

Volume 16 | Issue 2

1965

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Recommended Citation

Jerry M. Hamovit and M. R. Schlesinger, *New Treatment of Multiple Corporations*, 16 W. Res. L. Rev. 317 (1965)

Available at: <https://scholarlycommons.law.case.edu/caselrev/vol16/iss2/11>

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New Treatment of Multiple Corporations

Jerry M. Hamovit

M. R. Schlesinger

INTRODUCTION

Just as the graduated income tax applicable to individuals led to the formation of family partnerships with a consequent fragmentation of a single economic entity into several taxable entities, so has the difference in the tax applicable to the first \$25,000 of a corporation's taxable income from that applied on taxable income in excess of \$25,000 led to the division of a single economic entity into multiple corporations. The 2% additional tax levied on the privilege of filing a consolidated return, together with the extraordinarily complicated requirements applicable to such returns, further effectively discouraged corporate taxpayers who might otherwise have been agreeable to lumping together their various corporate operations.

While the Revenue Act of 1964 has done nothing to reduce the complexity of consolidation, it has made significant changes in the area of tax treatment of multiple corporations. Originally, the President proposed that commonly-controlled corporations be limited to one corporate surtax exemption. While the Congress did not accept that recommendation, it has in the Revenue Act of 1964 attempted, at least to some extent, to encourage corporations that are part of a single corporate family to be treated on a unified basis for federal income tax purposes.

The Treasury Department of course recognized that a reduction in the normal corporate tax rate from 30% to 22% would substantially stimulate the proliferation of claimants to additional surtax exemptions.¹ The surtax exemption and the new 22% rate were designed to benefit and stimulate small business, not to benefit large enterprises operating through a chain of separately incorporated units.² Congress therefore acted to insure that this reduction in the normal corporate tax rate would not encourage that proliferation, and at the same time attempted to forestall unlimited further acquisition of this benefit intended for small business.

1. Materials submitted by the Treasury Department before the House Ways and Means Committee during the hearings on the legislation that culminated in the Revenue Act of 1964 estimated that the tax reduction that ensued from fragmenting a business into separate corporations and claiming multiple surtax exemptions might run as high as 42% of the tax normally applicable to that business in the absence of multiple exemptions. STAFF OF HOUSE COMMITTEE ON WAYS AND MEANS, 81ST CONG., 1ST SESS., PRESIDENT'S 1963 TAX MESSAGE 160 (Comm. Print 1963).

2. 109 CONG. REC. 966 (daily ed. Jan. 24, 1963).

CONSOLIDATED RETURNS

For many years the Internal Revenue Code has permitted the filing of a consolidated tax return by multiple corporations, provided the corporations were part of an affiliated group.³ The existence of an affiliated group depended basically on a common parent and its 80% or more owned subsidiaries, none of which fell in such proscribed categories as foreign corporations or insurance companies.⁴ The consolidated return was of course available only where the parent-subsidiary relationship existed, and not in the case of brother-sister corporations.⁵

The Revenue Act of 1964 has made no change whatever in the right to file a consolidated return; but it has, for taxable years beginning after December 31, 1963, eliminated the 2% additional tax previously imposed on groups (other than regulated public utilities) filing such returns.⁶ While the Treasury Department conditioned its recommendation for elimination of this 2% additional tax upon a limitation of commonly controlled corporations to only one surtax exemption,⁷ the Congress removed this additional 2% tax without imposing the limitation requested on surtax exemptions. Where the corporate tax rate for an affiliated group filing consolidated returns may previously have been 54% of taxable income, the elimination of this additional tax, combined with the general reduction in corporate income tax rates, results in a reduction of from 54% to 48% in the income tax rate applicable to groups that heretofore filed a consolidated return. Their after-tax earnings are thus increased more than 10%, without any change in earnings prior to tax.

THE 100% DIVIDEND-RECEIVED DEDUCTION

Inter-company transactions between members of an affiliated group are generally eliminated by the group filing a consolidated return. In particular, the group is permitted in consolidation to exclude from income 100% of dividends received from members of the affiliated group⁸ and is not limited to the usual 85% exclusion.⁹

The act recognizes that some affiliated groups may properly not desire or be qualified to file a consolidated return, but should still not be denied this 100% exclusion of dividends received from other members

3. INT. REV. CODE OF 1954, § 1501 [hereinafter cited as CODE §].

4. CODE § 1504.

5. Ray Engineering Co., Inc., 42 T.C. No. 88 (Sept. 29, 1964)

6. CODE § 1503(a)

7. STAFF OF HOUSE COMMITTEE ON WAYS AND MEANS, 81ST CONG., 1ST SESS., PRESIDENT'S 1963 TAX MESSAGE 36 (Comm. Print 1963).

