Multiple Corporations Under the Revenue Act of 1964

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balance the schools by the use of racial criteria in zoning. The New York courts have reached essentially the same result although purporting to adhere to the qualification that the method used to secure racial imbalance is otherwise lawful and reasonable.

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I. Introduction

It is a maxim of taxation that where graduated tax rates are imposed on the income of a legal entity, tax avoidance in the form of income splitting will be attempted. This has proven true in the case of individuals[1] and trusts,[2] and has more recently become true of corporations. For over a decade the law governing the tax status of affiliated corporations has been developing.[3] The Revenue Act of 1964[4] introduces several important changes in the federal income tax treatment of multiple corporations.[5] The purpose of this note is to examine the tax status of multiple corporations both before and after the 1964 act in order to reach conclusions as to the effect of the changes made by the 1964 act. In addition, proposals of the American Law Institute and Professor Stanley S. Surrey[6] are reviewed as a background to a critique of the present law and proposals for reform.

II. The Non-Tax Benefits of Multiple Incorporation

When the decision is made to incorporate an enterprise, the non-tax as well as tax implications of operating the enterprise through

1. See Lucas v. Earl, 281 U.S. 111 (1930).
2. See Ervin, *Multiple Accumulative Trusts and Related Problems Under the Income Tax*, 29 So. Cal. L. Rev. 402 (1956); Comment, 24 U. Chi. L. Rev. 156 (1956).
3. The recent development of the law governing the tax status of affiliated corporations results from the fact that the principal tax benefits of multiple incorporation, the surtax exemption in its present form and minimum accumulated earnings credit, were enacted in 1950 and 1954 respectively. Revenue Act of 1950, ch. 994, § 15, 64 Stat. 915; Int. Rev. Code of 1954, § 535(c)(2).
4. 78 Stat. 19.
5. *I.e.*, two or more corporations having a high degree of common ownership.
6. Professor Surrey's proposals for the tax treatment of multiple corporations are contained in Surrey, *Income Tax Problems of Corporations and Shareholders: American Law Institute Tax Project—American Bar Association Committee Study on Legislative Revision*, 14 Tax L. Rev. 37 (1958).

more than one corporation should be analyzed. The non-tax reasons for organizing an enterprise into more than one corporation often may be of much greater importance than the tax reasons for using multiple corporations. For this reason, some of the more common non-tax benefits of multiple incorporation and examples of less common non-tax benefits arising from the circumstances of particular businesses are briefly discussed.

One of the most common non-tax benefits arising from multiple incorporation is the separation of assets used in one aspect of an enterprise into a separate corporation and the consequent protection of these assets from the tort or contractual liabilities of another aspect of the enterprise. The separately incorporated assets may be protected in two ways. First, the assets are protected by the substantive law rule that the assets of a corporation cannot ordinarily be reached to satisfy claims against a parent, subsidiary, or sister corporation.[7] Second, a parent corporation has jurisdictional immunity in a state where only a subsidiary transacts business.[8]

Another common non-tax benefit of multiple incorporation is the separation of an enterprise into logical and administratively convenient divisions based on geography, function, product, or service. Separate incorporation on a geographical basis may enable each corporation to incorporate in the state in which it does business and thereby the entire enterprise may have the advantage of favorable domestic corporation laws in several states.[9] Geographical division may also allow the use of local trade names. A product or service division may allow the use of independent merchandising policies.[10]

In some cases, separate incorporation may enable one or more corporations to present a sounder financial statement for credit purposes than could be presented by the enterprise as a whole.

7. *E.g.*, Miller v. Robertson, 266 U.S. 243 (1924) (subsidiary not liable for debts of another subsidiary); Gillis v. Jenkins Petroleum Process Co., 84 F.2d 74 (9th Cir. 1936) (holding company not liable for debts of subsidiary). However, a contrary result may be reached if a related corporation is deemed a mere agency, instrumentality, or alter ego of another corporation. The important factor is the degree of control a corporation exercises over its affiliate. See, *e.g.*, Steven v. Roscoe Turner Aeronautical Corp., 324 F.2d 157 (7th Cir. 1963); Forest Hill Corp. v. Latter & Blum, Inc., 249 Ala. 23, 29 So. 2d 298 (1947); American Indem. Co. v. Southern Missionary College, 195 Tenn. 513, 260 S.W.2d 269 (1953).

8. Cannon Mfg. Co. v. Cudahy Packing Co., 267 U.S. 333 (1925) (stock ownership alone does not render foreign parent amenable to suit where only subsidiary transacts business in state). The rule of the *Cannon* case does not, however, preclude jurisdiction where the subsidiary is deemed a mere instrumentality or agent of the foreign parent. Florio v. Powder Power Tool Co., 248 F.2d 367 (3d Cir. 1957); Mas v. Orange-Crush Co., 99 F.2d 675 (4th Cir. 1938); Intermountain Ford Tractor Sales Co. v. Massey-Ferguson, Ltd., 210 F. Supp. 930 (D. Utah 1962). See also Comment, 51 CALIF. L. REV. 574 (1963); Note, 104 U. PA. L. REV. 381 (1955).

9. See 2 DEWING, THE FINANCIAL POLICY OF CORPORATIONS 984 (5th ed. 1953).

10. *Id.* at 980-81.

An advantage of multiple incorporation in the form of a holding company, a parent corporation formed to control several subsidiaries, is the opportunity for controlling large amounts of capital with a small investment. "The comparatively small investment is represented by the amount required to own and control a majority of the common shares of the holding company; the large amounts of capital are the investments in the senior securities of the subsidiaries and in the senior securities of the holding company."[11]

Separation of an enterprise into more than one corporation may stimulate outside investment if investors are more willing to invest in a limited portion of the enterprise than to invest in the enterprise as a whole, portions of which may be physically remote from the investor or involve operations with which he is unfamiliar.

The particular circumstances of a business may provide other non-tax reasons for multiple incorporation. For example, additional corporations may be needed in order to avoid losing existing franchises.[12] A wholesaler who also sells at retail may improve his wholesale business relations with other retailers with whom he competes by incorporating his retail business under a different trade name.[13]

Increased formation, legal, and accounting costs are important non-tax disadvantages of multiple incorporation. They must, of course, be weighed against the non-tax and tax benefits when deciding whether to separate an enterprise into more than one corporation.

III. The Tax Benefits and Disadvantages of Multiple Incorporation

A. *Surtax Exemption*

One of the most important tax benefits of multiple incorporation is the acquisition of additional surtax exemptions. Prior to the 1964 Act, a normal tax of 30 per cent was imposed on all the income of a corporation and an additional surtax of 22 per cent was imposed on corporate income above 25,000 dollars.[14] Dividing the income of an enterprise among more than one corporation allowed an additional 25,000 dollars of income to avoid the 22 per cent surtax for each additional corporation having 25,000 dollars or more of income.

11. *Id.* at 982.
12. Camelot Realty Co. v. United States, 60-1 U.S. Tax Cas. ¶ 9132 (W.D. Pa. 1959); Sno-Frost, Inc., 31 T.C. 1058 (1959). The franchising corporation in these cases followed a policy of requiring the franchised product to be distributed by separate corporations.
13. A similar business purpose was advanced in Hiawatha Home Builders, Inc., 36 T.C. 491 (1961), to establish a business purpose for a separate corporation.
14. Int. Rev. Code of 1934, ch. 1, § 11(b),(c), 68A Stat. 11.

The 1964 act has altered the rates of both the normal tax and surtax[15] and has imposed an additional "penalty" tax on certain related corporations electing to take more than one surtax exemption among them,[16] but the basic tax-saving principle of forming additional corporations to acquire additional surtax exemptions remains operative.

