

Acquisitions for Tax Benefit*

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I. INTRODUCTION

IN THESE DAYS of high income and excess profits taxes, it is only natural for corporate taxpayers to devise means by which they may reduce their tax burden.¹ On the other hand, in these days of high governmental expenditures and ever mounting national debt, it is likewise natural for the Treasury Department and Congress to take steps to prevent taxpayers from "improperly" reducing their tax burden.²

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*The scope of this article is similar to the article of Mr. Harry J. Rudick, *Acquisitions Made to Avoid Income or Excess Profits Taxes: Section 129 Internal Revenue Code*, (1944) 58 HARV. L. REV. 196 (hereafter referred to as Rudick).

The author acknowledges his debt to Mr. Rudick for his stimulating review of the subject. Ordinarily it would be inappropriate to write another article on this subject within such a short time of the publication of Mr. Rudick's article. However, since Mr. Rudick in writing his article apparently did not have the benefit of the regulations promulgated under section 129 (Mr. Rudick's article appeared in the December, 1944, issue of the Harvard Law Review and the regulations were promulgated on December 29, 1944) and in view of the wide divergence between Mr. Rudick's views and those of the author, not only as to the scope of section 129, but also as to the rules laid down by the cases arising prior to the effective date of section 129, and the importance of the subject, the author has ventured to write this article thereon.

As used in this article, the term "code" refers to the Internal Revenue Code, and, unless otherwise indicated, all statutory references are to provisions in the Internal Revenue Code; thus the citation "§112(b)(5)" refers to §112(b)(5) of the Internal Revenue Code.

¹ Tax avoidance is to be contrasted with tax evasion. See opinion of Justice Holmes in *Bullen v. Wisconsin* (1916) 240 U.S. 625, 630-31, where the Justice said:

"We do not speak of evasion, because, when the law draws a line, a case is on one side of it or the other, and if on the safe side is none the worse legally that a party has availed himself to the full of what the law permits. When an act is condemned as an evasion, what is meant is that it is on the wrong side of the line indicated by the policy if not by the mere letter of the law."

See PAUL, *Restatement of the Law of Tax Avoidance*, appearing in his *STUDIES IN FEDERAL TAXATION*.

² The ethical side of tax avoidance as far as possible will be disregarded in the discussion of the cases. The line between legitimate and illegitimate tax avoidance is hard to draw and, to a large extent, is personal to the individual drawing the line. It must be admitted, however, that it has a considerable influence on the decision.

One of the means now employed by corporations for the purpose of tax reduction is to acquire the assets or the control of another corporation and thereby (1) obtain the benefit of some deduction or credit which, under the code, is incident to the acquired assets or is enjoyed by the acquired corporation, or (2) create some credit or deduction, or (3) enjoy the benefit of some credit or deduction which it already has.³

The courts have gone very far in denying taxpayers tax benefits sought to be gained from sham transactions.⁴ There is language in some cases which may indicate that the courts, in order to protect the revenues, may extend their vigilance in denying tax benefits to situations not involving sham transactions.⁵

In the type of transaction here under consideration, we are not primarily concerned with sham transactions. In the *Gregory v. Helvering* line of cases the taxpayer has sought to take advantage of some special privilege granted by the code, such as those granted by the "tax-free" reorganization provisions of section 112, by devising a transaction which in form only meets the requirements of the code provision.⁶

The claim that the transaction is sham is not an important factor in the cases here under consideration. For example, Corporation *A* acquires by statutory merger the assets of Corporation *B*, the value of which is substantially lower than their basis in the hands of *B*. Thereby *A* seeks to take advantage of this higher basis, either by

³ For example:

(i) *A* acquired, by merger with *B*, *B*'s assets having a basis to *B*, and accordingly to *A*, far in excess of their fair market value, hoping thereby to offset the depreciation of the assets based on the high basis against its income.

(ii) *A*, having high excess profits taxes for 1945, acquires *B* in 1946 and transfers its income producing business. *A* retains certain loss producing assets, thereby hoping to create a loss carry-back and an unused excess profits credit carry-back in order to obtain a refund of the 1945 excess profits taxes.

(iii) *A* anticipates a loss for 1946 and acquires an income producing business to offset against the loss

⁴ See *Gregory v. Helvering* (1935) 293 U.S. 465.

⁵ See *Higgins v. Smith* (1940) 308 U.S. 473. *Cf.*, however, *Moline Properties, Inc. v. Commissioner* (1943) 319 U.S. 436, and *National Investors v. Hoey* (C.C.A. 2d, 1944) 144 F. (2d) 466.