8. Treas. Reg. § 1.1502(b)(2)(ii) (1955) [hereinafter cited as Reg. §].

9. CODE § 243(a).

of the group, provided the group accepts the principal burdens of consolidation.¹⁰ This permitted 100% exclusion may be utilized by a group that does not file a consolidated return because of practical inability to cope with the extraordinarily complex Treasury Regulations governing such returns.¹¹

Alternatively, it may be availed of because one member of the group has, and wishes to retain, a different accounting method or taxable year than other members of the group. Similarly, it may be utilized where one member of the group is an insurance company; in such a case the group is disqualified from filing a consolidated return, presumably because of the special rates and principles applicable to insurance companies. In these circumstances, provided the necessary parent and 80% owned subsidiary relationship exists, the Revenue Act of 1964 permits the 100% exclusion from taxable income of dividends received from other members of the group, provided certain requirements are met.

This 100% exclusion is available for "qualifying dividends" received from other members of the same affiliated group.¹² In order to be a qualifying dividend, the dividend must be from post-1963 earnings.¹³ Just as elsewhere in the Code, a dividend is conclusively presumed to be from the most recent undistributed earnings.¹⁴ Moreover, during the entire year from which the earnings are derived, both the payer and the payee must have been part of the same affiliated group, and that group must not have claimed separate surtax exemptions. The common parent and its subsidiaries comprising the affiliated group must file an election to obtain this 100% dividend exclusion by the due date, as extended, of the parent's tax return for the year in question.¹⁵ While this election is in effect, the group is limited to only one surtax exemption, one accumulated earnings credit, one exemption from estimated tax, and one of each of the similar limitations or exemptions applicable to corporations, notwithstanding the fact that separate tax returns were filed by the corporations forming a part of the group.¹⁶

This election of the 100% exclusion of qualifying dividends may be

10. Secretary Dillon acknowledged that earnings of an 80%-owned subsidiary are more directly the earnings of the parent than is the case where one corporation derives investment income from an unrelated corporation. STAFF OF HOUSE COMMITTEE ON WAYS AND MEANS, 81ST CONG., 1ST SESS., PRESIDENT'S 1963 TAX MESSAGE 81 (Comm. Print 1963).

11. It takes approximately 75 pages for one major tax service to set forth these Regulations.

12. CODE § 243(b)(1).

13. CODE § 243(b)(1)(B).

14. CODE § 316(a); S. REP. NO. 830, 88th Cong., 2d Sess. 76 (1964).

15. CODE § 243(b)(2). Wholly owned subsidiaries are deemed to consent to this election when it is filed by the parent. Temporary Reg. § 19.5-1(b) (1964).

16. CODE § 243(b)(3); S. REP. NO. 830, 88th Cong., 2d Sess. 76 (1964).

terminated either by filing a consent to termination by the affiliated group, or by a new member of the group affirmatively refusing to consent to the election.¹⁷ Unlike the termination of a Subchapter S election, or the termination of an election to claim multiple surtax exemptions, discussed later, in which cases termination of the election bars re-election of the special tax treatment involved for such periods as five years, there is no limitation on re-election to exclude 100% of qualifying dividends from taxable income. In this respect, this pseudo-consolidated return is markedly superior to the filing of an actual consolidated return, where the consent of the Commissioner or a significant change in the tax laws is generally required to switch back and forth from the filing of such returns.¹⁸

IMPORTANCE OF MULTIPLE SURTAX EXEMPTIONS

It has thus far been shown that when corporations are associated in such a fashion as to be designated an "affiliated group," they then may file consolidated returns or may file what amounts to pseudo-consolidated returns pursuant to which certain inter-corporate dividends are 100%-exempt from income tax. Attention is now directed to associated corporations which, under the amendments to the 1954 Code by the 1964 Act, are classified as "controlled groups." Such a classification is unfavorable, and corporations which fall in this unfortunate category are faced with three choices. Moreover, inasmuch as some associated corporations which qualify as "affiliated groups" will also qualify as "controlled groups," it follows that five rather than three choices will be available. The two optional choices have already been discussed; thus, consideration is now directed to the remaining three. Since the three choices which are peculiar to controlled groups all relate to the use of multiple surtax exemptions, it is appropriate to examine first the tax importance of these exemptions.