B. *Minimum Accumulated Earnings Credit*

Another major tax benefit of multiple incorporation is the acquisition of additional minimum accumulated earnings credits allowed by section 535(c) of the Code.[17] In order to prevent tax avoidance by the utilization of the corporate form to achieve a lower rate of tax through accumulation of income than would be the case if the income were taxed to the individual shareholder-taxpayers, section 531 of the Code[18] imposes an additional tax on income of a corporation accumulated beyond the reasonable needs of the business.[19] Section 535(c), however, allows in effect a lifetime minimum accumulation of 100,000 dollars of taxable income by every corporation without the imposition of the additional accumulated earnings tax, regardless of whether the income is accumulated to meet the reasonable needs of the business and without inquiry into whether a tax avoidance purpose exists. Since the accumulated earnings credit is available for each corporation more income may be accumulated and taxed at the comparatively lower corporate rate without risking the imposition of the accumulated earnings tax.

C. *Estimated Earnings Tax Credit*

A less significant tax benefit of multiple incorporation is the reduction or elimination of the estimated corporate income tax imposed by section 6016 of the Code.[20] Section 6016 requires a declaration of an estimated income tax for the current taxable year by each corporation which reasonably expects its income tax for the current taxable year to exceed 100,000 dollars. Section 6154 requires an installment payment of the estimated tax during the current year. The estimated tax is the amount of the expected income tax for the current year in excess of 100,000 dollars. When the income of an enterprise is large enough to incur an income tax in excess of 100,000 dollars, multiple incorporation will produce a savings. The savings will equal the interest or return which can be generated by the amount of the

15. See text accompanying note 85 *infra*.
16. See notes 78-81 *infra* and accompanying text.
17. INT. REV. CODE OF 1954, § 535(c).
18. INT. REV. CODE OF 1954, § 531.
19. Section 535(c)(1) of the Code allows an accumulated earnings credit in the amount of earnings retained to meet the reasonable needs of the business.
20. INT. REV. CODE OF 1954, § 6016.

estimated tax which otherwise would have to be paid during the period between the dates when the estimated tax would have been paid and the date on which the aetual tax for the year is paid.

D. *Qualified Investment Tax Credit*

Another minor tax benefit of multiple incorporation is the expansion of dollar limitations on the qualified investment tax credit of section 38 of the Code.[21] Section 38 allows a tax credit of 7 per cent of the amount of certain qualified investments made by the taxpayer. The credit is limited by section 46[22] to the tax liability of the taxpayer not exceeding 25,000 dollars plus 25 per cent of the tax liability exceeding 25,000 dollars. The dollar limitation on the credit is not increased by the use of multiple corporations if the corporations are members of an affiliated group, as defined by section 1504(a),[23] for subsection 46(a)(5) limits the credit for an affiliated group to 25,000 dollars of the total tax liability of the corporations plus 25 per cent of the total tax liability of the corporations in excess of 25,000 dollars. However, if the corporations are not members of an affiliated group, multiple incorporation may increase the dollar limitation on the credit over what it would be if only one corporation were used, for then each corporation may receive a credit in the full amount of its tax liability up to 25,000 dollars plus 25 per cent of its tax liability exceeding 25,000 dollars.

E. *Other Benefits*

If investors anticipate the discontinuance of a portion of an enterprise it may be best to incorporate separately the assets devoted to the portion of the enterprise which may be discontinued. If the assets are not separately incorporated the investors may face serious problems in withdrawing the assets from the corporation without incurring ordinary income to the extent of the corporation's earnings and profits.[24] Although it may be possible to withdraw the assets at capital gain rates, the complexities and pitfalls of a section 302 stock redemption[25] or a partial liquidation under section 346[26] must be dealt with. In comparison, the complete liquidation of a separate corporation holding the assets is a simple and clear method of achiev-

21. INT. REV. CODE OF 1954, § 38.
22. INT. REV. CODE OF 1954, § 46.
23. INT. REV. CODE OF 1954, § 1504(a). Section 46 limits the credit in the case of affiliated groups as defined by § 1504(a), but without any exclusion under § 1504(b).
24. Withdrawal of assets by shareholders is a dividend aud therefore ordinary income to the extent of the corporation's earnings and profits, unless the transaction qualifies as a stock rcdemption under § 302 or a partial liquidation under §§ 331 and 346.
25. INT. REV. CODE OF 1954, § 302.
26. INT. REV. CODE OF 1954, § 346.

ing capital gain treatment on withdrawal of the assets from the business under section 331(a)(1),[27] provided that the transaction is not subject to the collapsible corporation rules of section 341.[28]

Revival of basis for the purpose of acquiring increased depreciation deductions may be another minor tax benefit of multiple incorporation. A corporation may sell low basis depreciable assets to a related corporation and thereby realize a capital gain at the 25 per cent rate on the difference between the cost basis and the price at which the property is sold.[29] The purchasing corporation acquires a new basis equal to the purchase price.[30] The property may then be depreciated at the new basis against corporate income taxed at 48 per cent, for an effective tax savings to the affiliated group of the difference between 48 per cent and 25 per cent times the difference between the low basis of the selling corporation and the new basis or purchase price of the property.

F. *Disadvantages*

The principal tax disadvantages of multiple incorporation for the purpose of gaining additional surtax exemptions and accumulated earnings credits are that the operating losses of one corporation will not be available to offset the gains of another affiliated corporation for tax purposes and intercompany transactions and dividends may produce taxable income. The gains of a corporation may be offset by the losses of an affiliate and intercompany transactions and dividends disregarded in the case of parent-subsidiary corporations filing consolidated returns, but the parent-subsidiary group is then limited to a single surtax exemption and accumulated earnings credit.[31] Corporations owned by the same individual or group of individuals, brother-sister corporations, are ineligible to file a consolidated return.[32]

IV. The Disallowance of Multiple Incorporation Tax Benefits

The Commissioner has employed several theories and code sections to disallow the tax benefits of multiple incorporation. The basic tax theories of disregarding sham entities[33] and taxing income to the

27. "Amounts distributed in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock." Int. Rev. Code of 1954, § 331(a)(1).
28. Int. Rev. Code of 1954, § 341.
29. Under § 1239 of the Code the sale of depreciable property to a corporation by a controlling shareholder will result in ordinary income. Section 1239 does not, however, apply to the sale of depreciable property by a corporation to a related corporation.
30. Int. Rev. Code of 1954, § 1012.
31. Treas. Reg. § 1.1502-30 (1955). For a discussion of the problems involved in filing consolidated returns to utilize preconsolidation losses see Strecker, *Multiple Corporations*, Corporate Practice Commentator, Aug. 1960, pp. 1, 12-14.
32. Treas. Reg. § 1.1502-1(a) (1955).
33. Corporations and transactions with corporations serving only tax avoidance

true earner[34] or to the owner of the property producing it[35] have been utilized. More important, however, have been the successes of the Commissioner in applying specific code sections designed to counter tax avoidance schemes.

A. *The Sham Theory*

In *Aldon Homes, Inc.*,[36] the government argued that the entire income from a real estate development project was taxable to one of sixteen alphabet corporations, Aldon Homes, Inc., because none of the income was earned by the fifteen other corporations.

