St. John's Law Review

Volume 46
Number 3 *Volume 46, March 1972, Number 3*

Article 31

Controlled Corporations--Allocation of Income (Phillipp Brothers Chemcials v. Commissioner)

St. John's Law Review

In reversing the Tax Court decision, the Court of Appeals maintained that all contractual rights incident to ownership had been transferred. It cannot be assumed that the divorce court would prohibit exercise of ownership powers where occasion required.[54] Therefore the first requirement to premium deductibility — assignment of policy ownership to the divorced spouse — had been fulfilled. The provision of the agreement terminating the former spouse's interest in the proceeds if she predeceased the taxpayer is not the kind of contingency which will forestall operation of the constructive receipt principle where the children are irrevocably designated contingent beneficiaries.[55] As assignee and irrevocable beneficiary of the policy the former spouse constructively received a taxable benefit. Accordingly, the premium payments are includible as part of her gross income and deductible by the husband.[56]

As a result of *Stevens* the constructive receipt doctrine will now be scrutinized more practically. If, in fact, a current economic benefit has been rendered to the former wife, it is now more likely that that benefit will be taxable to her and deductible by her former husband.

CONTROLLED CORPORATIONS — ALLOCATION OF INCOME

Section 482 of the Code provides that the Secretary of the Treasury or his delegate may allocate among two or more commonly controlled businesses "gross income, deductions, credits, or allowances" if he determines that such allocation is necesary in order "to prevent evasion of taxes or clearly to reflect the income" of the business.[57] A determina-

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[54] 439 F.2d at 72.

[55] *Id.* In acknowledging that such an interpretation differs from that of the Seventh Circuit (see note 48 *supra*), the court said:

> To deny constructive receipt of benefit whenever the wife's interest in the proceeds is contingent on her surviving her former spouse is to presume that an insurance policy's only value to the beneficiary lies in receipt of the face amount upon death of the insured. If this analysis were correct, premiums paid on a term insurance policy could never qualify as alimony payments because the protection of term insurance to an irrevocable beneficiary extends only for a specified period rather than over the life of the insured. . . . Rather the contingencies which will deny deductibility are those which might operate to thwart the wife's receipt of the economic benefit the premium payments conferred, that is, the protection, during a limited term, of the wife's right to receive alimony over the full alimony period. Such contingencies include the husband's retention of the power to borrow against the policy, to withdraw its cash surrender value or to substitute himself as beneficiary if the wife predeceases him.

Id.

[56] Only $850, the amount claimed by the husband in the Tax Court proceedings, was includible or deductible. *See* note 49 *supra*.

[57] INT. REV. CODE OF 1954 § 482. The purpose of this section is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer. This is done by determining the net income of the property and business of a controlled taxpayer, according to the standards of an uncontrolled taxpayer. Tennessee Life Ins. Co. v. Phinney, 280 F.2d 38 (5th Cir.), *cert. denied*, 364 U.S. 914 (1960); Simon J. Murphy Co. v. Commissioner, 231 F.2d 639

tion by the Commissioner under section 482 is essentially one of fact and must be affirmed if supported by substantial evidence.[58] The Commissioner has broad discretion in appraising particular fact situations.[59] His determinations wll not be set aside unless clearly shown to be unreasonable or arbitrary,[60] and the taxpayer has the burden of proving that this discretion has been abused.[61]

(6th Cir. 1956); Treas. Reg. § 1.482-1(b)(1) (1968).

"Control," as used in the statute, includes:

> any kind of control, direct or indirect, whether legally enforceable, and however exercisable or exercised. It is the reality of the control which is decisive, not its form of the mode of its exercise. A presumption of control arises if income or deductions have been arbitrarily shifted.

Treas. Reg. § 1.482-1(a)(3) (1968). Common control is not affected merely because some of the owners of the controlled businesses are different. Nor is allocation of income among related businesses justified merely on account of common control. Hall v. Commissioner, 294 F.2d 82 (5th Cir. 1961). *See also* Davis v. United States, 282 F.2d 623 (10th Cir. 1960); Grenada Indus., Inc., 17 T.C. 231 (1951), *aff'd*, 202 F.2d 873 (5th Cir.), *cert. denied*, 346 U.S. 819 (1953). *Compare* Lake Erie & P. Ry. Co., 5 T.C. 558 (1945), *with* Texsun Supply Corp., 17 T.C. 433 (1951).

