 38.61, at 159 (1967).

88. *Helvering v. Taylor*, 293 U.S. 507 (1935), established the precedent that the taxpayer has the burden of proving the Commissioner's determination is erroneous. *Id.* at 515. With respect to § 482, the court in *R.T. French Co.*, 60 T.C. 836 (1973), recently had to examine the taxpayer's burden of proof under § 482 and it reaffirmed the standard established by *Pauline W. Ach*, 42 T.C. 114, 126 (1964), that "[the] Commissioner has considerable discretion in applying this section and his determinations must be sustained unless he has abused his discretion. We may reverse his determinations only where the taxpayer proves them to be unreasonable, arbitrary, or capricious." *G.U.R. v. Commissioner*, 117 F.2d 187 (7th Cir. 1941); *Grenada Indus., Inc.*, 17 T.C. 231 (1951); *National Sec. Corp.*, 46 B.T.A. 562 (1942). See also Burke, *Multi-Corporate Operations: Joint Use of Assets, Management and Employees*, N.Y.U. 30TH INST. ON FED. TAX. 1283, 1292 (1972).

89. It was thought that placing the burden on the taxpayer to show the funds could be traced to nonproductive assets was consistent with the general burden of proof requirements and would also encourage the maintenance of accurate records. But see text accompanying notes 101-02 *infra*.

As to the funds which were clearly invested in non-income producing assets, the court rejected the reallocation,<sup>90</sup> noting that the court of appeals in *Forman* seemed to indicate an allocation could be made regardless of the borrower's income during the tax year and its holding in *Huber Homes*.<sup>91</sup> The court carefully considered its prior decisions and made clear the fact that in *Smith-Bridgman* the borrowing corporation had no gross income as a result of the loan and the Commissioner had made no attempt to reallocate its income; rather, the income of the lender was merely increased without a corresponding adjustment to the borrower.<sup>92</sup> *Huber Homes* was distinguished to the extent that there the Commissioner failed to show the sales transaction generated the income he had allocated.<sup>93</sup> And in *P.P.G. Industries* there was also a failure on the Commissioner's part to establish any link between the interest-free loan and the income earned twenty years later.<sup>94</sup>

In a concurring opinion to *Kerry Investment*, Judge Irwin, who wrote the majority opinion to the *Kahler* case, made clear the distinction between the two cases and the holding in each.<sup>95</sup> He stated that *Kerry* was the first instance where section 482 was applied to an "improper deflection of income caused by the *use or consumption* of interest-free advances."<sup>96</sup> In *Kahler*, however, the Commissioner merely attempted to allocate nonexistent income per se.

The *Kahler Corp.* case involved interest-free loans by the parent taxpayer to four of its subsidiaries which in turn utilized the funds for working capital. The Commissioner allocated interest income on the outstanding balances. Citing its previous holdings for the authority that the realization of income from the particular inter-company transaction was an absolute prerequisite to any allocation under section 482,<sup>97</sup> the court reviewed the Second Circuit's decision in the *Forman* case and concluded:

With due respect, we are of the opinion that the Second Circuit has incorrectly delineated *both* the purpose of section 482 and the circumstances required before the statute can operate. Hence, we opt to follow the interpretation of the intent and usage of section 482 expressed in previous Tax Court opinions on this issue.<sup>98</sup>

The court then set forth its opinion on the section's purpose and the proper circumstances calling for its operation.<sup>99</sup> The court found the interest income

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90. The taxpayer had met his burden of proof as to these funds. 58 T.C. at 490.

91. *Id.*

92. *Id.* at 491; see notes 70-73 *supra*.

93. The court in *Kerry* referred to the example in *Huber* dealing with income realized from the "use or consumption" of the goods transferred and indicated that the *Kerry* case was the type of situation previously envisioned. 58 T.C. at 491; see notes 71-72 *supra*.

94. 58 T.C. at 491; see notes 70-73 *supra* and accompanying text.

95. 58 T.C. at 493-94; see notes 69-70 *supra* and accompanying text.

96. 58 T.C. at 494.

97. *Id.* at 506.

98. *Id.* at 508.

99. The court stated: "The test is not simply whether or not correlative adjustments have been made to properly show the true taxable income of all the related parties concerned. Rather, the question which must be asked is whether or not an item exists, re-

could not be allocated to the Kahler Corporation as it was created solely by application of the regulations and did not result from the transactions themselves.<sup>100</sup> This use of the regulations was found to be clearly beyond the intent of Congress and an abuse of the Commissioner's discretion.<sup>101</sup>

Judge Featherston dissented from the majority's holding in *Kerry*<sup>102</sup> and again in *Kahler* for the reasons set forth in his *Kerry* dissent.<sup>103</sup> He agreed with the Second Circuit's decision in the *Forman* case and felt it was not sufficiently distinguished by the majority. The regulations were, to him at least, consistent with section 482 and inconsistent with any kind of tracing theory. The tracing concept would, in Judge Featherston's opinion, place "a premium on accounting sophistication and lays a 'trap' for the unwary."<sup>104</sup> He argued that by simply investing interest-free funds, borrowed from its parent, in nonproductive assets, a subsidiary could use its own capital for productive purposes and yet avoid the section's application.<sup>105</sup> Thus, while the Tax Court continued to reject the Commissioner's arguments, it became clear the Commissioner was determined to resolve the issue in his favor.