The facts of the case present an example of the extremes to which taxpayers may go in their efforts to secure additional surtax exemptions. Organized to undertake a realty development project, Aldon Homes, Inc. purchased land, obtained governmental approval for the subdivision plan, and sold sections of the subdivision to fifteen other alphabet corporations organized by the same interests. Through the handling of bond redemptions, Aldon Homes directed the disposition of profits from the overall development of the tract among the corporations, effectuating an understanding that profits from the entire development would be divided fifty-fifty between the management group controlling Aldon Homes and the investor group controlling the other corporations.

The government contended the other corporations should be disregarded as shams since they "were not formed for any business purpose, did not function in income-producing capacities, and lacked substance and reality."[37] The court concluded that the fifteen other corporations

> did not carry on business activities which resulted in the profits from the development . . . nor any substantial business activities, and consequently did not earn the income in question; that, though legal entities in form, for purposes of taxation they were unreal or shams and to be disregarded.[38]

While *Aldon Homes* clearly indicates that the sham theory may be applied to disallow tax benefits of multiple incorporation, the case has been interpreted to have application only in extreme situations

purpose may be disregarded as shams. Higgins v. Smith, 308 U.S. 473 (1940); Gregory v. Helvering, 293 U.S. 465 (1935); Paymer v. Commissioner, 150 F.2d 334 (2d Cir. 1945); National Investors Corp. v. Hoey, 144 F.2d 466 (2d Cir. 1944).

34. See Lucas v. Earl, *supra* note 1.

35. See Blair v. Commissioner, 300 U.S. 5 (1937).

36. 33 T.C. 582 (1959).

37. *Id.* at 595. The other 15 corporations were created by transfers of land from Aldon Homes prior to January 1, 1951, and therefore § 1551 was not applicable.

38. *Id.* at 597.

such as were present in *Aldon Homes*.[39] If a reasonable number of corporations are actually engaged in distinct business functions or operate in more widely separated geographic locations, the sham theory should have no application.

B. *Section 1551*

Section 1551 of the Code[40] disallows the 25,000 dollar surtax exemption and the 100,000 dollar accumulated earnings credit to a transferee corporation receiving property, other than money, from a transferor corporation where the transferee was formed to receive the property or was not actively engaged in business at the time of the transfer, unless the transferee establishes by a clear preponderance of the evidence that securing an additional surtax exemption or accumulated earnings credit was not a major purpose of the transfer. Prior to the 1964 act, the section applied only to transfers from one corporation to another, and transfers of property from one or more individuals to a corporation were not covered by the section.[41]

Where section 1551 is applicable, allowance of the surtax exemption or accumulated earnings credit depends upon a factual determination that securing such an exemption or credit was not a major purpose of the transfer. In order to establish that securing tax benefits was not a major purpose of the transfer, the taxpayer must present a convincing business purpose served by the transfer. The business purpose must render the tax benefit of the transfer a strictly incidental factor.[42] It is consistent with the language of the section for a corporation to prove that a business reason was a major purpose for the transfer and for the court or jury to find that the acquisition of tax benefits was another major purpose of the transfer.[43] Where the income tax savings resulting from the additional surtax exemptions and accumu-

39. "Thus, except in instances where a taxpayer forms several corporations to engage in substantially identical operations, nonrecognition of the multiple entities on the sham or tax avoidance theory cannot be maintained." Paley, *Forming Multiple Corporations*, 39 TAXES 375, 378 (1961). The other leading case applying the sham theory to disallow multiple incorporation tax benefits, Shaw Constr. Co., 35 T.C. 1102 (1961), involved an extreme situation of 88 corporations.

40. INT. REV. CODE OF 1954, § 1551.

41. For a discussion of the expansion of section 1551 to cover transfers by individuals made by the 1964 act, see text accompanying notes 94-96 *infra*.

42. See, *e.g.*, Camelot Realty Co. v. United States, *supra* note 12, and Sno-Frost, Inc., *supra* note 12, where a strong showing of business purpose was made by the taxpayers to meet the burden of proof.

43. "It is sufficient if it appears . . . that the obtaining of such exemption was a major purpose that prompted . . . [the corporation's] formation. Thus, the securing of the surtax exemption may constitute a major purpose of the transfer, notwithstanding that such formation was effected for a valid business purpose." LaBarge Water Well Supply Co. v. United States, 63-1 U.S. Tax Cas. ¶ 9109, at 87,124 (E.D. Mo. 1962) (jury instruction).

lated earnings credits is substantial in relation to the overall income and tax liability of the corporation, the burden placed upon the taxpayer to show that such tax savings did not play a major part in the decision to make the transfer may often be insurmountable.[44] In order to succeed in such a case, the corporate officers may need to show their ignorance of the tax consequences of the transaction. Such ignorance is rare in most cases, since corporate officers are usually well-advised on tax consequences.

Notable cases in which the taxpayer has succeeded in resisting the application of section 1551 have involved circumstances in which the taxpayer was forced to create a new corporation and transfer assets to it either by the threat of losing existing franchises or by governmental regulation.[45]

In *Sno-Frost, Inc.*[46] and *Camelot Realty Co. v. United States*,[47] securing additional surtax exemptions and accumulated earnings credits was found not to be a major purpose of the creation of subsidiary corporations where the transferor corporations were compelled to create subsidiaries under threat of losing existing franchises.[48] The same result was reached in *Truck Terminals, Inc.*,[49] where the

44. It is surprising to note that several jury instructions do not mention among the relevant factors to be weighed in determining whether a major purpose of the transfer was to secure the tax benefits the relative size of the tax savings in relation to the overall net income of the affiliated group of corporations. See LaBarge Water Well Supply Co. v. United States, *supra* note 44; Camelot Realty Co. v. United States, *supra* note 12; Contract Battery Mfg. Co. v. Tomlinson, 58-2 U.S. Tax Cas. ¶ 9655 (S.D. Fla. 1958).

45. Other cases in which the taxpayer has succeeded in showing that securing the tax benefits was not a major purpose of the transfer are: Frames, Inc. v. United States, 65-1 U.S. Tax Cas. ¶ 9217 (M.D.N.C. Sept. 18, 1964); Contract Battery Mfg. Co. v. Tomlinson, *supra* note 44; Bush Hog Mfg. Co., 42 T.C. No. 52 (July 16, 1964); Esrenco Truck Co., 22 CCH Tax Ct. Mem. 287 (1963) (one surtax exemption allowed and one denied); Stater Bros., Inc.—Second Street, 21 CCH Tax Ct. Mem. 780 (1962); Constroms Mfg., Inc., 36 T.C. 500 (1961); Hiawatha Home Builders, Inc., 36 T.C. 491 (1961). Cases in which the surtax exemption or minimum accumulated earnings credit have been disallowed under § 1551 are: Coastal Oil Storage Co. v. Commissioner, 242 F.2d 396 (4th Cir. 1957); LaBarge Water Well Supply Co. v. United States, *supra* note 44; James Realty Co. v. United States, 176 F. Supp. 306 (D. Minn. 1959), *aff'd on other grounds*, 280 F.2d 394 (8th Cir. 1960); Central Valley Management Corp. v. United States, 165 F. Supp. 243 (N.D. Cal. 1958); Perfection Foods, Inc., 1965 P-H Tax Ct. Mem. Dec. ¶ 65,015 (Jan. 29, 1965); The Challenger, Inc., 1964 P-H Tax Ct. Mem. Dec. ¶ 64,338 (Dec. 31, 1964); Esrenco Truck Co., *supra* (one surtax exemption denied and two allowed); Napier Furniture Co., 22 CCH Tax Ct. Mem. 575 (1963); Theatre Concessions, Inc., 29 T.C. 754 (1958). See also Rev. Rul. 57-202, 1957-1 Cum. Bull. 297.