⁶ In *Gregory v. Helvering* the sole stockholder of *A* desired to acquire certain securities held by *A*. With this plan in mind, the stockholder incorporated *B* and had *A* transfer the securities to *B*. (This would have been "reorganization" under the Revenue Act then in effect). Thereupon the taxpayer acquired the securities on the liquidation of *B*, on which liquidation the taxpayer would ordinarily have realized a capital gain or loss. *Held*, a property dividend by *A* and not a "reorganization."

claiming a deduction for a capital loss on the sale of the assets, or for depreciation thereon, or an increased credit under the excess profits tax law.⁷ Assuming that the transaction meets the requirements of section 112 relating to tax-free "reorganizations" and that the stockholders of Corporation *B* were given only stock of Corporation *A*,⁸ there is nothing sham about the transaction and it would appear that this transaction would not come within the rule of *Gregory v. Helvering*.⁹

In cases of transactions of this kind between corporations controlled by the same interest, the courts have the assistance of section 45, which confers on the Commissioner broad powers to reallocate income between such corporations.¹⁰ With the view in mind that the rule laid down by the cases and the scope of section 45 were not sufficiently broad to meet the problem, Congress by section 128 of the Revenue Act of 1943 added section 129 to the code. It generally provides for the disallowance of the benefit of credits, deductions and allowances resulting from the acquisition of the assets of one corporation by another corporation, or the control of a corporation by any person or persons, where the principal purpose of the acquisition was evasion or avoidance of federal income or excess profits taxes.¹¹

Before discussing section 129, we will first consider the rule of the cases obtaining before its adoption.¹²

⁷ *A* would claim that the transaction was a "reorganization" under section 112(g)(1)(A) and accordingly it inherited the basis of such property in the hands of *B* for the purpose of determining gain or loss on the sale thereof [§113(a)(7)]; and for the purpose of taking depreciation [§114(a)]; that under the excess profits tax provisions it was entitled to increase its invested capital credit by the amount of the basis of the acquired assets. Supplement C of Sub-Chapter E of Chapter 2 of the code.

⁸ See *Pinellas Ice & Cold Storage Co. v. Commissioner* (1933) 287 U.S. 462; *Helvering v. Minnesota Tea Company* (1935) 296 U.S. 378; and *LeTulle v. Scofield* (1940) 308 U.S. 415.

⁹ Mr. Rudick appears to take the view that the rule of *Gregory v. Helvering* would apply in the event the stockholders of Corporation *B* only received a small amount of stock, Rudick, 58 HARV. L. REV. 196, 221. It is submitted that Mr. Rudick is in error. *Infra* p. 55 *et seq.*

¹⁰ See *Asiatic Petroleum Co. v. Commissioner* (C.C.A. 2d, 1935) 79 F. (2d) 234; *G.U.R. Co. v. Commissioner* (C.C.A. 7th, 1941) 117 F. (2d) 187; *National Securities Corp. v. Commissioner* (C.C.A. 3d, 1943) 137 F. (2d) 600; *Cf. Continental Oil Co. v. Jones* (C.C.A. 10th, 1940) 113 F. (2d) 557; *National Investors v. Hoey* (C.C.A. 2d, 1944) 144 F. (2d) 466.

¹¹ H.R. REP. No. 871, 78th Cong., 1st Sess. (1943) p. 49; SEN. REP. No. 627, 78th Cong., 1st Sess. (1943) p. 59; CONFERENCE REP. No. 1079, 78th Cong., 2d Sess., comments in regard to Amendment 61, p. 16.

¹² This discussion will serve several purposes: (i) it will furnish a background for the consideration of section 129; (ii) it will serve as a statement of the law in effect prior

II. RULE PRIOR TO SECTION 129

For the purpose of analysis, it is necessary that acquisitions of this kind here under consideration be divided into four groups:¹³

- (a) Acquisition of the control of a corporation for the purpose of including it as a member of an affiliated group in a consolidated tax return.
- (b) Direct acquisition of the assets of one corporation by another corporation.
- (c) Acquisitions of the control of a corporation for the purpose of transferring to it the assets of another corporation.¹⁴
- (d) Acquisition between members of the same controlled group of corporations. The addition of the element of common control changes the situation, since on the basis of this added element the Commissioner has the assistance of section 45.