Tax Value of Each Surtax Exemption

The normal tax of a corporation is 22% and this rate applies to all of a corporation's income.¹⁹ The 26% added surtax, however, applies only to a corporation's taxable income in excess of \$25,000.²⁰ Thus, there is a surtax exemption which relates to the first \$25,000 of a corporation's taxable income. Manifestly, therefore, the tax value of that surtax exemption to a corporation is 26% of \$25,000, or \$6,500 in the case of any corporation which has \$25,000 or more of taxable income.

17. CODE § 243(b)(4)

18. Reg. § 1.1502-11 (1955)

19. CODE §§ 11(a), (b).

20. CODE §§ 11(c), (d)

Valuation of Multiple Surtax Exemptions

While it is true, therefore, that the value of each surtax exemption is \$6,500 (assuming throughout that a corporation's taxable income is \$25,000 or more), the aggregate value of *multiple* surtax exemptions in the case of associated corporations is not the number of corporations times \$6,500. By way of example, if three associated corporations each has more than \$25,000 of taxable income, it is quite true that the value of each exemption is 26% of \$25,000, or \$6,500. The benefit of obtaining *multiple* exemptions, as compared with the single exemption which would obtain if there were only one corporation, is manifestly not three times \$6,500, but two times \$6,500, or \$13,000. This concept is rather important to matters which will follow: the value of multiple surtax exemptions, as compared with a single exemption, will ordinarily be \$6,500 times the number of corporations reduced by one.

CHOICES IF A CONTROLLED GROUP

It is important to keep in mind that classification as a controlled group is unfavorable, and that the three choices of a controlled group are alternatives which must be faced willy-nilly, *i.e.*, its choice is only among these alternatives.²¹

Single \$25,000 Exemption Apportioned Equally

If a group of corporations in a controlled group does nothing in the way of electing one of the other two choices, then a single \$25,000 exemption will be apportioned equally among the corporations.²²

Apportionment of \$25,000 Exemption as Desired

Under the second alternative, the group of corporations is still limited in the aggregate to one \$25,000 surtax exemption, but all of the corporations may elect to apportion that \$25,000 exemption in any manner desired.²³ Suppose, for example, the taxable income of Corporation No. 1 is \$15,000 and the taxable income of Corporation No. 2 is \$10,000, the two corporations being the sole members of a controlled group. Manifestly, an equal apportionment of the surtax exemption would result in Corporation No. 1 needlessly paying a 26% surtax on \$2,500 of its \$15,000 of taxable income; that is to say, \$2,500 of the

21. CODE §§ 1561-62.

22. CODE §§ 1561(a)(1), (2), 1562.

23. CODE § 1561(a)(2).

surtax exemption would be lost. Accordingly, both corporations should elect to apportion the single \$25,000 surtax exemption so that Corporation No. 2 claims only \$10,000, but Corporation No. 1 has available to it \$15,000 of that exemption.

Election of Multiple Surtax Exemptions

By far the most fascinating alternative is that of electing multiple surtax exemptions. Under this provision, the various corporations of a controlled group can elect to have each corporation accorded a full \$25,000 of surtax exemption.²⁴ If that is done, however, there is an added 6% tax on each corporation's taxable income up to \$25,000.²⁵ Thus, the first \$25,000 of each corporation's taxable income will be taxed not at the conventional rate of 22%, but at a rate of 28%.

The question of whether to elect multiple surtax exemptions arises frequently in the everyday business practices of lawyers. As a result, it is important that attorneys realize that before they can properly advise on this third choice it will be necessary for them to compare the advantage of electing multiple surtax exemptions with the cost of electing such exemptions.

It has been shown above that generally the advantage of multiple surtax exemptions, as compared with the advantage of a single surtax exemption, is \$6,500 times the number of corporations minus one. As has been shown, there is a cost in obtaining this advantage: 6% of each corporation's taxable income up to \$25,000.

In making a decision of whether or not to elect multiple surtax exemptions, it will be necessary to compare the above advantage with the above cost. The net saving or the net detriment will of course lie in the excess of the advantage over the cost, or the cost over the advantage, as the case may be.