46. *Supra* note 12.

47. *Ibid.*

48. In both cases, the corporation was formed only after the loss of a franchise had been threatened. Sno-Frost, Inc., *supra* note 12, at 1060; Camelot Realty Co. v. United States, *supra* note 12, at 75,167.

49. 33 T.C. 877 (1960).

transferor corporation transferred equipment to an inactive subsidiary to avoid state regulation.[50]

C. *Section 269*

Section 269 of the Code and its predecessor[51] were enacted primarily to deal with loss corporation acquisitions.[52] The broad language of the section provides that if an individual or corporation acquires control of a corporation and "the principal purpose for which such acquisition was made is avoidance of Federal income tax by securing the benefit of a deduction credit or other allowance which such person or corporation would not otherwise enjoy, then such deduction, credit, or other allowance shall not be allowed." Section 269 has been applied to disallow various tax benefits of multiple incorporation,[53] but tax avoidance is required to be *the principal* purpose of the acquisition in contrast to section 1551 which only requires tax avoidance to be *a major* purpose of the transfer.[54]

Section 269 has had important application in denying the tax benefits of multiple incorporation because until the 1964 act section 1551 was inapplicable to transfers by individuals to corporations.[55] In addition, section 269 may conceivably deny any tax benefit, whereas section 1551 is expressly limited to the disallowance of surtax exemptions and accumulated earnings credits. However, it is unlikely that the securing of any multiple incorporation tax benefit other than the surtax exemption or accumulated earnings credit would ever be the principal purpose of an acquisition. The Commissioner prefers to

50. California law prohibited encumberancing of equipment by companies licensed by the Public Utilities Commissioner of California, except upon hearing and approval by the Commissioner. The regulation on borrowing was not applicable to companies which merely leased equipment to those licensed by the Commissioner. The parent corporation of the petitioner wished to operate encumbered vehicles in California under a license from the California Commissioner as a common carrier. Therefore, the encumbered vehicles were transferred to the petitioner and leased back to the parent to avoid state regulation.

51. Revenue Act of 1944, § 129, 58 Stat. 47.

52. S. REP. No. 627, 78th Cong., 1st Sess. 58-60 (1943); Rudick, *Acquisitions to Avoid Income or Excess Profits Tax: Section 129 of the Internal Revenue Code*, 58 HARV. L. REV. 196 (1944).

53. Kesmar Constr. Co. v. Commissioner, 64-2 U.S. Tax Cas. ¶ 9741 (9th Cir. 1964); Shaw Constr. Co. v. Commissioner, 323 F.2d 316 (9th Cir. 1963); James Realty Co. v. United States, 280 F.2d 394 (8th Cir. 1960); Coastal Oil Storage Co. v. Commissioner, *supra* note 45; Bonneville Locks Towing Co. v. United States, 63-2 U.S. Tax Cas. ¶ 9782 (W.D. Wash. 1963); Fine Realty, Inc. v. United States, 209 F. Supp. 286 (D. Minn. 1962); J. Dillier, 41 T.C. 762 (1964); Concord Supply Corp., 37 T.C. 919 (1962); H. S. Alper, 21 CCH Tax Ct. Mem. 185 (1962).

54. Of course, under either section the taxpayer has the burden of proving a negative, *i.e.*, that securing the tax benefits was not a major or the principal purpose of the transfer or acquisition.

55. For a discussion of the amendment of § 1551 by the 1964 act, see text accompanying notes 94-97 *infra*.

utilize section 1551 when possible since under this section the taxpayer must meet what is, at least in theory, the more demanding test of showing that securing tax benefits was not a major purpose of the transaction, as opposed to showing that the acquisition of tax benefits was not *the principal* purpose under section 269.[56]

It has been urged that section 269 does not disallow the tax benefits of multiple incorporation in the case of an acquisition of an existing corporation nor in the case of a newly formed corporation.[57] In the case of an acquisition of an existing corporation, the argument is based on a dictum of the Tax Court decision of *Alprosa Watch Corp.*,[58] and the cases which followed. In *Alprosa*, the court stated that section 269 will not disallow credits or deductions to the acquired corporation, but only to the acquiring corporation.[59] Therefore, it has been reasoned in the case of an acquisition of one or more corporations for the purpose of acquiring additional surtax exemptions and accumulated earnings credits, the acquired corporations cannot be deprived of these tax benefits by section 269.[60] However, the line of Tax Court decisions following the *Alprosa* dictum have been overruled by the circuit courts,[61] and the Tax Court itself has reversed its position[62] so that the argument based on the *Alprosa* dictum no longer has vitality.

In the case of a newly formed corporation, it has been argued that the creation of a new corporation is not an acquisition of control of a corporation within the meaning of section 269.[63] Therefore, it is contended, section 269 does not apply to deny additional surtax exemptions and accumulated earnings credits to newly formed corporations. This argument has been rejected by the Eighth Circuit in *James Realty Co. v. United States*,[64] where the court approved the statement of the district court that "'there is no settled view that "acquisition of control" cannot and should not include the organization of a new corporation . . . .'"[65]

56. The Commissioner, of course, urges disallowance of tax benefits under both sections in the alternative where possible. See, *e.g.*, Coastal Oil Storage Co. v. Commissioner, *supra* note 45; James Realty Co. v. United States, *supra* note 45.

57. See James Realty Co. v. United States, *supra* note 53, at 398.

58. 11 T.C. 240 (1948).

59. *Id.* at 245 (dictum).

60. See James Realty Co. v. United States, *supra* note 53, at 398.

61. Commissioner v. British Motor Car Dist., Ltd., 278 F.2d 392 (9th Cir. 1960), *reversing* 31 T.C. 437 (1958); Mill Ridge Coal Co. v. Patterson, 264 F.2d 713 (5th Cir. 1959); Coastal Oil Storage Co. v. Commissioner, *supra* note 45.

62. Thomas E. Snyder Sons Co., 34 T.C. 400 (1960).

63. See James Realty Co. v. United States, *supra* note 53, at 398.

64. *Ibid.*

65. *Ibid.* However, the Tax Court has held that the revival of a dormant corporation with funds borrowed from related entities is not equivalent to an acquistion of control under § 269. The Challenger, Inc., *supra* nete 45.

In cases in which the Commissioner has sought disallowance of multiple incorporation tax benefits under sections 269 and 1551, taxpayers have presented a variety of business purposes served by the use of two or more corporations in order to show that business reasons were the principal motives behind the use of two or more corporations and that tax considerations were of only secondary or incidental importance. The business reasons most often advanced in these cases have been division of a business on the basis of either geography, function, product or service, and the limitation of liability.[66] The success of taxpayers urging various business purposes has varied widely.[67] As might be expected in an area where success depends upon the proper factual determination of a degree of a state of mind, tax planning must remain uncertain in many cases.

D. *Section 482*

Section 482 of the Code[68] has also been effectively applied by the Commissioner to disallow the major tax benefits of multiple incorporation.[69] The section provides that in the case of two or more businesses owned or controlled by the same interests the Commissioner "may distribute, apportion, or allocate gross income, deductions, credits, or allowances between such . . . businesses if . . . necessary to prevent evasion of taxes or clearly to reflect the income of such . . . businesses." The section allows the Commissioner a wide discretion in adjusting

66. See the cases cited in notes 45 & 53 *supra.*

67. There are several articles discussing the business purposes advanced in the cases and the success of taxpayers in urging particular business purposes. See Adkins, *Taxation of Multiple Corporations,* 41 TEXAS L. REV. 276 (1962); Cuddihy, *Obtaining Multiple Deductions and Credits for Multiple Corporations,* TULANE 10TH INST. ON FED. TAX 564 (1961); Ekman, *How Many Corporations Can Conduct a Business,* N.Y.U. 19TH INST. ON FED. TAX 391 (1961); Emmanuel & Lipoff, *Commissioner v. Corporate Complex: An Expanding Attack,* 15 U. FLA. L. REV. 352 (1962); Paley, *Multiple Corporations Face Ever-Increasing Attack: Realty Development Vulnerable,* 18 J. TAXATION 130 (1963); Paley, *Forming Multiple Corporations,* 39 TAXES 375 (1961).