A. ACQUISITION OF CONTROL OF CORPORATION—INCLUSION IN CONSOLIDATED RETURN

In this type of acquisition, for example, Corporation *A* acquires all the stock of Corporation *B* which has some large credit or deduction such as a loss carry-over which *A* seeks to offset against its income by the filing of a consolidated return including itself and *B*. In view of certain recent amendments to the regulations on consolidated returns,¹⁵ corporate taxpayers have been effectively prevented from further employing this type of acquisition to gain tax advantage.

to the effective date of section 129 (§129 is applicable to taxable years commencing after December 31, 1943, and is applicable only in case the acquisition took place on or after October 8, 1940 (see §128(c) of the Revenue Act of 1943 providing for effective date); and (iii) it will serve as a basis for determining whether any loopholes have been left under section 129. The latter consideration is particularly pertinent in the case of acquisitions between corporations controlled by the same interests, since section 129 generally is not applicable to such transactions. See Senate Finance Committee Report on the Revenue Act of 1943; SEN. REP. No. 627, 78th Cong., 1st Sess., p. 59, 61.

¹³ Each of the four classes of acquisition noted gives rise to separate and distinct problems and it would only serve to confuse, as is hereinafter more fully set forth, to indiscriminately apply rules arising in connection with one class of transactions to another class of transactions. For example, the transactions discussed under (a) require the application of sections 141 and 730 of the code (relating to consolidated returns) and transactions discussed under (b) require the application of section 113(a)(7) (relating to substituted basis of assets acquired by a corporation on a "reorganization") and cases coming under (d) require application of section 45.

¹⁴ Cases where the acquired corporation is liquidated, its assets being transferred to the acquiring corporation are discussed under (b).

¹⁵ See particularly Regulations 104, §23.31 (d) (11) and Regulations 111, §§33-31 (c) (14) and (16).

However, even in the absence of the assistance of any regulation on the matter, the courts have established certain rules denying to corporate taxpayers certain advantages from this type of acquisition. These cases will be discussed before we examine the regulations.

The leading case is *Woolford Realty Co. v. Rose*.¹⁶ In this case the Court held that under the Revenue Act of 1926 a net loss carry-over of a member of an affiliated group could be deducted only from the income of such member where the loss arose prior to the time of its affiliation. The Court in reaching this conclusion pointed out that, under the provisions of the 1926 Revenue Act authorizing deduction of loss carry-overs, provision was made that the loss carry-over of any corporation should be deducted from *its* net income and that any excess of such net loss carry-over over the income of such year could be deducted against its net income for the next succeeding year. The Court in support of its decision further pointed out that any other construction would permit corporations having large income to acquire control of other corporations which have suffered losses in prior years and thereby use a loss carry-over based thereon to wipe out their own income. In this connection the Court said:¹⁷

"Doubt, if there be any, is not likely to survive a consideration of the mischiefs certain to be engendered by any other ruling. A different ruling would mean that a prosperous corporation could buy the shares of one that had suffered heavy losses and wipe out thereby its own liability for taxes. The mind rebels against the notion that Congress in permitting a consolidated return was willing to foster an opportunity for juggling so facile and so obvious. *Submission to such mischiefs would be necessary if the statute were so plain in permitting the deduction as to leave no room for choice between that construction and another.* Expediency may tip the scales when arguments are nicely balanced. True, of course, it is that in a system of taxation so intricate and vast as ours there are many other loopholes unsuspected by the framers of the statute, many other devices whereby burdens can be lowered. This is no reason, however, for augmenting them needlessly by the addition of another. The petitioner was prosperous in 1927, and so far as the record shows for many years before. Piedmont was unfortunate in 1927, and unfortunate in the years preceding. The petitioner, affiliating in 1927, has been allowed the loss suffered by Piedmont though the business of that year as a permissible deduction from the consolidated balance. What it claims is a right to deduct the losses that were suffered in earlier years when the

¹⁶ (1932) 286 U.S. 319.

¹⁷ *Ibid.* at 329-30.

companies were separate. To such an attempt the reaction of an impartial mind is little short of instinctive that the deduction is unreasonable and cannot have been intended by the framers of the statute. Analysis of the sections shows that there is no gap between what they wrote and what in reason they must have meant." (Italics supplied).

It is important to note that this latter argument of the Court was used only to support its construction of the statutory provision in regard to loss carry-overs, and that the Court in the *Woolford Realty* case did not deny the taxpayer the benefit of the loss carry-over on the ground that it had acquired control of a subsidiary with the intention of obtaining the benefit of the loss carry-over. Indeed the court admitted it would have been powerless to deny the deduction if it had been clearly provided for by the Act. Under the reasoning of the Court's opinion the benefit of the subsidiary's loss carry-over would have been denied the taxpayer irrespective of its intention in acquiring the control of the subsidiary.¹⁸ This was the holding of the Court in *Planter's Cotton Oil Co. v. Hopkins*,¹⁹ which was decided one week after the decision in the *Woolford Realty* case.