### C. The Circuits' Response

The *Kahler* case was appealed by the Commissioner on the basis of the decision by the Second Circuit in *Forman* and that his allocation was necessary and proper under section 482 and its regulations clearly to reflect the income of the Kahler Corporation.<sup>106</sup> The Court of Appeals for the Eighth Circuit made particular note of the fact that the lack of an interest charge in this case to the subsidiaries was obviously to Kahler's advantage from a tax standpoint.<sup>107</sup>

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alized out of the particular transaction between the related entities, which has been improperly deflected to the wrong entity." *Id.* at 510.

100. The court noted that the subsidiaries unquestionably put the funds to productive use but the Commissioner had failed to make any allocation of the subsidiaries' income in the years in question. The Commissioner asserted that the income allocated would have been realized had the parties been dealing at arm's length. But to this assertion the court said:

The legislative history of section 482 does not reveal in any respect a congressional intent to require an arm's-length charge on an interest-free loan between related parties where an improper deflection of income is not factually substantiated. Absent a declared congressional purpose in section 482 to this end, the imposition of such a charge without the deflection of realized income within the group would be tantamount to an unreasonable check on the mere existence of common control or ownership.

*Id.* at 511.

101. The court indicated it was the responsibility of Congress to impute interest charges on loans between related entities rather than the Treasury's through its regulations. Citing §§ 483 and 1232, the court referred to the Internal Revenue Code's provisions for "imputing" income in specific situations where Congress felt it necessary. 58 T.C. at 511. Section 483 requires the imputation of interest in deferred installment sales situations, where none is otherwise provided for. Section 1232 requires a ratable portion of an original issue discount on a bond to be included in the income of the holder each year.

102. 58 T.C. at 494.

103. *Id.* at 512.

104. *Id.* at 495.

105. He also stated that perhaps the best solution would be to declare the regulations invalid in the expectation that Congress would then focus on the problem. 58 T.C. at 496. See notes 57 and 66 *supra*.

106. 486 F.2d 1 (8th Cir. 1973), *rev'g* 58 T.C. 496 (1972).

107. Kahler was borrowing funds at rates in excess of 5% and loaning a portion of

The court found the Commissioner's allocation to be consistent with the regulations and therefore the question presented was "whether or not the regulation is unreasonable or clearly inconsistent with the statute."<sup>108</sup> The court quoted from the Second Circuit's opinion in *Forman* which held the regulation was reasonable and "entirely consistent with the scope and purpose of §482."<sup>109</sup> The court also adopted the Second Circuit's reasoning as to the Commissioner's authority to create income where none in fact existed. The arm's length standard was affirmed and the Tax Court's tracing concept was rejected as totally lacking any legislative support and in fact, being of no importance at all.<sup>110</sup> Noting that through interest-free loans from Kahler to its subsidiaries while it in turn was taking interest deductions on its own indebtedness to its lenders, a substantial tax savings was effected, the court said: "It is difficult to imagine a situation in which Section 482 would be more applicable on either an equitable or a legal basis."<sup>111</sup>

The United States Court of Appeals for the Ninth Circuit in *Kerry* considered and rejected the taxpayer's contention that the regulations under which the Commissioner's allocations were made were not authorized or proper under a correct construction of section 482.<sup>112</sup> The Ninth Circuit affirmed the Tax Court's judgment insofar as the Commissioner's allocations had been allowed, and reversed the Tax Court and required an allocation of income with regard to the loan which the Tax Court felt the taxpayer had shown to be unproductive of any gross income in the subsidiary. The court indicated its concurrence with Judge Featherston's dissenting opinion and the Eighth Circuit's decision in *Kahler*, and further noted that "[a]ny scheme which permits related entities to regulate their tax obligations by transfer and retransfer of monies between themselves should be carefully scrutinized."<sup>113</sup> The Ninth Circuit joined the Eighth Circuit in rejecting the tracing concept,<sup>114</sup> and allowed allocations by the Commissioner under the section 482 regulations. In so holding, the court was in accord with the Second Circuit's *Forman* decision,<sup>115</sup> and the three circuits thus presented a unanimous response to the Tax Court's decisions on the question.

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these funds to its subsidiaries interest-free. Kahler deducted the interest payments from its 48% tax bracket income. The interest allocated to Kahler from the subsidiaries would also be taxed at Kahler's 48% rate, but the interest deduction to the subsidiaries would have been largely offsetting income in the 22% tax bracket.