68. INT. REV. CODE OF 1954, § 482.

69. Advance Machinery Exchange, Inc. v. Commissioner, 196 F.2d 1006 (2d Cir.), *cert. denied,* 344 U.S. 835 (1952); Hamburgers York Road, Inc., 41 T.C. 821 (1964); Kessmar Constr. Co., 39 T.C. 778 (1963), *aff'd on other grounds,* 64-2 U.S. Tax Cas. ¶ 9741 (9th Cir. 1964); Aldon Homes, Inc., 33 T.C. 582 (1959) (concurring opinion). *Cf.* Commissioner v. Chelsa Prod., Inc., 197 F.2d 620 (3d Cir. 1952): "Section 45 [now INT. REV. CODE OF 1954, § 482], based upon a recognition of the various corporate entities, merely allows the Commissioner to prevent distortions in income between controlled corporations. In fact, the Treasury Regulation itself states that Section 45 is 'not intended (except in the case of the computation of consolidated net income under a consolidated return) to effect in any case such a distribution, apportionment, or allocation of gross income, deductions . . . as would produce a result equivalent to a computation of consolidated net income under § 141 [now INT. REV. CODE OF 1954, §§ 1501-04].' The Commissioner, in disregarding the corporate entities of the sales companies and lumping together all net incomes, has proceeded beyond his statutory bounds." 197 F.2d at 623.

transactions between related taxpayers who have not dealt with each other at arm's length.[70] In addition, the section has been broadly applied to allocate the entire net income of one or more related corporations to another related corporation.[71] This broad application effectively limits the corporate group to a single surtax exemption and accumulated earnings credit since after the allocation is made only one corporation in the group has taxable income.

This application of section 482 was first made in *Advance Machinery Exchange v. Commissioner*,[72] where the court held that the Commissioner's allocation of the entire net income of two related corporations to the corporate taxpayer was not an improper consolidation of the income of the corporate group.

In *Hamburgers York Road, Inc.*,[73] a recent case involving this application of section 482, the Commissioner allocated the entire net income of a sister corporation to the corporate taxpayer. Stockholders of the taxpayer had formed the sister corporation to operate a suburban branch of the taxpayer's clothing business. The sister corporation displayed the trade name of the taxpayer; charge accounts at the taxpayer's store were used at the suburban store; the taxpayer's bank account was used by both corporations throughout most of the operation of the sister corporation; advertising and buying for both stores were conducted by employees of the taxpayer; and for the use of these assets and services the taxpayer made no charge to the sister corporation. The Tax Court stated the question under section 482 to be:

> Have the petitioners established that the respondent was arbitrary, capricious, or unreasonable in his determination that if [taxpayer] and [the sister corporation] had been dealing at arm's length as uncontrolled organizations, [taxpayer] would have required that all profits of [the sister corporation] be turned over to it?[74]

The court answered the question in the negative saying, "For such use of its business organization and assets, [the taxpayer] would . . . have claimed for itself the profits in their entirety of the [sister corporation's] segment of the business."[75] The court relied on *Ballentine Motor Co.*,[76] in rejecting the taxpayer's contention that section

70. See Pomeroy, *Allocation of Income, Deductions, Credits, and Allowances Among Related Taxpayers*, 15 W. Res. L. Rev. 250 (1964).

71. Advance Machinery Exch., Inc. v. Commissioner, *supra* note 69; Hamburgers York Road, Inc., *supra* note 69.

72. *Supra* note 69.

73. *Ibid.*

74. *Id.* at 835.

75. *Id.* at 837.

76. 39 T.C. 348, *aff'd*, 321 F.2d 796 (4th Cir. 1963).

482 conferred no power on the Commissioner to allocate net income, and that only "gross income," in the language of the statute, may be reallocated. The court did not reach the question of whether the surtax exemption could be denied the sister corporation under sections 269 or 1551, although it stated that the principal purpose of organizing the sister corporation was to avoid federal income taxes by securing the benefit of an additional surtax exemption.[77]

In view of *Advance Machinery* and *Hamburgers York*, section 482 has a very broad application in the area of multiple incorporation tax planning. The limits of the section's application are not as yet clear, thus making tax planning in an already difficult and complex area even more hazardous.

V. The 1964 Act

The Revenue Act of 1964 makes four important changes affecting the tax status of multiple corporations. These changes are: (1) the limitation of controlled corporate groups to a single surtax exemption unless an election is made to claim a surtax exemption for each member of the group and each member pays an additional tax of 6 per cent on its first 25,000 dollars of income; (2) the amendment of Code section 1551 extending its application to transfers to brother-sister corporations; (3) repeal of the 2 per cent tax on consolidated returns; and (4) the amendment of Code section 243 to allow corporations to deduct 100 per cent of the dividends received from affiliated domestic corporations.

A. *Election of Multiple Surtax Exemptions by Controlled Groups*

Perhaps the most important change made by the 1964 act with regard to the taxation of corporate groups is the enactment of code sections 1561-63,[78] limiting "controlled groups"[79] of corporations to a single surtax exemption unless the group elects to claim a surtax exemption for each corporation and each corporation pays an additional 6 per cent tax on its first 25,000 dollars of income. Additional surtax exemptions may be disallowed under other sections of the Code even though the group has elected to claim additional exemptions.[80] If additional surtax exemptions are disallowed, the additional

77. 41 T.C. at 832.

78. Int. Rev. Code of 1954, §§ 1561-63. Proposed regulations have been issued for these sections. Proposed Treas. Reg. §§ 1.1561-1 to 1.1563-4 7 CCH Stand. Fed. Tax Rep. ¶ 8982 (Feb. 25, 1965).

79. See text accompanying note 92 *infra*, for a discussion of the definition of controlled groups of corporations.

80. H.R. Rep. No. 749, 88th Cong., 1st Sess. 118 (1963).

6 per cent tax is not imposed.[81] Election of additional surtax exemptions may be made by a controlled group retroactively within three years of the date of the income tax return of the member of the controlled group whose taxable year ends first after the December 31st for which the election is made.[82] The controlled group may terminate the election with the consent of all members of the group, but after termination a new election cannot be made for five years.[83]

The purpose of requiring controlled groups to elect additional surtax exemptions and to pay an additional 6 per cent tax on the first 25,000 dollars of income of each corporation is to prevent the change in the normal and surtax rates made by the 1964 act from further encouraging the formation of multiple corporate groups.[84] Prior to 1964, the normal rate was 30 per cent and the surtax rate was 22 per cent.[85] A surtax exemption was therefore worth a maximum of 22 per cent of 25,000 dollars or 5,500 dollars. Since the 1964 act reduces the normal rate to 22 per cent and inereases the surtax rate to 26 per cent for 1965 and subsequent years, a surtax exemption is now worth a maximum of 26 per cent of 25,000 dollars or 6,500 dollars. The imposition of the additional 6 per cent tax on the first 25,000 dollars of income of related corporations electing to claim multiple surtax exemptions reduces the benefit of additional surtax exemptions to a savings comparable to the savings under the former rates.