For those who are opposed to the use of formulae, there is a longer way of arriving at the same comparison. Under this alternative method, one simply computes the total taxes of a group of corporations which do not elect the multiple surtax exemptions, and then compares that figure with the total taxes which result if the election is chosen. The following two examples are illustrative of this method. In both examples assume two corporations with aggregate taxable incomes of \$50,000. In Example No. 1, assume that each corporation has \$25,000 of taxable income. The tax results then work out as follows:

24. CODE § 1562(a)(1).

25. CODE § 1562(b)

EXAMPLE NO. 1

(Two corporations each with \$25,000 taxable income)

a. <i>If no election:</i>		
22% of \$50,000	-----	\$11,000
26% of \$25,000	-----	6,500
		<hr/>
		\$17,500
b. <i>If elect:</i>		
28% of \$50,000	-----	\$14,000
		<hr/>
<i>Saving by electing</i>	-----	<u>\$ 3,500</u>

The election saves \$3,500 in taxes. However, that can be checked out rather readily with use of the formula suggested above. The value of the multiple surtax exemption in this case is one (*i.e.*, the two corporations minus one) times \$6,500, or \$6,500, as compared with the cost of electing the exemption which is 6% of \$50,000, or \$3,000. The resulting indicated saving is \$3,500.

In Example No. 2, the two corporations still have aggregate taxable incomes of \$50,000, but it will be assumed that Corporation No. 1 has taxable income of \$49,000 whereas Corporation No. 2 has taxable income of only \$1,000. In this case, the taxes and the indicated loss by electing the multiple surtax exemptions work out as follows:

EXAMPLE NO. 2

(One corporation with \$49,000 and the second corporation with \$1,000 of taxable income)

a. <i>If no election:</i>		
22% of \$50,000	-----	\$11,000
26% of \$25,000 (Assume exemption is not spread equally but is allocated so that first corporation received at least \$24,000 of the exemption.)	-----	6,500
		<hr/>
		\$17,500
b. <i>If elect:</i>		
22% of \$50,000	-----	\$11,000
6% of \$26,000	-----	1,560
26% of \$24,000	-----	6,240
		<hr/>
		\$18,800
<i>Loss by electing</i>	-----	<u>\$ 1,300</u>

The loss by electing the multiple surtax exemptions in Example No. 2 can also be readily checked against the suggested formula. The cost of the election is 6% of \$26,000 (*i.e.*, each corporation's taxable income up to \$25,000), or \$1,560. The advantage of the election, however, is rather minimal. If only a single surtax exemption is used, \$25,000 of taxable income is exempt from the 26% surtax; if by contrast multiple surtax exemptions are used, only \$26,000 of taxable income is exempted from surtax, because the second corporation has only \$1,000 of taxable income. As a result, the election excludes from surtax only an additional \$1,000 of taxable income. Therefore, the election saves in gross only \$260, as compared with the cost of \$1,560, resulting in the above indicated loss of \$1,300.

It has been widely suggested that, as a rule of thumb, when a controlled group of corporations has aggregate taxable income in excess of approximately \$32,500 and when none of the corporations has a loss, it will generally pay for that group of corporations to elect multiple surtax exemptions. That suggestion is exactly what it purports to be, merely a rule of thumb. Example No. 2 above demonstrates this rather vividly; the corporations have an aggregate taxable income of \$50,000, but as has been shown there is actually a substantial loss by electing multiple surtax exemptions in spite of the fact that the aggregate corporate income is substantially above the level suggested by the rule of thumb. The moral is, of course, that such a rule of thumb cannot be depended upon in actual practice.²⁶

COMMON TAXABLE YEAR

If in a given taxable year two or more corporations are members of a controlled group, they are then faced with the alternative tax choices which have been discussed. As a result, it becomes necessary to determine which taxable years are under consideration for members of a controlled group when the different corporations have different taxable years. Although the new tax provisions for this purpose use the term "taxable year,"²⁷ reference herein will be made to the "common taxable year." To determine the common taxable year for a group of corporations, it is necessary to look at a given December 31. The common taxable year for all members of a controlled group is that taxable year for each of them which ends on a given December 31, or embraces a given

26. Mr. Edward J. Hawkins, Jr., suggests that the rule of thumb will work universally when stated in this qualified fashion: A controlled group should elect multiple surtax exemptions whenever the aggregate taxable incomes (*excluding taxable income over \$25,000 in the case of each corporation*) exceed \$32,500, and vice versa. Repeated tests have failed to prove him wrong.