Section 482 can only be invoked by the Commissioner and its use is not a matter of right with the taxpayer. Treas. Reg. § 1.482-1(b)(3) (1968). However, the Commissioner may be estopped to deny its use. Interstate Fire Ins. Co. v. United States, 215 F. Supp. 586 (E.D. Tenn. 1963), *aff'd per curiam*, 339 F.2d 603 (6th Cir. 1964). In determining the true taxable income of a controlled taxpayer the Commissioner is not restricted to cases involving fraud, deliberate tax avoidance or improper accounting. The authority to allocate extends to any case in which taxable income, either by inadvertence or design, of a controlled taxpayer, is other than it would have been had there been an uncontrolled individual dealing at arm's length with another uncontrolled individual. George W. Knipe, 24 CCH Tax Ct. Mem. 668 (1965), *aff'd per curiam sub. nom.* Equitable Publishing Co. v. Commissioner, 356 F.2d 514 (3d Cir. 1966); Mel Dar Corp. v. Commissioner, 309 F.2d 525 (9th Cir. 1962); Treas. Reg. § 1.482-1(c). *See generally* 7 MERTENS § 38.61 *et seq.*

58 Advance Mach. Exch. v. Commissioner, 196 F.2d 1006, 1007-08 (2d Cir.), *cert. denied*, 344 U.S. 835 (1952).

59 Treas. Reg. § 1.482-1(b)(1) (1968) provides that

> [t]he interests controlling a group of controlled taypayers are asumed to have complete power to cause each controlled taxpayer so to conduct its affairs that its transactions and accounting records truly reflect the taxable income from the property and business of each of the controlled taxpayers. If, however, this has not been done, and the taxable incomes are thereby understated, the district director shall intervene, and, by making such distributions, apportionments, or allocations as he may deem necessary of gross income, deductions, credits, or allowances, or of any item or element affecting taxable income . . . , shall determine the true taxable income of each controlled taxpayer.

See also Central Cuba Sugar Co. v. Commissioner, 198 F.2d 214 (2d Cir.), *cert denied*, 344 U.S. 874 (1952).

60 Ballentine Motor Co. v. Commissioner, 321 F.2d 796, 800 (4th Cir. 1963). Section 482 does not permit the Commissioner to allocate income and deductions simply because he finds that the common owners have the power to shift income. His authority extends only to cases wherein an allocation is necessary to prevent the evasion of taxes or to clearly reflect income. Bush Hog Mfg. Co., 42 T.C. 713 (1964); *cf.* T. R. Vardeman v. United States, 209 F. Supp. 346 (E.D. Tex. 1962); Motor & Indus. Fin. Corp. v. Scofield, 55-1 U.S. Tax Cas. ¶ 9493 (D.C.W.D. Tex. 1955). In Bank of Kimball v. United States, 200 F. Supp. 638 (S.D.S.D. 1962), the court rejected the Commissioner's allocation as arbitrary, and then proceeded to make its own allocation on the basis of the *Cohan* rule, note 27 *supra.*

61 Hall v. Commissioner, 294 F.2d 82, 85 (5th Cir. 1961). *See also* Brentwood Homes, Inc. v. United States, 240 F. Supp. 378 (D.C.E.D.N.C. 1965), *aff'd sub. nom.* J.R. Land Co.

In *Phillipp Brothers Chemicals v. Commissioner*,[62] the Court of Appeals for the Second Circuit upheld the Commissioner's allocation of all of the net income of five commonly controlled foreign sales corporations to an affiliated New York corporation, holding that there was substantial evidence to support the Commissioner's allocation. The New York corporation was the principal corporation of a group of eleven corporations organized by an individual to engage in the business of buying and reselling industrial and agricultural chemicals. All eleven corporations during the period in question were under the control of the same interests.[63] The shipping and bookkeeping arrangements for all the corporations were handled in the office of the New York corporation. Only one of the five foreign sales corporations maintained an inventory. On their returns for 1960 and 1962 the five foreign sales corporations claimed no deductions for salaries, wages or rent, except for a single item claimed by one of them.[64]

The court indicated that section 482 was specifically designed to combat situations such as presented in this case.[65] Income is taxable to the party who earns it. Economic reality, not legal formality, determines who earns income.[66] In rejecting the contention that the Commissioner cannot, as a matter of law, reallocate the entire income of a corporation unless such a corporation is a sham, the court highlighted the fact that there was no evidence that the foreign sales corporations actually did anything at all. In such a case, a one hundred percent reallocation is appropriate.[67] As the taxpayer did not meet the burden of showing that

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v. United States, 361 F.2d 607 (4th Cir. 1966); L.E. Shunk Latex Rubber Prod., Inc., 18 T.C. 940 (1952).