The operation of the 6 per cent additional tax and the consequent reduction in value of additional surtax exemptions to controlled groups of corporations under the new rates has not been fully appreciated.[86] It may appear at first that the value of each additional surtax exemption to a controlled group is 5,000 dollars, since the difference between the tax rates applicable to income above and below 25,000 dollars is 20 per cent (48–28=20), and 20 per cent of 25,000 dollars is 5,000 dollars.[87] However, this is not accurate,

81. Int. Rev. Code of 1954, § 1562(b)(1)(B).
82. Int. Rev. Code of 1954, § 1562(e).
83. Int. Rev. Code of 1954, § 1562(d).
84. "While your committee recognizes the importance to small business of reducing the tax on the first $25,000 of income from 30 to 22 percent, it also recognizes that this substantial tax reduction should not provide added inducement to existing medium and large corporations to split up into multiple corporations." H.R. Rep. No. 749, 88th Cong., 1st Sess. 117 (1963).
85. Int. Rev. Code of 1934, ch. 1, § 11(b),(c), 68A Stat. 11.
86. See, *e.g.*, Colquhoun, *Multiple Corporations,* 15 W. Res. L. Rev. 242, 248 (1964): "The effect of this 6% penalty tax in 1964 is to preserve the present 22% differential between the tax rates applicable to income below and above $25,000. In subsequent years, however, the 6% penalty tax will reduce this differential to 20%, and, therefore, will reduce the value of a surtax exemption in years subsequent to 1964 from $5,500 to $5,000." This statement is not entirely accurate.
87. *Ibid.*

because the corporate group will pay an additional 6 per cent tax on 25,000 dollars of income which a single corporation or group of corporations filing consolidated returns will not pay. This concept may be made clearer by the following example:

Corporation *A* has a taxable income of 50,000 dollars. Corporation *A* being entitled to one surtax exemption will pay a tax of 22 per cent on the first 25,000 dollars of income and a tax of 48 per cent (22 per cent normal tax and 26 per cent surtax) on the remaining 25,000 dollars of income. Corporations *B* and *C* each have 25,000 dollars of taxable income and compose a controlled group which has elected to claim separate surtax exemptions. Each corporation will pay a tax of 28 per cent on its 25,000 dollars of income (22 per cent normal tax and 6 per cent penalty tax). While the corporate group has achieved a lower rate on 25,000 dollars of income than corporation *A* (28 per cent as compared to 48 per cent), it has paid at a higher rate than corporation *A* on the remaining 25,000 dollars of income (28 per cent as compared to 22 per cent). Thus, a controlled group of corporations pays a fixed cost of 6 per cent of 25,000 dollars or 1,500 dollars for claiming multiple surtax exemptions, since 25,000 dollars of income will always be taxed at a rate 6 per cent higher than would be the case if a consolidated return were filed.

The total tax savings resulting from additional surtax exemptions claimed by a controlled group, assuming each corporation in the group has at least 25,000 dollars of taxable income, may be expressed by the formula $(.20N - .06) \times 25{,}000$, where N equals the number of corporations above one in the controlled group.[88] Applying the formula, the total tax savings where two corporations compose the controlled group is 3,500 dollars, where three the savings is 8,500 dollars, and where four the savings is 13,500 dollars.

The value of each additional surtax exemption to a controlled group may be stated in two different ways: first, as the total tax savings divided by the number of additional surtax exemptions, in which case the value of each additional surtax exemption will vary directly with the number of additional surtax exemptions. Thus, where two corporations compose the controlled group the value of each additional surtax exemption is 3,500 dollars, where three the value is 4,250 dollars, and where four the value is 4,500 dollars. Stated in another way, the first additional surtax exemption is worth only 3,500 and each additional surtax exemption is worth 5,000 dollars. In any case,

88. For example, where two corporations compose a controlled group, *N* equals one; where three corporations compose a controlled group, *N* equals two. This formula takes into account the fact the electing groups pay 20% of $25,000 less for each additional corporation, but pay a tax 6% higher on $25,000 of income than groups not electing.

it is clear that the tax savings are disproportionately greater where three or more corporations compose the controlled group as opposed to when only two corporations compose the controlled group. This result is contrary to the avowed purpose of the 6 per cent additional tax of discouraging the proliferation of multiple corporations under the new corporate rates,[89] since where more than one corporation is used a tax savings bonus is offered taxpayers forming at least three corporations.

Another important feature of the additional 6 per cent tax is that a controlled group of corporations cannot save taxes by electing to claim additional surtax exemptions unless the total taxable income of the group exceeds 32,500 dollars.[90] This results from the fact that without an election 25,000 dollars of income is taxed at the rate of 22 per cent, whereas with an election the minimum tax on all income is 28 per cent.

It should be noted, however, that the tax savings resulting from additional surtax exemptions when the corporations are not within the definition of a controlled group is substantially increased by the change in rates made by the 1964 Act. Under the rates for 1965 and subsequent years, an additional surtax exemption is worth 6,500 dollars if the corporation is not a member of a controlled group, while prior to 1964 a surtax exemption was worth only 5,500 dollars.[91]

Section 1563 of the Code[92] defines a "controlled group of corporations." In the case of a parent-subsidiary relationship, a controlled group includes corporations connected by stock ownership with a common parent where 80 per cent of the voting power or value of the shares of each corporation, except the common parent, is owned by one or more of the other corporations and the common parent owns 80 per cent of the voting power or value of the shares of at least one of the other corporations, excluding the voting power or value of stock owned directly by the other corporations. In the case of a brother-sister corporate relationship, a controlled group includes two or more corporations if stock possessing at least 80 per cent of the voting power or value of the stock of each corporation is owned by one individual, estate, or trust. In addition, a controlled group includes three or more corporations each of which is a member of a group of brother-sister corporations or parent-subsidiary corpora-

89. See note 84 *supra*.

90. If X equals the total taxable income of a controlled group of corporations which will pay the same amount of tax whether or not an election of multiple surtax exemptions is made, then:

$$.28X = (.22 \times 25{,}000) + .48\ (X - 25{,}000)$$
$$X = 32{,}500$$

91. See text accompanying note 85 *supra*.

92. Int. Rev. Code of 1954, § 1563.

tions and one of which is a common parent corporation included in the parent-subsidiary group and also included in the brother-sister group. The determination of whether a controlled group exists is made on December 31, of each year for both calendar and fiscal year corporations.

Constructive ownership rules are established in subsection 1563(e) for the purpose of determining controlled groups. The most significant difference between the constructive ownership rules of section 1563(e) and those of other Code sections[93] is the treatment of stock owned by a spouse. Under the rules of section 1563(e) an individual is not considered to own stock owned by his spouse if four conditions are satisfied: (1) the individual does not own directly any stock in the corporation during the taxable year; (2) the individual is not a director or employee and does not participate in the management of the corporation at any time during the taxable year; (3) not more than 50 per cent of the corporation's gross income for the taxable year was derived from royalties, rents, dividends, interest, and annuities; and (4) the stock in the corporation is not, at any time during the taxable year, subject to conditions which substantially restrict or limit the spouse's right to dispose of the stock and which run in favor of the individual or his children who have not attained the age of twenty-one. The purpose of this exception to the ordinary constructive ownership rules is to allow a husband and wife to operate separate businesses without being subject to the limitations on surtax exemptions imposed on controlled groups of corporations by sections 1561-63.