27. CODE §§ 1561(a), 1561(a)(2), 1563(b)(1), (2)

December 31.²⁸ For purposes of illustration, assume a simple example of Corporation No. 1 whose calendar year ends December 31, 1964, and Corporation No. 2 whose fiscal year ends September 30, 1965. Those two years are common years for the two corporations, and if they are members of a controlled group then only one surtax exemption is available to them for those years,²⁹ unless they elect the multiple surtax exemption option and pay the added 6% tax.³⁰

MANNER AND TIME OF MAKING ELECTION

Election to Apportion One Surtax Exemption Equally

Temporary Regulations have been issued setting out a rather exceptional rule applicable to corporations with years ending prior to December 31, 1964, which corporations desire to apportion a simple surtax exemption equally.³¹ At this late date there is little concern with that exceptional rule. The general rule respecting corporations having years ending December 31, 1964 or later, however, is of great importance. Although the statute itself is not specific and expressly leaves the manner and time of making an election up to the Commissioner in his Regulations,³² these temporary Regulations now provide that election must be made on or before three years after the return due date for that corporation whose tax return due date is the earliest in a given component group for a given common taxable year.³³ Suppose, however, that instead of waiting until the latest possible date to make an election, this determination to apportion one \$25,000 surtax exemption unequally is made at the time the earliest return is filed, or at any rate before the time limit has expired. Suppose further that on audit of the tax returns by an Internal Revenue agent, the taxable income is shifted around among the corporations in such a fashion as to make it advisable to reallocate the one surtax exemption. Will it be permissible to reallocate that \$25,000 even though a different election was previously made? The Regulations do not deal with this question, but presumably the answer will be in the affirmative, so that reallocation will be permitted within the time allowed for an original election; perhaps the permanent Regulations will purport to answer this question.

Election of Multiple Surtax Exemptions

The new law is explicit on when multiple surtax exemptions may be elected. This option may be exercised at any time within three years

28. *Ibid.*

29. CODE § 1561.

30. CODE § 1562.

31. Temp. Treas. Reg. § 19.5-1(b) (1964).

32. CODE § 1561(a)(2).

33. Temp. Treas. Reg. § 19.5-1(a) (1964).

after the due date of the earliest income tax return for a controlled group with respect to any given common taxable year.³⁴ The law is explicit that this three-year period is not extended by virtue of any extension of time for filing a tax return.³⁵ The election, once made, will hold over from year to year and it is not necessary to refile.³⁶ Explicit provision is made for termination at any time within the same three-year period, this termination to be exercised by unanimous consent of all members of the controlled group, or if a new member has come into the group, then by that member filing a non-consent.³⁷ In order to prevent vacillation back and forth, there is express provision that once a multiple surtax exemption has been terminated, the election may not be reinstated for approximately five years thereafter.³⁸

DEFINITION OF "CONTROLLED GROUP"

It has been shown that a controlled group is an unfavorable classification because such controlled group members are remitted to a single surtax exemption, or a 6% added tax for electing multiple surtax exemptions. Accordingly, it becomes necessary to determine when this unfavorable classification as a controlled group exists.

Parent-subsidary Corporations

A parent-subsidary chain of corporations may qualify unfavorably as a controlled group. In order to qualify each corporate member of the group, excepting the parent corporation, must have 80% of its stock, reckoned by vote or value, owned by one or more of the other corporations in the chain.³⁹ Furthermore, there must be a parent corporation which owns 80% or more, by vote or value, of one or more of the corporations in that same chain.⁴⁰ The definition of a controlled group for the purpose of determining whether a parent-subsidary relationship will qualify as such a group is somewhat similar to a definition of an "affiliated group" for purposes of determining whether consolidated returns or pseudo-consolidated returns may be filed.⁴¹ In the latter connection, however, only an 80% voting test obtains, while for purposes of an affiliated group the 80% test is met if there be either a stock voting or a stock value qualification. As a result, it will be appreciated that whenever a parent-sub-

34. CODE § 1562(e).

35. CODE § 1562(e)(1).

36. CODE § 1562(a)(2).

37. CODE § 1562(c).

38. CODE § 1562(d).

39. CODE § 1563(a)(1)(A).

40. CODE § 1563(a)(1)(B).

41. See CODE § 1504(a)(1).

subsidiary relationship qualifying as a controlled group exists, that same group will always qualify as an affiliated group; in addition, however, because of the additional 80% value test for purposes of a controlled group, a controlled group will frequently exist, given a vertical chain of corporations, where qualification is not met for purposes of an affiliated group.

