Case Western Reserve Law Review

Volume 15 | Issue 2

1964

Multiple Corporations

Norman W. Colquhoun

II

MULTIPLE CORPORATIONS

Norman W. Colquhoun

ADVANTAGES AND DISADVANTAGES OF MULTIPLE CORPORATIONS

For more than 25 years, federal income tax laws have provided for a lower rate of tax on the first $25,000 of a corporation's income.[1] Consequently, the use of more than one corporation to carry on related business activities has long been practiced by taxpayers, opposed by the Internal Revenue Service, and discussed by the commentators.[2]

The attraction of the lower tax rate applicable to the first $25,000 of corporate income has not been the only inducement to utilize multiple corporations. During World War II and the Korean conflict, excess profit taxes could be reduced where several corporations were involved rather than a single corporation.[3] Since 1954, section 535 of the Internal Revenue Code has further encouraged the use of multiple corporations. This section allows a minimum $100,000 accumulated earnings credit to each corporation before the section 531 penalty tax on unreasonable accumulations of surplus can be applicable.

In the case of "brother-sister"[4] corporations, the use of several corporations is often well advised from a tax standpoint because it offers an opportunity for a subsequent disposal of part of a business enterprise

1. Since the Revenue Act of 1938, ch. 289, 52 Stat. 447, lower tax rates have been applicable to corporate income under $25,000. See CCH 1963 STAND. FED. TAX REP. ¶ 151, for a summary of corporate tax rates under all prior Revenue Acts.

2. See, *e.g.*, Adkins, *Taxation of Multiple Corporations*, 41 TEXAS L. REV. 276 (1962); Cuddihy, *Obtaining Multiple Deductions and Credits for Multiple Corporations*, TUL. 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 & Kipoff, *Commissioner v. Corporate Complex: An Expanding Attack*, 15 U. FLA. L. REV. 352 (1962); Hewitt, *Section 482 —Allocation of Income and Deductions Among Related Taxpayers*, N.Y.U. 20TH INST. ON FED. TAX 463 (1962); Paley, *Multiple Corporations Face Ever-Increasing Attack; Realty Development Vulnerable*, 18 J. TAXATION 130 (1963); Paley, *Forming Multiple Corporations*, 39 TAXES 375 (1961).

3. Each corporation was allowed a minimum $25,000 excess profits tax credit. INT. REV. CODE OF 1939, ch. 1199 § 431(2), 64 Stat. 1137. Since the excess profits tax was applicable only to corporate income, this period saw an unusual flowering of the partnership form of doing business.

4. "Brother-sister" corporations are corporations controlled by the same non-corporate taxpayers and are thus to be distinguished from "parent-subsidiary" corporations. The phrase has now been dignified by an official definition and frequent use in the provisions of the Revenue Act of 1964, Pub. L. No. 88-272 (Feb. 26, 1964), which establishes new rules for the allowance of surtax exemptions and accumulated earnings credits to certain related corporations. See pp. 247-50 *infra*, for a discussion of these provisions.

(the stock or assets of one of the corporations) at capital gain rates which otherwise might not be available.[5]

The advantages to be derived from multiple corporate entities must be weighed against certain disadvantages. The likelihood of losses being incurred by one corporation should be considered, since they will not be available in computing the tax on the income of the other corporations.[6] A variety of additional costs resulting from the operation of several corporations rather than one might in any given case outweigh the advantages discussed above. Such costs include higher initial fees payable upon incorporation and possibly higher annual state franchise taxes.[7] The additional legal and accounting fees necessarily required in connection with creating and maintaining the several corporate entities also must be considered. One of the most difficult factors to evaluate is the additional expenditure of employee time which will be required to insure that the several corporate entities do in fact perform the functions contemplated at the time of their formation. Intercompany arrangements must be formalized and intercompany transactions must be policed to assure that they are conducted on an arm's length basis. While failure to observe these precautions will result in the loss of the tax advantages from the use of separate corporate entities, observance of such precautions will involve a cost in professional fees and employee time which must be assessed on the basis of the facts in each case.