62 435 F.2d 53 (2d Cir. 1970).

63 The individual who organized all eleven was president of each corporation. Nearly ninety percent of the stock of each of the five foreign sales corporations was owned by the president and his family.

64 One corporation claimed a $472 deduction for salesmen's expenses. There was no evidence that the foreign corporations had any employees. The sole deductions for 1960 and 1962 were for charitable contributions, taxes, minimal amounts for office, legal and accounting expenses, and special tax-saving deductions for Western Hemisphere trade corporations. (*See* INT. REV. CODE OF 1954 sections 921 and 922).

65 435 F.2d at 57.

66 *Id.*

67 *Id.* at 58. The proposition cited by the taxpayer referred to the court's decision in W. Braun Co. v. Commissioner, 396 F.2d 264 (2d Cir. 1968). In *Braun* the court stated that

> [t]he Commissioner was therefore not justified in arbitrarily allocating all of Braunware's taxable income to petitioner. Such an allocation is authorized only where there is no business purpose to the challenged transaction or corporate structure. Section 482 does not give the Commisioner the power to disregard separate corporate entities if they are being used for a bona fide business purpose.

Id. at 268. The court felt *Braun* was distinguishable in that substantial evidence indicating that the separate corporation performed some business functions, as evidenced in that case, which fact was lacking here. 435 F.2d at 58. *See also* National Investors Corp. v. Hoey, 144 F.2d 466, 468 (2d Cir. 1944).

this allocation was unjustified, the Commissioner's findings must be affirmed.

As the *Phillipp* decision indicates, section 482 is a principal weapon in attacking taxpayer transactions. Although there is nothing in *Phillipp* to indicate that the burden of proving that the Commissioner's actions, in applying section 482, were unreasonable or arbitrary is appreciably greater than the burden of overcoming the presumptive correctness of the Commissioner's determinations in most civil tax litigation, it would appear that the proof required by section 482 is nearly unattainable. If this becomes a fact the authorization to make allocations under section 482 will provide a sword for revenue producing, not a shield to preclude the loss of revenue through artificial arrangements among controlled entities. The thrust of section 482 must therefore be employed only where the principal purpose of the questioned transaction was to avoid federal income tax.

ESTATE TAXATION

Section 2055(a)(3) of the Code provides for a deduction from the decedent's gross estate for the value of property transferred to a trustee if used exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to childern or animals. The deductions will be disallowed if a substantial part of the activities of the transferee is "carrying on propaganda, or otherwise attempting, to influence legislation. . . ."[68] Other provisions of section 2055 allow a deduction for similar transfers: to or for the use of a domestic governmental body for exclusively public purposes;[69] to or for the use of any corporation organized or operated exclusively for religious, charitable, scientific, literary, or educational purposes;[70] and to or for the use of any

An additional contention that the foreign sales corporations had a right to receive some income from the transactions which were assigned to them by the New York office, because their capital was at risk, was also denied. No sales contracts, insurance policies, or shipping documents were put into evidence to indicate that the foreign corporations did, in fact, risk capital, as it appeared to the court that "after a profitable sale had been completely arranged by the New York corporation, it was thereafter arbitarily assigned to one of the foreign corporations." 435 F.2d at 58.

68 INT. REV. CODE OF 1954 § 2055(a)(3). The Tax Reform Act of 1969, 83 Stat. 487, added the requirement that transfers of property made after December 31, 1969 will not be deductible if the transferee in any way participates in any political campaign. 83 Stat. 553.

69 INT. REV. CODE OF 1954 § 2055(a)(1).

70 *Id.* § 2055(a)(2). No part of the net earnings of the corporation may enure to the benefit of any private stockholder or individual. *Id.* The prohibition concerning propaganda activities applicable in section 2055(a)(3) also applies here. Treas. Reg. § 20.2055-1(a)(4) (1958) does not strictly enforce the provision that the transferee must be a corporation; any institution meeting the requirements will suffice.