B. *Section 1551*

Section 1551[94] is extended by the 1964 act to disallow surtax exemptions and accumulated earnings credits to brother-sister corporations. Under the 1964 act section 1551 is applicable to corporations controlled by five or fewer individuals.[95] Control by five or fewer individuals is defined as ownership of at least 80 per cent of the voting power or value of the stock of each corporation, and more than 50 per cent of the voting power or value of the stock of each corporation, taking into account the stock ownership of each individual only to the extent it is identical with respect to each corporation. For the purpose of determining stock ownership the constructive ownership rules of section 1563(e) are applicable. Since section 1551 did not apply to brother-sister corporations prior to the 1964

93. *E.g.*, INT. REV. CODE OF 1954, § 318.

94. INT. REV. CODE OF 1954, § 1551.

95. Prior to the 1954 act § 1551 applied only to transfers from one corporation to another, *i.e.*, parent-subsidiary corporate groups. See text accompanying note 41 *supra*.

act, the Commissioner was forced to seek disallowance of exemptions and credits under section 269 in the case of brother-sister corporations.[96] It has already been noted that section 269 requires tax avoidance to be the *principal* purpose of the acquisition of control of a corporation for the disallowance of tax benefits. Under the 1964 act brother-sister corporations must meet the more difficult test of establishing that tax avoidance was not a *major* purpose of the transfer under section 1551.

Prior to the 1964 act section 1551 applied only to transfers of property, other than money, *directly* to a controlled corporation. It was thought that section 1551 did not apply to indirect transfers of property where a parent transfers money to a newly formed subsidiary which then purchases the property from the parent.[97] To foreclose this possibility, the 1964 act amends section 1551 to apply to transfers of property, other than money, directly or *indirectly* to a controlled corporation.

C. *Repeal of Two Per Cent Tax on Consolidated Income*

Prior to the 1964 act section 1503 of the Code imposed an additional 2 per cent tax on the income of corporations filing consolidated returns. "[I]n accord with the reality of the situation" and to encourage the filing of consolidated returns,[98] the 2 per cent tax on consolidated income is repealed by the 1964 act.[99]

D. *Dividends Received Deduction*

Prior to the 1964 act corporations were allowed to deduct 85 per cent of the dividends received from domestic corporations.[100] This provision is continued, but in addition Code section 243 is amended by the 1964 act to allow affiliated groups, as defined by section 1504(a),[101] to elect a deduction of 100 per cent of the dividends received from affiliated domestic corporations.

An election under section 243 by an affiliated group limits the number of certain credits and deductions the group may take. The most important limitations are that the group is limited to one surtax exemption, one accumulated earnings credit, and one 100,000 dollar estimated tax exemption.[102] It is therefore clear that an election should be made under section 243 only when the affiliated group

96. See text accompanying note 55 *supra*.
97. S. Rep. No. 830, 88th Cong., 2d Sess. 155 (1963).
98. H.R. Rep. No. 749, 88th Cong., 1st Sess. 116 (1963).
99. Revenue Act of 1964, § 234.
100. Int. Rev. Code of 1954, § 243.
101. Int. Rev. Code of 1954, § 1504(a).
102. Int. Rev. Code of 1954, § 243(b)(3)(C).

files a consolidated return. Since an election eliminates the major tax benefits of multiple incorporation, the group should have the benefit of offsetting the gains of one corporation by the losses of another and having inter-member transactions disregarded. The amendment, in effect, makes the consolidated return more attractive by allowing the receipt of tax free dividends from affiliated corporations.

It has been noted by one writer that an election under section 243 eliminates a tax benefit not eliminated by the consolidated return regulations,[103] for under the consolidated return regulations the group may pay its estimated tax by using a 100,000 dollar estimated tax exemption for each corporation.[104]

VI. THE EFFECT OF THE 1964 ACT ON MULTIPLE INCORPORATION TAX PLANNING

It is clear that the tax advantages of multiple incorporation have been substantially reduced by the 1964 act. Not only has the value of additional surtax exemptions in the case of controlled groups of corporations been substantially reduced, but in addition corporate groups are given additional incentive to file consolidated returns by repeal of the 2 per cent tax on consolidated income and the opportunity to deduct 100 per cent of the dividends received from affiliated domestic corporations. Add to these factors the increasing success of the Commissioner in achieving disallowance of multiple incorporation tax benefits under sections 269, 1551, and 482 and the expansion of section 1551 to cover brother-sister corporations and it becomes apparent that in the future taxpayers will increasingly tend to shun multiple incorporation as a tax saving device.[105]

However, since the benefits of multiple incorporation are only reduced, not eliminated, multiple incorporation remains a tax planning possibility, and in this connection certain aspects of the 1964 act should be kept in mind.

First, a corporate group may have a high degree of common ownership and yet not constitute a controlled group of corporations. In such a case the value of each surtax exemption jumps from 5,500 dollars under the former corporate tax rates to 6,500 dollars under the new rates of the 1964 act.[106] Simple examples of corporate groups with a high degree of common ownership which are not controlled

103. Dale, *1964 Act: Climate Improved for Multiple Corporations Despite Penalty Tax*, 21 J. TAXATION 264, 267 (1964).
104. Treas. Reg. § 1.6016-1 (1957).
105. The very complexity of the new law concerning controlled groups may itself prove a deterrent to multiple incorporation.
106. See text accompanying note 85 *supra*.

groups are a group of corporations whose stock is owned equally by two or more unrelated[107] individuals; or, in the case of a parent-subsidiary relationship, a group in which the parent owns slightly less than shares possessing 80 per cent of the voting power or value of the shares of its subsidiaries, and the remaining shares are held by unrelated interests.

Second, brother-sister corporations are still not covered by section 1551 if stock ownership is spread among more than five unrelated individuals. This, however, is not of great importance because closely held family corporations will almost always be owned by five or fewer individuals when constructive ownership rules are applied.

More important is the fact that the brother-sister form of corporate organization may no longer be the more desirable form of multiple incorporation from a tax planning point of view. Prior to the 1964 act the brother-sister form was thought to be somewhat preferable to the parent-subsidiary form of multiple incorporation, because section 1551 was inapplicable to brother-sister corporations and, therefore, disallowance of multiple incorporation tax benefits was possible under section 269 where the taxpayer failed to show that tax avoidance was not the *principal* purpose of an acquisition, as compared to showing tax avoidance was not a *major* purpose under section 1551.[108] Now, however, section 1551 applies to most brother-sister corporations, and, in the event multiple incorporation tax benefits are disallowed, brother-sister corporations cannot file consolidated returns in future years. Multiple incorporation in the parent-subsidiary form may now be preferable, for if multiple incorporation tax benefits are disallowed, consolidated returns may be filed in future years. This is especially true in light of the fact that consolidated returns are now even more attractive since the 2 per cent tax on consolidated income has been repealed.

It is appropriate at this point to question why brother-sister corporations are not allowed to file consolidated returns.[109] Since the 1964 act includes brother-sister corporations within the definition of a controlled group and extends section 1551 to cover transfers to brother-sister corporations, brother-sister corporations are now subjected to the same burdens as parent-subsidiary groups and should

107. "Unrelated" in the sense that the constructive ownership rules of § 1563(e) would not apply.