In the *Planter's Cotton Oil* case two joint stock associations suffered a loss in their business and thereafter an individual owning 98% of their stock caused the associations to transfer their assets to a newly formed corporation which he likewise controlled. A consolidated return was filed by the newly formed corporation and the joint stock associations. It was held that the loss carry-overs of the joint stock associations could not be applied against the income of the newly formed corporation under the rule of the *Woolford Realty* case. In applying the rule of the *Woolford Realty* case the Court gave no weight whatsoever to the fact that the ultimate ownership of the associations and the corporation was practically identical or to the fact that it was the same identical assets which in the earlier year had produced the loss and in the later year produced the net income.

The rule of the *Woolford Realty* case has been extended to cases where a loss was realized during the affiliation and during the period for which consolidated returns had been filed.²⁰ The extent of the holdings in these cases gives further support to the point that the decision in the *Woolford Realty* case is predicated not on grounds

¹⁸ Cf. for an apparently different view of this case Rudick, 58 HARV. L. REV. 196, 217.

¹⁹ (1932) 286 U.S. 332.

²⁰ *Delaware & Hudson R.R. Co. v. Commissioner* (C.C.A. 2d, 1933) 65 F. (2d) 292; *American Pacific Whaling Co. v. Commissioner* (C.C.A. 9th, 1938) 100 F. (2d) 46.

of tax avoidance but entirely on a strict construction of the statutory provisions allowing loss carry-overs. It would appear that in the absence of a regulation to the contrary, under the code in view of the above decisions, net operating loss deductions under section 122, capital loss carry-overs under section 117(e) and unused excess profit credits under section 710(c) could be deducted or applied on consolidated returns only against the income of the corporation which realized the loss or had the unused credit.²¹

The holding in the *Woolford Realty* case was greatly extended by the Board of Tax Appeals in *J.D. & A.B. Spreckels Co. v. Commissioner*.²² In this case the taxpayer corporation acquired the stock of a tire company for \$1. At the time of the acquisition of the stock the tire company had entered into negotiations for the sale of its plant at a substantial loss. After the affiliation the assets were sold at the anticipated loss. The Board upheld the contention of the Commissioner that the loss of the tire company could not be deducted from the net income of the taxpayer on a consolidated return of both companies covering the period during which the property was sold. The Board, in reaching this conclusion, said:²³

"In the broad sense, the same reasoning (the reasoning in the *Woolford Realty* case) applies here. If Congress did not intend that the privilege of making a consolidated return should be enjoyed by a corporation which acquired ownership of another corporation in order to take advantage of a loss already sustained by the corporation, it seems to follow that Congress did not intend that the privilege should be enjoyed by a corporation which acquired the ownership of another corporation in order to take advantage of a loss certain to be sustained by that corporation in the immediate future, particularly where the acquisition of the ownership of the other corporation served no business purpose.

"The same general problem of statutory construction, which is involved here, was involved in *Gregory v. Helvering*, 293 U.S. 465. The Supreme Court held in the *Gregory* case that a 'letter perfect' reorganization which served no business purpose was not within the intent of the reorganization exemption provisions of the statute. In this case, we find a parallel. The affiliation in question, although 'letter perfect,' served no business purpose, and it does not, in our opinion, come within the intent of the affiliation provisions of the Statute."

²¹ As to similarity in language between the above cited provisions and the 1926 Act provisions construed in the *Woolford Realty Co.* case, see *infra* note 65.

²² (1940) 41 B.T.A. 370.

²³ *Ibid.* at 378.

The fallacy in the Board's first argument is that the Supreme Court in the *Woolford Realty* case was not construing a provision authorizing filing of consolidated returns but instead was construing statutory provisions relating to the deduction of a loss carry-over. As a matter of fact the reasoning of the *Woolford Realty* would indicate a result directly contrary to that reached in the *Spreckels* case. The Court in the *Woolford Realty* case relied on the peculiar language in the loss carry-over provisions and distinguished it from the language of the statutory provisions authorizing other deductions, such as losses in the current year.²⁴

The second argument of the Court is predicated on *Gregory v. Helvering* and is to the effect that, since the affiliation served no business purpose, it did not comply with the provisions of the Revenue Act authorizing the filing of consolidated returns. In this connection the Board expressly distinguished its decision in *Bishop Trust Co. v. Commissioner*,²⁵ where it allowed deduction on a consolidated return of a loss of the acquired subsidiary against the consolidated income, on the ground that in the *Bishop* case the subsidiary was acquired for a bona fide business purpose.