---

5. If a single corporation conducts several business activities, a sale of the assets related to one of these activities will result in a tax upon the corporation. The non-recognition provisions of INT. REV. CODE OF 1954 § 337 [hereinafter cited as CODE §] are applicable only in the case of sales in connection with complete liquidations. Distribution of the profits of the sale will result in the realization of dividend income by the shareholders, unless the "two business" requirement of CODE § 346(b) can be satisfied so as to make the distribution qualify as a partial liquidation. It frequently is possible to separately incorporate two different activities which would not satisfy the "two business" requirement of CODE § 346(b). For example, a separate real estate holding company which rents real estate to an operating company owned by the same interests may be incorporated, thus making possible a subsequent sale of stock or assets of either company subject to a single capital gains tax at the shareholder level.

6. Usually, the net operating loss carryover provisions of CODE § 172 will eliminate the possibility of a complete loss of the tax benefit of operating losses. The use of separate corporations does involve, however, the loss of the opportunity to apply currently the loss of one corporation against the income of another. This disadvantage cannot be avoided by "brother-sister" corporations through the filing of consolidated returns, since they are not eligible to file consolidated returns. Under present law, a parent-subsidiary corporation could avoid this disadvantage through the use of consolidated returns, but only at the cost of an additional 2% tax on the consolidated net income.

7. In Ohio, the initial fee payable upon filing articles of incorporation is based upon the aggregate number of shares authorized; the amount payable per share decreases as the number of authorized shares increases. The minimum fee is $50. OHIO REV. CODE § 111.16. Since the aggregate Ohio Franchise Tax is based upon a valuation of the issued and outstanding shares, it would not be increased by the use of more than one corporation. See OHIO REV. CODE §§ 5733.05-.08.

LIMITATIONS ON THE USE OF MULTIPLE CORPORATIONS

The Commissioner has employed four different weapons in his efforts to deny the benefits inherent in doing business in a multiple corporate form. These are: (1) section 482, which permits an allocation of gross income from one controlled corporation to another so as to leave one or more of a group of related corporations without income against which the surtax exemption or the accumulated earnings tax credit can be applied;[8] (2) section 269, which permits the disallowance of a surtax exemption or accumulated earnings credit if the principal purpose of the creation of a corporation was the securing of the benefit of such exemption or credit;[9] (3) section 1551, which authorizes the disallowance of the exemption or credit if the major purpose of a transfer of property (other than money) from one corporation to a newly organized controlled corporation was the securing of the tax exemption or credit;[10] and (4) section 61, which merely defines "gross income," but has been interpreted as authority for the Commissioner to disregard a "sham" corporation and to tax the income which it reports to a related corporation regarded as having earned that income.[11]

In most cases, the Commissioner asserts two or more of the Code sections described above as the basis for denying the benefits of multiple corporations.[12] While the applicability of each of the four sections will depend upon quite different verbal conclusions, the basic consideration

8. The many other applications of CODE § 482 are discussed in Pomeroy, *Allocation of Income, Deductions, Credits, and Allowances Among Related Taxpayers*, 15 W. RES. L. REV. 250 (1964). Section 482 was first applied to achieve the result cited in the text in Advance Mach. Exch., Inc., 196 F.2d 1006 (2d Cir.), *cert. denied*, 344 U.S. 835 (1952). A recent unsuccessful attempt by the Commissioner to apply this section was made in Esrenco Truck Co., 22 CCH Tax Ct. Mem. 287 (1963).

9. Recent decisions upholding the application of CODE § 269 to multiple corporations include: James Realty Co. v. United States, 280 F.2d 394 (8th Cir. 1960); Fine Realty, Inc. v. United States, 209 F. Supp. 286 (D. Minn. 1962); and Kessmar Constr. Co., 39 T.C. 778 (1963), *appeal docketed*, Nos. 89333-348, Ninth Circuit, Jan. 30, 1964. Recent decisions involving multiple corporations in which § 269 was found not to be applicable include: Fedcal Distrib. Co., 22 CCH Tax Ct. Mem. 935 (1963) and Stater Bros., Inc., 21 CCH Tax Ct. Mem. 780 (1962).

10. This section, unlike CODE §§ 269 and 482, is applicable only to transfers between two corporations. A "transfer" includes sales and leases of property as well as transfers in exchange for stock or securities. See Hiawatha Home Builders, Inc., 36 T.C. 491 (1961); Theatre Concessions, Inc., 29 T.C. 754 (1958); Rev. Rul. 57-202, 1957-1 CUM. BULL. 297. But regular sales of inventory between related corporations probably are not "transfers" within the meaning of the section; see Esrenco Truck Co., 22 CCH Tax Ct. Mem. 287 (1963). For recent decisions involving this section, see Esrenco Truck Co., *supra;* Napier Furniture Co., 22 CCH Tax Ct. Mem. 575 (1963); Hiawatha Home Builders, Inc., *supra;* Cronstroms Mfg. Inc., 36 T.C. 500 (1961); James Realty Co., *supra* note 9.