108. See, *e.g.*, Strecker, *Multiple Corporations*, Corporate Practice Commentator, August 1960, pp. 1, 10.

109. Section 1501 allows only "affiliated groups" of corporations to file consolidated returns and "affiliated groups" are defined by § 1504 to include only parent-subsidiary corporations. The suggestion of allowing brother-sister corporations to file consolidated returns has been made before, see Strecker, *supra* note 108, at 7, but the enactment of the 1964 act gives the suggestion greater force than ever.

therefore be accorded the same privilege of filing consolidated returns unless substantial reasons for not doing so are presented. The House Ways and Means Committee dealt with the problem in the following manner:

> Your Committee did not attempt to achieve complete symmetry between the definition of a controlled group of corporations for purposes of foregoing multiple surtax exemptions and the definition of a group eligible to file a consolidated return. Several differences arise. However, many complicated problems are involved in equating the two, and mauy avoidance possibilities might be created if they were equated.[110]

Given the treatment of brother-sister corporations under the 1964 act, it is submitted that the denial of the privilege of filing consolidated returns to brother-sister corporations demands more concrete justification than a vague "many complicated problems are involved."

As noted earlier,[111] if multiple incorporation is undertaken with a view to tax savings, the use of at least three corporations in the case of a controlled group provides a tax savings bonus over two corporations disproportionate to the additional number of corporations. On the other hand, the larger the number of corporations the greater is the risk that the additional corporations will be found to have been created for the purpose of securing tax benefits and the benefits disallowed. A compromise of these competing considerations may be the use of three corporations as the ideal number with which to achieve the tax savings bonus while avoiding the tax evasion implications that may arise from a larger number of corporations.

Finally, there is an interesting possibility that the election of additional surtax exemptions by a controlled group and consequent payment of the additional 6 per cent tax may lead to a judicial tendency to regard the taxpayer as having paid the price and made his choice with respect to acquiring additional surtax exemptions and, therefore, to hold against the Commissioner seeking disallowance of additional surtax exemptions under sections 269, 1551, or 482. Of course, it is unlikely that this tendency will ever be the express basis of a decision, since the election of multiple surtax exemptions was clearly not intended to have such an effect.[112] Yet, the election may have a subtle influence in this direction in some cases.

VII. Tax Reform

The provisions of the present Code, as amended by the Revenue

110. H.R. Rep. No. 749, 88th Cong., 1st Sess. 118 (1963).

111. See text accompanying note 89 *supra*.

112. "Of course, nothing in this bill is intended as changing the application of sections 269, 1551, or 482 if the multiple corporation form of organization is adopted to avoid taxes." H.R. Rep. No. 749, 88th Cong., 1st Sess. 118 (1963).

Act of 1964, do not provide a satisfactory solution to the tax problem of multiple incorporation. The basis of the problem is the lack of a clear and well-defined policy with regard to extending certain tax concessions, principally the surtax exemption and accumulated earnings credit, to "small business."[113] The lack of a clear policy in this respect began with the enactment of the principal tax concessions for "small business" and the policy question has not been clarified by the 1964 act nor the committee reports on the act.

A second basic problem, once the policy question has been answered and the businesses for which the tax concessions are designed have been more clearly defined, is the functional and administrative problem of limiting the tax benefits to the businesses for which they are designed.

Several years ago Professor Stanley S. Surrey recognized the need for a clearer statement of policy in this area.[114] Under the tax law then, as now, large corporate chains could operate identical businesses in different locations and receive tax concessions designed to benefit "small business."[115] Certainly, such corporate chains are not what Congress intended by the term "small business" in committee reports on the legislation which created these tax concessions. In other situations, it is less clear what Congress intended by the term "small business" in the context of multiple corporations.[116] For example, if each corporation in a group of corporations controlled by a few individuals is a small competitor in a business that is completely distinct from the businesses operated by each of the other corporations in the group, should each corporation be considered "small business" for the purpose of receiving tax concessions? If the purpose of the tax concessions is to aid small competitors in order to promote competition, perhaps each corporation should be considered "small business."[117]

113. Committee reports merely indicate that these tax concessions were intended to benefit "small business." Precisely what purpose is served by extending tax concessions to "small business" and what "small business" means in the context of multiple corporations is not explained. See, *e.g.*, S. Rep. No. 2375, 81st Cong., 2d Sess. 12 (1950) (surtax exemption); S. Rep. No. 1622, 83d Cong., 2d Sess. 72 (1954) (minimum accumulated earnings credit).

114. Surrey, *Income Tax Problems of Corporations and Shareholders: American Law Institute Tax Project—American Bar Association Committee Study on Legislative Revision*, 14 Tax L. Rev. 37 (1958).

115. Turner-Moore No. 22 v. United States, 60-2 U.S. Tax Cas. ¶ 9675 (W.D. Tex. 1960); Stater Bros., Inc.—Second Street, 21 CCH Tax Ct. Mem. 780 (1962); Alcorn Wholesale Co., 16 T.C. 75 (1951); Berlands, Inc., 16 T.C. 182 (1951).

116. See note 113 *supra*.

117. Congress probably enacted the tax concessions to promote competition by aiding small competitors. Such a purpose has been more clearly spelled out in other legislation. See Small Business Act, 67 Stat. 232 (1953), as amended, 15 U.S.C. § 631 (1958).

However, once the policy decision is made as to which corporations constitute "small business" for the purpose of receiving tax concessions, it is very difficult, if not impossible, to write an administratively workable law that will limit the tax benefits to those corporations which policy dictates should have them, while at the same time allowing multiple corporations to receive the benefits.[118] Professor Surrey has pointed out that the present limitations on the allowance of exemptions and credits to multiple corporate groups are based on tax avoidance standards which are irrelevant to any purpose which the tax concessions might serve.[119] While the formation of multiple corporations may be motivated by a desire to minimize taxes, this fact is irrelevant in all but extreme cases if allowance of the tax concessions to each corporation in a group serves an economic purpose which the concessions are intended to promote.

It is in light of these considerations that Professor Surrey concluded that parent-subsidiary corporations should be limited to a single surtax exemption and accumulated earnings credit.[120] Similarly, he proposed to limit brother-sister corporations to a single exemption and credit if their business activities are conducted in an integrated manner.[121]

Professor Surrey's proposal was embodied in the President's 1963 Tax Message to Congress.[122] While Congress rejected this essential part of Professor Surrey's work on multiple corporations in the 1964 act, its reasons for doing so are not clear.[123] Professor Surrey's proposal

118. For example, if the purpose of the tax concessions is to benefit small competitors and thereby promote competition, it would be within this purpose to allow each corporation in a brother-sister or parent-subsidiary controlled group to receive the tax benefits if each corporation is a competitor in a business entirely distinct from the businesses operated by each of the other corporations. But at what point would the businesses become so similar or integrated into the production of a single product that each would not be a competitor in a distinct field? How could such distinctions be effectively administered?

119. "[T]he primary issue is whether a tax-avoidance standard, apart from its inherent uncertainties, is even a relevant criterion. Thus, in determining whether each corporate entity in a chain of parent and subsidiary corporations should be entitled to a $25,000 surtax exemption, is it at all a relevant question whether the purpose behind the use of these multiple corporate entities was a tax-avoidance purpose intended to secure a number of surtax exemptions?" Surrey, *supra* note 114, at 39.

120. *Id.* at 42.

121. *Ibid.*

122. *Hearings Before the House Committee on Ways and Means on Tax Recommendations of the President*, 88th Cong., 1st Sess., pt. 1, at 14 (1963).

123. Several witnesses spoke strongly against this portion of the President's tax recommendations at the House hearings. Perhaps the House committee was persuaded by arguments similar to the following: "Our tax laws recognize that there are good and valid business reasons for the establishment of separate corporate entities. The denial of the surtax exemption to a corporation within an affiliated group would seriously impair its competitive position with respect to a corporation of similar size that is not a part of an affiliated group. The affiliated corporation would be paying