The difficulty with this argument is that the term "affiliation" as used in the statute is a word of art defined therein to mean the ownership of at least 95% of the stock of the corporation.²⁶ In the *Spreckels* case the parent corporation actually acquired and retained ownership of 95% of the stock of the subsidiary. Accordingly it would seem that the requirements of the definition were met. In *Gregory v. Helvering* the Court held that the requirements of the definition of reorganization were not met because of the transitory holding by the "reorganized" corporation of the assets transferred to it.²⁷

²⁴ The *Woolford Realty* case arose under the Revenue Act of 1926 and the filing of consolidated returns was authorized by section 240, but the court in making its decision construed the language of section 206(b) of the 1926 Act relating to loss carry-overs.

As a matter of fact in its opinion the court carefully pointed out the difference in the statutory language contained in section 234 of the 1926 act, generally allowing deductions for expenses, interest, taxes, losses, etc., for the current year, and the language of section 206(b) which specifically provided that any excess in the amount of the loss carry-over of a corporation for one year over its income for the succeeding year should be carried over against its income for the next succeeding year.

In view of this distinction which the Supreme Court made, it is difficult to understand the holding in the *Spreckels* case.

²⁵ (1937) 36 B.T.A. 1173.

²⁶ §141 of the Revenue Act of 1932.

²⁷ *Supra* note 6.

The exact state of facts in the *Spreckels* case do not clearly appear in the opinion of the Board. There is some indication that the plant which had been sold was substantially the only asset which the subsidiary owned and that, after its sale, the subsidiary had few or no assets left. If such were the case, it is arguable that the acquired subsidiary was merely a shell after the sale of the plant, and that the temporary holding of its stock pending the sale of the plant would be disregarded.²⁸

It appears fairly clear that the Board did not rest its decision on the above narrow grounds, but purported to hold that, if a subsidiary was acquired for the purpose of tax benefit, the requisite affiliation between the parent corporation and itself would be lacking.

If the *Spreckels* case is correct, it would follow that, in the absence of a regulation to the contrary, should a subsidiary be acquired for the purpose of obtaining a tax benefit, it could not be included in a consolidated return filed by the acquiring corporation and, accordingly, no tax benefit could be obtained on the basis of such acquisition. However, for the reasons above given, it is doubtful whether the rule of the *Spreckels* case would be followed by the courts.²⁹

We come now to an examination of the regulations on consolidated returns. Under Regulations 104 (relating to consolidated income tax returns) and Regulations 110 (relating to consolidated excess profits tax returns) net operating loss of a corporation arising prior to the period for which its income had been included in the consolidated return of the group can be deducted against only *its* net income.³⁰ Likewise under the consolidated return regulations, unused excess profits credit of the corporation arising prior to the period for which its income has been included in the consolidated return of the group can be used only by such corporation.³¹ By a recent amendment to the regulations a similar restriction has been invoked in connection with

²⁸ Cf. *Helvering v. Bashford* (1938) 302 U.S. 454; *National Investors v. Hoey* (C.C.A. 2d, 1944) 144 F. (2d) 466.

²⁹ See *National Investors v. Hoey*, *ibid.*

³⁰ Regulations 110, §33.31(c)(3) for all years; Regulations 104, §23.31(a)(2)(b), applicable to the year 1939; §21.31(a)(3)(iv) applicable to the year 1940; and §21.31(d)(3) applicable to the year 1941 and subsequent years.

The net operating loss since its reintroduction is now applicable only to the years commencing on or after January 1, 1939. See §122 of the code as originally enacted by the Revenue Act of 1939. The former loss carry-over provisions were omitted from the Revenue Act of 1934 and were not reintroduced until 1939. See Regulations 75, article 41, for consolidated return provisions, under the earlier acts, relating to loss carry-overs.

³¹ Regulations 110, §33.31(c)(6).

capital loss carry-overs. This amendment is applicable to taxable years ending on or after December 31, 1943.³² In view of the fact that the capital loss carry-over provisions now included in the code are applicable only in the case of capital losses arising in years commencing after December 31, 1941, practically speaking, this amendment, if the provision for its retroactivity is valid, would, despite its tardy adoption, be applicable to all years to which the present capital loss carry-over is applicable.³³ These provisions of the regulations merely made applicable the rule of the *Woolford Realty* case and the *Planter's Cotton Oil* case to net operating loss carry-overs, capital loss carry-overs and unused excess profit credits.³⁴

These provisions operate irrespective of any intention on the part of the parent corporation to acquire the subsidiary in question for tax benefit. But, on the other hand, it would appear that under the regulations (in the absence of a change of members of an affiliated group after March 14, 1941), loss carry-overs and unused excess profits tax credits of a corporation, arising during the period during which its income is included in the consolidated return, may be deducted or applied without limitation against consolidated net income or consolidated net capital gain, as the case may be.³⁵ It therefore follows that,

³² See §21.31(d) (10) added to Regulations 104 and §33.31(c) (15) added to Regulations 110 by T.D. 5341 issued on March 14, 1944, and applicable to taxable years for which returns were not yet due. For comment on retroactivity of these amendments, see *infra* note 40.