Brother-sister Corporations

The controlled group concept is broader than the affiliated group concept in an even more important respect. Thus, brother-sister corporations qualify as members of a controlled group whenever there exists two or more corporations 80% of whose stock, reckoned by vote or value, is owned by one individual, estate or trust.⁴² In view of the requirement that 80% of the stock be owned by *one* individual, estate or trust, one might suppose that unfavorable classification of a brother-sister group of corporations can be easily avoided. Unfortunately, however, things are not that easy because, as will be shown presently, a new set of the ubiquitous attribution rules has been formulated for the purpose of attributing constructive ownership of stock where actual ownership does not exist.

Combinations of Parent-subsidiary and Brother-sister Groups of Corporations

The law recognizes that in groups of three or more corporations one or more of such corporations might qualify both as a member of a parent-subsidiary controlled group and as a member of a brother-sister controlled group.⁴³ In such a case, the two groupings are aggregated and the parent-subsidiary controlled group, as well as the brother-sister controlled group, are treated as a single controlled group.

As a general rule, in determining whether the 80% stock test is met so that a controlled group does exist, one looks to the stockholding situation as of a given December 31.⁴⁴ This December 31 date, for purposes of determining application of the 80% test, ties in with the concept of a common taxable year. As has been shown, the common taxable years for various members of a controlled group are those taxable years which end on a given December 31, or embrace a given December 31. To this rule that a corporation qualifies or disqualifies as a member of a controlled group depending upon stock ownership as of a given Decem-

42. CODE § 1563(a)(2).

43. CODE § 1563(a)(3).

44. CODE § 1563(b).

ber 31, however, there are two exceptions to which attention is now directed.

Additional Members

Even though a corporation is not a member of a controlled group on a given December 31 and hence does not fall within the general rule respecting controlled group membership, if that corporation meets the 80% stock requirement for one-half or more of the days prior to December 31 falling within that corporation's particular fiscal year, then that corporation will nevertheless be deemed a member of the controlled group.⁴⁵ By way of example, assume a corporation with a fiscal year ending November 30, 1965. Assume that this corporation's stock was owned 100% by an individual who also owns 100% of the stock in a second corporation. Assume, however, that this individual disposes of his stock in the first corporation on December 17, 1964. As a result, the first corporation is not a member of the controlled group under that general rule on December 31, 1964, the critical date under the general rule. Under this exceptional rule, however, the first corporation is treated as an additional member of the controlled group because for more than one-half of the days falling prior to December 31, 1964, such days being within its November 30, 1965 fiscal year, it did meet the 80% stock ownership test.

Excluded Members

The excluded member exclusion is a corollary to the additional member exception. Thus, even though a corporation on December 31 meets the test as a member of a controlled group, if it was a member for less than one-half of its days prior to a given December 31, which days fall within its taxable year embracing that December 31, then it will be excluded as a member of the controlled group.⁴⁶ Assume again a corporation with a November 30 fiscal year. Assume further that 100% of its stock was acquired on December 17, 1964, by the same person who owns 100% of the stock in a second corporation. Even though that second corporation qualifies as a member of a controlled group under the general December 31 rule, it was a member for less than one-half of its days ending prior to December 31, 1964, which days fall within its November 30, 1965 fiscal year; accordingly, it is deemed an excluded member.

Manifestly, these exceptional rules dealing with additional and excluded members will lead in some cases to unexpected paradoxical results,

45. CODE § 1563(b)(3)

46. CODE § 1563(b)(2).

as in the two examples discussed above. As corporate advisors it will be necessary for attorneys to be aware of these rules in the planning stages in determining whether and how to reset stock ownership to avoid controlled group qualification.

Attribution Rules

In the case of parent-subsidary groups, stock owned by one owner, but subject to an option, is attributed to the optionee and treated as constructively owned by that optionee.⁴⁷ The same rule applies in determining brother-sister controlled groups, but in the case of such groups an additional series of attribution rules also applies.⁴⁸ Thus, stock owned by a partnership is attributed to its partners, stock owned by estates and trusts to its beneficiaries, and stock owned by corporations to its stockholders; oddly enough, however, the converse of these rules does not apply so that, for example, stock owned by partners is not attributed to a partnership. With an exception of limited application, stock is attributed between spouses and between minor children and parents. If an individual owns 50% or more in vote or value of stock, then there is attribution between adult children and parents and between grandchildren and grandparents.