11. See Aldon Homes, Inc., 33 T.C. 582 (1959); Shaw Constr. Co., 35 T.C. 1102 (1961), *aff'd*, 323 F.2d 316 (9th Cir. 1963). The courts refused to disregard the corporate entities in Stater Bros., Inc., 21 CCH Tax Ct. Mem. 780 (1962) and Napier Furniture Co., *supra* note 10.

12. See cases cited in notes 8-11 *supra.*

upon which a decision for or against a taxpayer will depend is whether the court is convinced that bona fide business considerations prompted the taxpayer's decision to use several corporations to carry on related business activities.[13] Regardless of the Code sections cited by the Commissioner, the taxpayer's success depends upon its ability to present convincing business reasons for the choice of the multiple corporate form.

While each case involves a factual determination, certain general conclusions can be drawn from the cases. If each of the corporations performs a different business function, separate surtax exemptions usually will be allowed.[14] In this situation, the taxpayer's argument that the assets of one business should be protected from the risks of another is most persuasive.

Where several corporations perform the same function, but in different locations, limitation of liability as a business purpose for the multiple corporate form is not as persuasive. Nevertheless, if each corporation has it own employees who are actively engaged in a business enterprise, the separate surtax exemptions usually are allowed. In *Stater Bros. Inc.*,[15] the use of twenty corporations, each of which operated a separate food market as a joint venture with the manager of the market, was upheld for tax purposes. In *Fedcal Distrib. Co.*,[16] separate surtax exemptions were allowed where four corporations owned by the same individual were used to operate separate liquor stores in the same metropolitan area. In addition to the usual argument that the taxpayer desired to protect each store from the financial risks involved in the operation of the other stores, the business purpose advanced for the use of the multiple corporations was the owner's opinion that the licensing authorities would limit the number of liquor licenses which could be issued to each operator, and that the use of different corporations could

---

13. Apparently it is easier for a taxpayer to demonstrate that tax avoidance was not its "principal purpose" within the meaning of CODE § 269 than to prove that securing a tax benefit was not a "major purpose" of the incorporation within the meaning of § 1551. On the other hand, § 1551 requires that the absence of such a "major purpose" be established by the "clear preponderance of the evidence." Section 269, however, does not purport to impose any burden on the taxpayer in addition to his usual one of overcoming the presumption of the correctness of the Commissioner's determination. But the decisions in this area do not seem to turn upon the niceties of statutory language. Traditionally, the courts have been reluctant to disregard the corporate entity. *Cf.* Moline Properties, Inc., 319 U.S. 436 (1943). Consequently, the Commissioner's use of CODE § 61 for the purpose of disregarding multiple corporations might be expected to have met with less success than attacks based upon the specific statutory provisions of §§ 269 and 1551. The courts in Aldon Homes, Inc., 33 T.C. 582 (1959) and Shaw Constr. Co., 35 T.C. 1102 (1961), *aff'd*, 323 F.2d 316 (9th Cir. 1963), however, elected to base their decisions squarely upon this ground, rather than on one of the specific statutory provisions.

14. *Compare* Hiawatha Home Builders, Inc., 36 T.C. 491 (1961) and Cronstroms Mfg., Inc., 36 T.C. 500 (1961), *with* James Realty, Inc. v. United States, 280 F.2d 394 (8th Cir. 1960); Aldon Homes, *supra* note 13; and Shaw Constr. Co., *supra* note 13.

15. 21 CCH Tax Ct. Mem. 780 (1962).