³³ See §117(e), as amended by the Revenue Act of 1942. The capital loss carry-over would have to arise in a year commencing in 1942 to comply with section 117(e) and the first succeeding year would commence in 1943 and end on or after December 31, 1943. Only in case the succeeding year were a short taxable year would the effect of the regulations amendment be avoided. Apparently the regulations did not provide for the limitation of the deduction of net short term capital loss carry-overs allowed by section 117(e) prior to its amendment by the Revenue Act of 1942.

³⁴ The statement in the text is subject to this qualification: In the *Woolford Realty Co.* and *Planters' Cotton Oil* cases the loss was realized prior to affiliation. See, however, *supra* note 20 for cases extending the rule of these cases. Under the regulations the limitation applies if the loss or unused credit arose prior to the period for which the income of the corporation was included in the consolidated return so that, even though affiliation existed at the time the loss or unused credit arose, the limitation of the regulations would apply if for any reason the income of the corporation was not included in the consolidated return, either because none was filed for such period, or for any other reason.

³⁵ See Regulations 104, §23.31(b) (1) (iii) C and D and (b) (2) (iii) C and D, (a) (2) (v) and (a) (3) (iv); Regulations 110, § 33.31(a) (6) (i) C and D, (a) (6) (iii) C and D, (b) (3) (iii) and (iv), (relating to net operating loss carryovers); Regulations 110, §33.31(a) (3) (iii), (b) (46) (iii) and (iv) and (a) (35) (ii) and (iv) (relating to unused excess profits tax credit); Regulations 104, §23.31(b) (2) (vii) and (b) (1) (vi), (vii), (viii) and (ix); Regulations 110, §33.31(b) (7), (a) (2) (3) and (4) (relating to cap-

if a loss carry-over or unused excess profits credit in respect of any member of an affiliated group arises during the period for which consolidated returns have been filed and thereafter any members are added to the affiliated group, irrespective of whether before or after March 14, 1941, such loss carry-over and unused excess profits credit could be applied against the income of the new subsidiary.

On March 14, 1944, the Treasury Department issued T.D. 5340 and 5341, amending the consolidated return regulations applicable to affiliated groups formed after Mar. 14, 1941,³⁶ and to affiliated groups having one or more members who became subsidiaries after said date. The amendments are applicable only to taxable years for which the returns were not due on March 14, 1944, *viz.*, taxable years ending on or after December 31, 1943.

Under these amendments:

- (1) In the event the affiliated group was formed subsequent to March 14, 1941, (a) the excess profits credit of each member may be applied only against its excess profits net income, and any unused excess profits carry-over or carry-back *arising therefrom* may likewise, be applied only against its excess profits net income; and (b) deductions on account of loss on sales of capital assets and under section 117(j) (relative to involuntary conversions and sale of assets held in trade or business), or on account of worthless debts and securities, in the case of the parent, irrespective of the time they arose, and in the case of a subsidiary corporation, attributable to events preceding the date upon which it became a member of the group, may be deducted only against its capital gains or ordinary income, as the case may be, and carry-overs and carry-backs *arising from such deductions*, may be deducted only against its capital gains or ordinary income; and
- (2) In the case of an affiliated group already formed on March 14, 1941, but having among its members one or more subsidiaries which became members of the group subsequent to March 14, 1941, (a) the excess profits credit of the parent corporation and the members of the group on March 14, 1941, may be applied only against the excess profits net income of such parent and members and the excess profits tax credit of each new subsidiary

ital losses); Regulations 104, §23.31(b)(2)(ix); Regulations 110, §33.31(b)(9), (10) and (11) (relating to capital loss carryovers).

To this extent, the rule of *Delaware & Hudson R.R. Co. v. Commissioner* and *American Pacific Whaling Co. v. Commissioner*, *supra* note 20 has been changed by the Regulations.