Excluded Stock

It has been observed that an 80% vote or value test is used in determining whether a controlled group of corporations exists. Of intense practical importance in this connection, however, are detailed provisions for excluding as outstanding stock certain stock in certain situations.⁴⁹ Thus, nonvoting preferred stock is not counted.⁵⁰ While that exception is rather understandable, there is a whole series of other exceptions which no doubt will frequently be overlooked and which offer some very real pitfalls. Thus, where one corporation in a parent-subsidary set-up owns 50% or more in stock or value of another corporation's stock, the other stock (*i.e.*, the stock not owned by that corporate holder of 50% or more of the subsidiary's stock) is excluded if the other stock in the subsidiary is held by a trust pursuant to a plan of deferred compensation, or if the other stock in the subsidiary is owned by a principal stockholder of the parent (as defined) or by an officer of the parent, or if the other stock is owned by an employee of the subsidiary and is subject to certain conditions respecting disposition of that stock running in favor of the parent

47. CODE §§ 1563(d)(1), (e)(1), (f).

48. CODE §§ 1563(d)(2), (e), (f).

49. CODE § 1563(c).

50. CODE § 1563(c)(1)(A).

or subsidiary.⁵¹ In a rather similar fashion, in the case of brother-sister relationships, certain other stock is excluded and not counted where an individual, estate or trust owns 50% or more in vote or value of the stock of a given corporation, where that other stock is held by a qualified employees' pension or profit-sharing trust, or where that other stock is cluttered with certain conditions respecting its disposition and these conditions run in favor of the corporation or its principal stockholder (as defined)⁵²

In brief, when 50% or more in vote or value of the stock of a given corporation is owned by another corporation, individual, estate or trust, then the additional outstanding stock of that given corporation is not counted as outstanding if the conditions set out in the statute apply. At the practical level, the importance of the exclusion of this other stock is that although in general, absent 80% actual or constructive stock ownership, the unfavorable controlled group rules will not apply, corporate advisors must be on their guard whenever 50% or more of the stock is actually or constructively owned. Caution is then in order for if the other stock is excluded and treated as not outstanding, then for purposes of the 80% computation one might find that 50% or more, but less than 80% of the stock which is owned, jumps up to 80% or more of that stock which is counted. This is a very real trap unless this excluded stock concept is borne in mind.

CONTINUING BARRIERS TO MULTIPLE SURTAX EXEMPTION

It has been shown that the Revenue Act of 1964 does not preclude the claiming of multiple surtax exemptions, but only imposes a 6% higher tax rate on the first \$25,000 of taxable income for each corporation in a controlled group claiming separate surtax exemptions. However, acceptance of this 6% additional tax may not be sufficient to protect a corporation's claim to a separate surtax exemption. Nothing in the act limits the applicability of sections 269, 482 or 1551 to members of a controlled group that elect multiple surtax exemptions, and the committee reports make it abundantly clear that the application of these statutes to multi-corporate enterprises continues unabated.⁵³ Thus, section 269 may be invoked to deny surtax exemptions where there has been an acquisition of control of a corporation where the *principal purpose* was to secure an additional surtax exemption.⁵⁴ Of course, where the

51. CODE § 1563(c)(2)(A).

52. CODE § 1563(c)(2)(B).

53. H.R. REP. NO. 749, 88th Cong., 1st Sess. 118 (1963); S. REP. NO. 830, 88th Cong., 2d Sess. 150 (1964)

54. James Realty Co. v. United States, 280 F.2d 394 (8th Cir. 1960).

taxpayer is able to establish that its *principal purpose* in a multiple corporate operation was not the securing of additional surtax exemptions, section 269 cannot be utilized to deny that tax benefit.⁵⁵

An additional barrier to multiple surtax exemptions is section 482 which permits the reallocation of income, deductions, credits and allowances between commonly-controlled entities when the Commissioner determines that reallocation is necessary to prevent tax evasion or clearly to reflect income.⁵⁶ Likewise, section 61 has been utilized, and may in the future continue to be utilized, to tax income of an entire group of corporations to one corporation of this group if the income is really earned by that corporation.⁵⁷

Finally, section 1551 which applies to transfers of property to a new or previously dormant corporation where a major purpose for the transfer was the securing of an additional surtax exemption, not only may continue to be utilized by the Service against a multi-corporate enterprise, but has been significantly strengthened by the Revenue Act of 1964.