16. 22 CCH Tax Ct. Mem. 935 (1963).

avoid this limitation.[17] In *Turner-Moore No. 22 v. United States*,[18] the only business reason noted by the court for the use of twenty-four corporations to operate separate gas stations was the owner's desire to limit the liability from each operation. While this particular court accepted this purpose as a valid business reason, it should be noted that other courts have rejected the limitation of liability argument where essentially the same business risks were involved in the activities of each corporation.[19]

Regardless of the nature and location of the business activity of each of several multiple corporations, separate surtax exemptions have been allowed when the business purpose for the use of the multiple corporate form was to provide an opportunity for investment by different minority shareholders in each operation.[20]

The Commissioner has been most successful in cases involving real estate developments. These cases involved the use of a large number of corporations performing the same function in the same general location. In the typical case, a number of corporations are organized for the purpose of acquiring land and contracting with related corporations for the construction and sale of houses. The land held by each corporation is usually a part of a single real estate development which is advertised as a single unit. Each separate corporation owns real estate and enters into loan, construction, and sales agreements. Nevertheless, the courts in *Aldon Homes*[12] and *Shaw Constr. Co.*[22] found no reason, other than tax savings, for the existence of many different corporations. The corporations were held to be "shams," and the income of all of the corporations was taxed to the one corporation the court regarded as the dominant entity. In *James Realty Co.*[23] and *Fine Realty, Inc. v. United States*,[24] involving similar facts, surtax exemptions were denied under sections 269 and 1551. All of these decisions were influenced by the fact that the corporations involved had no employees and, although each of them performed a substantial number of formal acts (*i.e.*, held board meetings, entered into loan agreements, construction contracts, etc.),

17. Having found that this was in fact one of the considerations which prompted the use of the several corporations, the court refused to consider whether such limitations were actually imposed by the licensing authorities.

18. 60-2 U.S. Tax Cas. 77851 (W.D. Tex. 1960).

19. See James Realty, Inc. v. United States, 280 F.2d 394 (8th Cir. 1960); Fine Realty, Inc. v. United States, 209 F. Supp. 286 (D. Minn. 1962); Kessmar Constr. Co., 39 T.C. 778 (1963); Shaw Constr. Co., 35 T.C. 1102 (1961), *aff'd*, 323 F.2d 316 (9th Cir. 1963).

20. *Cf.* Cronstroms Mfg., Inc., 36 T.C. 500 (1961); Fedcal Distrib. Co., 22 CCH Tax Ct. Mem. 935 (1963).

21. 33 T.C. 582 (1959).

22. 35 T.C. 1102 (1961).

23. 280 F.2d 394 (8th Cir. 1960).

24. 209 F. Supp. 286 (D. Minn. 1962).

the activities of each corporation followed an identical pattern dictated by the controlling entity.

In *Aldon Homes* and *Shaw Constr. Co.*, another corporation was the controlling entity to which the income of the multiple corporations was taxed. The effect, therefore, was the same as the allowance of a single surtax exemption to the group of corporations. If an individual or partnership were singled out as the controlling entity, as the Commissioner unsuccessfully attempted to do in *Stater Bros. Inc.*, the tax consequences could be much more severe. As the Tax Court pointed out in *Stater Bros. Inc.*, corporations are always controlled by shareholders, and control of corporate activity does not justify taxation of corporate income to the party who wields such control. It is submitted that multiple exemptions should have been denied in *Aldon Homes* and *Shaw Constr. Co.* under section 269, and not on the grounds that the corporate entities may be disregarded. Either section 269 or 1551 may be applied properly where the corporate formations are dictated by tax considerations. The fact that corporate activities are limited to the performance of legal acts as distinct from physical activity carried on through employees may be relevant to determinations under those sections. But these considerations do not justify regarding the corporate entity as a "sham."[25]

PROVISIONS OF THE REVENUE ACT OF 1964 IMPOSING ADDITIONAL LIMITATIONS ON BENEFITS OF MULTIPLE CORPORATIONS

On February 26, 1964, President Johnson signed into law the Revenue Act of 1964. This act includes a new set of complex rules which governs the availability of surtax exemptions to certain related corporations. According to the Ways and Means Committee Report,[26] the objective of these rules is not to deny the existing benefits of multiple surtax exemptions, but rather to avoid the increase in the value of each surtax exemption which would otherwise result from the changes in the corporate normal and surtax rates. Under prior law, a surtax exemption was worth $5,500, *i.e.*, 22% (the surtax rate applicable only above $25,000) of $25,000. The 1964 Revenue Act reduces the tax rate on the first $25,000 of corporate income to 22%, and increases the surtax rate applicable only above $25,000 to 28% in 1964. The effect of this change is to increase the value of a surtax exemption to $7,000 (28%

25. The Tax Court recently indicated that it does not regard *Aldon Homes* and *Shaw Constr. Co.* as authority for disregarding a corporate entity on the ground that its formation was tax motivated, or that its business was in the nature of an investment or holding company, rather than the active conduct of a business enterprise. See Armais Arutunoff, 22 CCH Tax Ct. Mem. 931 (1963).