³⁶ March 14, 1941, is the date of the issuance of Regulation 110 relating to excess profits tax consolidated returns.

becoming a member after March 14, 1941, may be applied only against the excess profits net income of such new subsidiary and any unused excess profits carry-over or carry-back *arising therefrom* may, likewise, only be applied against their, or its, excess profits net income and (b) deductions on account of loss on sales of capital assets and under section 117(j) or on account of worthless debts and securities, in the case of the parent corporation and members of the affiliated group on March 14, 1941, may be deducted only against their capital gain and ordinary net income, as the case may be. In the case of a subsidiary corporation which became a member of the group after March 14, 1941, such deductions attributable to events preceding the date upon which it became a member of the group, may be deducted only from its capital gains or ordinary income, as the case may be. Loss carry-overs and carry-backs arising therefrom may be deducted only against the capital gains and ordinary income of such group or new subsidiary, as the case may be.³⁷

It should be noted that these amendments to the regulations only apply to excess profits tax credits and to certain types of deductions, *viz.*, deductions on sale of capital assets, losses under section 117(j) and deductions on account of worthless debts and securities. Apparently the Treasury Department considered depreciation was not of sufficient consequence to cover by amendment to the Regulations. Furthermore, in the case of deductions, a distinction is made between the deductions of a post-March 14, 1941 acquired subsidiary, to which the limitations apply only if the loss deductions are attributable to events preceding the time it became a member, and deductions in the case of a parent corporation and subsidiaries which were members of the group on March 14, 1941, to which the limitations apply irrespective of the time they arose and even though they are attributable solely to events which occurred after the date of the change in the membership of the group.³⁸ Furthermore these amendments are applicable

³⁷ Regulations 110, §33.31(c)(14) and (16); Regulations 104, §23.31(d)(11).

³⁸ It may be noted that by T.D. 5340, paragraphs (ii) were added to §23.31(d)(1) of Regulation 104 and §33.31(c)(1) of Regulation 110, providing that if a parent corporation becomes a parent during the first taxable year for which a consolidated return is filed and the deductions for the first portion of the year prior to the time it became a parent corporation exceed its income for such portion of such year, the excess of the deduction shall be excluded in determining consolidated net income. This amendment served to place parent corporations on somewhat the same footing as subsidiaries, since the income of a subsidiary prior to its affiliation may not be included in a consolidated return, where it becomes a subsidiary during the course of the taxable year [see Regulations 104, §23.13(b) and Regulations 110, §33.13(b)]. Under these regulations, however, the income of the parent corporation for the entire taxable year is included in the

only if the group was formed or the change in its members occurred subsequent to March 14, 1941, irrespective of whether consolidated returns were not filed until after that date.

Under the amendments, under certain conditions, the provisions thereof do not apply, *viz.*:

- (A) If the group consists solely of a common parent corporation and subsidiaries created directly or indirectly by the parent or other members of the group;
- (B) If at the time the subsidiary became a member of the group and thereafter 95% of the voting power of its voting stock and 95% of each class of non-voting stock was directly or indirectly owned by substantially the same interest by which such stock was owned on March 14, 1941;
- (C) If the affiliated group was formed or the new subsidiary became a member as an incident to involuntary conversion or due to a transfer made pursuant to an order of the Securities and Exchange Commission, Federal Communications Commission, the Interstate Commerce Commission or a similar regulatory body of a state or the Federal government; or
- (D) In cases where the Commissioner determines that the computation of the consolidated excess profits credit or consolidated net income without regard to these limitations will not serve to distort the tax liability of the group or any of its members. (It is not clear under what conditions the Commissioner will exercise such authority).

The limitation set forth in (A) above, relating to subsidiaries created by the parent and other members of the group, removed from the operation of the amendments a case where the subsidiary was not acquired for tax saving purposes. In this connection it may be noted that under section 141(c) only one specific exemption for excess profits tax purposes is allowed an affiliated group filing a consolidated return. Likewise, the limitation set forth in (C) above, relating to involuntary conversions and orders of regulatory bodies, removed from the operation of the amendments cases where tax saving purposes would not be the motive for making the change. It may be assumed that under such circumstances the group was not formed or the new subsidiary acquired for tax saving purposes.

The provisions of the above relating to determinations of the Commissioner will be discussed below.

The limitations set forth in (B) above have, for our purposes, the

consolidated return, subject to the limitations above noted, when it forms the affiliated group during the year.

greatest significance. Under it, if there was a group existing on March 14, 1941 which was part of a larger chain of corporations, a member of the chain which was not a part of the group on said date could become a member of the group and the limitations of the amendments would not apply. Thus, on March 14, 1941, the chain consisted of P-S₁-S₂-S₃ and S₄ and in each case the stock of each subsidiary was owned by the subsidiary immediately above it in the chain, but the group which filed the consolidated return was only P-S₁ and S₂ and it was desired to make S₄ a member of the group. Under section 141(d), unless S₄'s stock was acquired by P-S₁ and/or S₂, this could not be done, since in the absence of such acquisition, S₄'s stock would not [as required by section 141(d)] be held by other members of the affiliated group. Under the provisions of (B) above, the stock of S₄ may be so acquired by P-S₁ and/or S₂ and S₄ may become a member of the affiliated group without invoking the limitations imposed by the amendments. Accordingly, by the transfer, the group may enjoy, without limitation, the benefit of S₄'s excess profits credit and anticipated losses on the sale of S₄'s assets, etc. The right to make such changes in the affiliated group, as well as the right to file consolidated returns free of the restrictions imposed by the amendments, apparently is part of the consideration received for the payment of the additional 2% tax imposed by section 141(c) on affiliated groups filing consolidated returns.