108. 486 F.2d at 4. The court said: "Treasury regulations constitute *contemporaneous* construction by those charged with administration of these statutes and should not be overruled except for weighty reasons." *Id.* (emphasis added).

109. *Id.*

110. The court felt the proof that the funds actually produced income was of no importance and related the use of money in many corporations to the use of raw materials within a manufacturing concern. This would seem to reemphasize Judge Featherston's argument that money is actually a fungible commodity and the tracing theory would leave an irrational test for the application of the section as well as a loophole Congress could not have intended. See notes 102-05 *supra* and accompanying text.

111. 486 F.2d at 5.

112. CCH 1974 STAND. FED. TAX REP., U.S. TAX CAS. (74-2, at 84,606) ¶ 9522 (9th Cir., June 6, 1974).

113. *Id.* at 84,607.

114. See note 110 *supra*.

115. See notes 76-82 *supra* and accompanying text.

## IV. CONCLUSION

When the Second Circuit upheld the Commissioner's creation of interest income in *Forman*<sup>116</sup> it was thought appeal might be had to the United States Supreme Court on the basis of the conflict then existing between the Sixth Circuit, which had decided the *Tennessee-Arkansas* case, and the Second Circuit.<sup>117</sup> The Supreme Court denied certiorari in *Forman*, however,<sup>118</sup> and some commentators advanced the notion that this may have been because no real split existed. The Commissioner made a correlative adjustment to the borrowing corporation in the *Forman* case and the borrower did in fact have gross income for the year in question. In addition, the Commissioner was acting under regulations issued for the application of section 482. In *Tennessee-Arkansas* it was never shown that the subsidiary had any income during the year in question and no corresponding adjustment was made by the Commissioner. Regulations were also lacking in that case.

The decisions in *Kahler* and *Kerry* by the Eighth and Ninth Circuits would certainly lend credence to this argument and the impending doom of such intercompany transactions' tax benefits in the future. The Tax Court, set as it is against the Commissioner's per se creation of income, will now have to recognize the validity of the regulations authorizing such power in at least three circuits.<sup>119</sup>

The decision in the *Kerry* case may have eliminated any remaining vestiges of support the taxpayer had in the Tax Court.<sup>120</sup> The potential conflict upon which an appeal to the Supreme Court might have been predicated—that the Commissioner could not exercise his full authority under section 482's regulations where the taxpayer establishes that the funds were used for non-productive purposes—was eliminated by the Ninth Circuit's disavowal of the

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116. See note 80 *supra* and accompanying text.

117. See Loening, *Section 482 Allocations Resulting in the Creation of Income or in Constructive Dividends to Shareholders*, N.Y.U. 30TH INST. ON FED. TAX. 1247, 1259 (1972).

118. 407 U.S. 934 (1972).

119. In *Liberty Loan Corp. v. United States*, 359 F. Supp. 158 (E.D. Mo. 1973), the taxpayer, a consumer finance company, would loan borrowed funds to its subsidiaries, charging interest only to its solvent subsidiaries in amounts necessary to cover its own interest expense. A district court within the Eighth Circuit found the Commissioner had ignored "the substance of the group relationship and imputed income where an objective analysis of the group business discloses that none had been realized." *Id.* at 165. The court disallowed the interest allocation as producing a wholly fictitious result. This decision, however, upon appeal to the Eighth Circuit which had already decided the *Kahler* case against the Tax Court, was reversed. The Eighth Circuit treated each subsidiary's loan as a separate transaction and the Commissioner's imputation of interest income on each loan to the insolvent subsidiaries was allowed. CCH 1974 STAND. FED. TAX REP., U.S. TAX CAS. (74-1, at 84,263) ¶ 9474 (8th Cir., May 31, 1974).

120. In two recent decisions, the Tax Court followed its theory of tracing and its requirement of clearly distorted income. An allocation was allowed in *Fitzgerald Motor Co.*, 60 T.C. 957 (1973), to reflect arm's length interest charges on interest-free loans between sister corporations. The court again rejected the Commissioner's contention that section 482 empowered him to impute interest income regardless of the use of the funds, but in accord with *Kerry* allowed the charge in this case since the lender failed to show the loans did not generate income. The Tax Court upheld the Commissioner's determination as to a deficiency resulting from the allocation of income between the two commonly controlled corporations, in *Palo Alto Town & Country Village*, 32 CCH Tax Ct. Mem. 1048 (1973). This was a clear case, however, of two related corporations attempting to shift their income through a purchase and sale-back of timber by an airline from and to the taxpayer construction company.

Tax Court's tracing concept. The circuit's response to the allocation issue thus far clearly eliminates the obvious loopholes envisioned by Judge Featherston in his dissent to *Kerry* and makes unnecessary<sup>121</sup> the congressional action called for by many commentators.

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121. See Nauheim, *B. Forman & Co., Inc.—A Crucial Test of the Future of Section 482*, 26 TAX LAW. 107 (1972).