26. H.R. REP. No. 749, 88th Cong., 1st Sess. 117-18 (1963).

of $25,000) in 1964. In subsequent years, the surtax rate will be 26% and in those years the value of the exemption will be $6,500 (26% of $25,000). The method adopted to prevent this slight increase in the value of a surtax exemption is to require that certain related corporations either submit to an apportionment of a single surtax exemption among them, or elect to retain their separate surtax exemptions but be subject to an additional 6% tax on the first $25,000 of the corporate income of each of them. 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. If the purpose of the new provision was to preserve the prior value of surtax exemptions in the case of related corporations, the penalty tax in years subsequent to 1964 should have been reduced from 6% to 4%.

Since the new legislation is not designed to eliminate the existing benefit of multiple surtax exemptions, the tax advantages of using multiple corporations will continue to attract taxpayers, and the Commissioner will continue to contest the availability of surtax exemptions under sections 61, 269, 482, and 1551.[27]

A brief summary of the new legislation should serve to demonstrate the incredible complexity of the rules necessary to implement any attempt to define a class of corporations which can properly be regarded as sufficiently related to justify special rules applicable to their use of surtax exemptions.[28]

The first step in applying the new rules is to identify the related corporations to which the rules are applicable. For this purpose, the new section 1563 defines a "controlled group of corporations" as (1) members of a "parent-subsidiary controlled group" (any corporation in a chain of ownership with a common parent, where 80% of the stock, in value or voting power, is owned by other members of the group) or (2) members of a "brother-sister controlled group" (those corporations which are related by reason of 80% of their stock, in value or voting power, being owned by a single individual, estate, or trust) or (3) a "combined group" (a combination of the other two types of controlled groups, where one corporation happens to be both a parent in a parent-subsidiary group and a member of a brother-sister group). In determining whether this 80% ownership exists, the new section 1563

27. The new legislation extends the application of CODE § 1551 to cover certain transfers from non-corporate transferors, and to apply to transfers of money if the money is thereafter used to acquire property from the transferor.

28. The proposals do not relate to the availability of the accumulated earnings credit under CODE § 535.

applies its own set of new attribution rules. In addition, this section provides that under certain circumstances stock owned by certain proscribed entities is "excluded," *i.e.*, is not counted as outstanding stock in determining whether the 80% control exists. Stock so treated includes stock owned by pension or profit-sharing trusts, officers or principal shareholders of a parent corporation, and stock owned by an employee if subject to restrictions upon the employee's right to transfer the stock.

The requirement that a surtax exemption be allocated, or an election be made to pay the additional 6% tax, is applicable only to "component members of a controlled group of corporations." After determining whether a controlled group exists, it is next necessary to determine which of the corporations involved are "component members" of the group. To make this determination, it is necessary to establish which corporations were members of the controlled group on December 31 of the year in question. After finding that a given corporation was a member of the group on December 31, it then is necessary to inquire whether it was such a member for more than one-half of the days in its taxable year preceding December 31. If these conditions are satisfied, the corporation in question is a "component member."[29] In addition, even though not a member of the group on December 31, a corporation nevertheless may be a "component member" if it was a member of the group for more than one-half of the days in its taxable year preceding December 31.

After painfully identifying the "component members" of a "controlled group," the only task remaining is to decide whether a lower over-all tax will be exacted from the group if one surtax exemption is allocated (either in equal parts or pursuant to an agreed apportionment plan) among all of the component members under section 1561, or if the lower over-all tax will result from an election, under section 1562, to have each component member pay an additional 6% tax on its first $25,000 of income and keep its full $25,000 surtax exemption. Those charged with making this decision can derive some comfort from the fact that elections can be made or terminated at any time within three years after the date for filing the first return for a member of a controlled group with respect to a given year. In most cases, the election to pay the additional 6% tax will prove to be the preferable course of action. As indicated by the following examples, however, a small group of corporations, each of which has an income of less than $25,000,

29. Non-resident foreign corporations, certain insurance companies, and specially defined "franchised corporations" are excluded from the definition of component members. The requirements for qualification as a franchised corporation are so particularized that it is doubtful that many corporations, other than the specific ones which presented the case for this exception to the Ways and Means Committee, will qualify.