Enlarged Scope of Section 1551

Prior to the Revenue Act of 1964, it was a relatively simple matter to protect additional surtax exemptions from the bite of section 1551 since the applicable Treasury Regulations indicated this section did not apply to indirect transfers of property, but only to direct ones. As a consequence, the Commissioner was frequently forced to rely on sections 269 or 482, rather than utilizing section 1551 with its references to "a major purpose" rather than "the principal purpose." However, the amendments to section 1551, which apply to transfers after June 12, 1963, will permit the Service to invoke this section with greater ease. In fact, high officials of the Internal Revenue Service have indicated that they consider these amendments to provide the most effective weapon available against further proliferation of multi-corporate operations.

Application to indirect transfers.—Section 1551 now applies not only to direct transfers of property between corporations and a clear splitting-up of the assets or operations of a corporation, but also to indirect transfers of property other than money.⁵⁸ However, the section continues to be inapplicable where the transfer to the new corporation is only of money, and that money is not utilized to acquire property from the shareholder-transferor.

Statements of congressional leaders on the floor of Congress indicate

55. Bush Hog Mfg. Co., Inc., 42 T.C. No. 52 (July 16, 1964).

56. Compare Hamburgers York Road, Inc., 41 T.C. 821 (1964), with Bush Hog Mfg. Co., Inc., *supra* note 55.

57. Shaw Constr. Co. v. United States, 323 F.2d 316 (9th Cir. 1963).

58. 110 CONG. REC. 3401, 3428-29 (daily ed. Feb. 25, 1964).

that section 1551 is, however, not intended to be utilized against indirect transfers of property that are a normal consequence of expansion of business activities, as opposed to a mere change of location or organization of a business activity previously conducted.⁵⁹ Of course, there is no test provided for defining what is a business expansion, and presumably protracted litigation will be necessary before such a test is available.

Transfers by individuals and commonly controlled corporations.—In addition, the act extends section 1551 for the first time to transfers of property to a new corporation by individuals, as well as to transfers by commonly-controlled corporations. It now applies to transfers of property (other than money) by five or fewer individuals where these individuals are in control of another corporation. In such cases, where a major purpose for the transfer was the securing of an additional surtax exemption, section 1551 results in the loss of that separate surtax exemption.⁶⁰

With respect to transfers by five or fewer individuals, they must possess control of both the transferee corporation and another corporation. For this purpose, control requires ownership of stock with at least 80% of the voting power or value of both corporations, and more than 50% of the stock when taking into account only identical stockholdings of both corporations.⁶¹ To illustrate this latter requirement, assume shareholders *A*, *B*, and *C* own 10%, 70%, and 20% respectively, of the stock in Corporation X, and 70%, 5%, and 25% respectively, of the stock in Corporation Y

	Corporation X	Corporation Y	Identical Stockholdings
<i>A</i> -----	10%	70%	10%
<i>B</i> -----	70	5	5
<i>C</i> -----	20	25	20

In this example, the identical stockholdings total only 35% and as a consequence section 1551 is inapplicable. However, should *B* sell *A* 20% of the shares of Corporation X, the identical stockholdings would increase to 55% and section 1551 might apply. In computing stock ownership of individuals for control purposes under section 1551, the attribution rules that apply to controlled groups are applicable.⁶²

Finally, if either section 1551 or section 269 results in the disallowance of a surtax exemption, the additional 6% tax generally applicable to a controlled group of corporations electing separate surtax exemptions

59. CODE § 1551(a)(3).

60. CODE § 1551(b)(2)

61. H.R. REP. NO. 749, 88th Cong., 1st Sess. A212-13 (1963).

62. CODE § 1551(b).

does not apply.⁶³ However, this provision for the inapplicability of the additional 6% tax does not apply to cases of reallocation of income such as section 482 presents. Of course, if as is usually the case the Commissioner utilizes section 482 to reallocate all of a corporation's income, no practical problem occurs.

CONCLUSION

As has been shown, an affiliated group of corporations may file a consolidated return without payment of additional tax, or file separate returns and exclude 100% of dividends received from other members of the group from income. A controlled group of corporations also has a number of choices, dividing one surtax exemption equally or disproportionately within the group, or claiming separate surtax exemptions and paying a 28% tax on the first \$25,000 of each corporation's taxable income. In any event, the Revenue Act of 1964 presents a multi-corporate enterprise with numerous and difficult alternatives. And even after electing the course it will follow, such an enterprise continues to face the traditional hurdles of sections 269, 482 and 61, as well as an expanded section 1551. Clearly, sound guidance from competent tax practitioners is a necessity in reaching decisions in this area.

63. CODE § 1562(b)(1)(B).