It was above pointed out that these amendments were issued on March 14, 1944, and were put into effect retroactively. It is clear that prior to the issuance of T.D. 5340 and 5341, containing these amendments, the limitations provided thereby did not apply.³⁹ Accordingly, the question arises under the rule of *R. J. Reynolds Tobacco Co. v. Helvering*⁴⁰ whether the attempt to make the regulations retroactive is valid.

³⁹ *Supra* note 35.

⁴⁰ (1939) 306 U.S. 110. The situation here presented does not squarely fall within the holding of the Reynolds Tobacco case, since there has been no legislative adoption of the regulations by the continued re-enactment by Congress without change of the code provisions (*viz.*, sections 141 and 730), pursuant to which the regulations were issued, and the regulations which were amended had been in effect for only a comparatively short period. However, it is not clear to what extent these factors are decisive under the Reynolds Tobacco case. See PAUL, *USE AND ABUSE OF TAX REGULATIONS IN STATUTORY CONSTRUCTION STUDIES IN FEDERAL TAXATION* (3d series) pp. 420, 445. The Commissioner in support of such retroactivity cannot rely upon the provisions of section 129 of the code. Section 129 was added by section 128(a) of the Revenue Act of 1943, which was enacted over Presidential veto on February 25, 1944. But under the

Finally it should be noted that, except to the extent that the absence of a motive of tax avoidance may be the predicate of action on the part of the Commissioner to permit the group to disregard the limitations of these amendments pursuant to the provisions set forth in (D) above, the presence or absence of such motive has no bearing upon the application of the limitations provided by these amendments. It is doubtful, in view of the language of the provision granting the Commissioner this authority, that mere absence of a motive of tax avoidance in making the change in the membership of the group would constitute sufficient reason in and of itself for the Commissioner to exercise his authority. On the other hand, it seems that if the reason for the change in membership was to obtain a tax benefit or to avoid taxes, the very situation which gave rise to the attempt to obtain the tax benefit would preclude the Commissioner from exercising his authority to permit the group to disregard the limitations prescribed by the amendments, since the situation which would give rise to the tax benefit sought to be obtained would probably result in a distortion of the consolidated excess profits tax credit or consolidated net income if the limitations of the regulations were disregarded.⁴¹

In view of the fact that the scope of the provisions of the consolidated return regulations above referred to constitute a standard of comparison of the scope of the decisions in cases dealing with other types of acquisitions and of section 129, it is advisable to briefly summarize the scope of these regulations.

It is clear that under the consolidated return regulations a corporation may not be acquired for inclusion in a consolidated return in

provisions of section 128(c) of the Revenue Act of 1943 the provisions of section 129 are only applicable to taxable years *commencing* after December 31, 1943. The amendments to the regulations purport to be retroactively effective to taxable years *ending* on or after December 31, 1943.

The amendment in respect to capital loss carry-overs would probably be sustained under *Helvering v. Reynolds* (1941) 313 U.S. 438, since the amendment to the regulations was adopted less than two years after the adoption of the 1942 amendment to section 117(e).

In any event the retroactivity subject to attack would apply merely to the application of the amendments to the tax liability for years ending prior to March 14, 1944, and the applicability of the amendments to tax liability for years ending subsequent to said date would not be subject to attack, even in respect to groups formed, or in which there was a change in membership between March 14, 1941, and March 14, 1944. *Helvering v. Wilshire Oil Co.* (1939) 308 U.S. 90, *reh'g den.*, 308 U.S. 639; *MacLaughlin v. Alliance Insurance Co.* (1932) 286 U.S. 244.

⁴¹ See for a critical review of the amendments, Austin, *The Amendments to the Consolidated Return Regulations* (June, 1945) *JOURNAL OF ACCOUNTANCY*, p. 52.

order to take advantage of its existing unused excess profits tax credit or loss carry-over. It was above pointed out that if a group was filing consolidated returns on March 14, 1941, and had unused profits tax credits or loss carry-overs, it could apply the same against the income of a post-March 14, 1941 acquired subsidiary. However, it may not deduct from the income of the post-March 14, 1941 acquired subsidiary any such unused excess profits credit or loss carry-over or carry-back arising after the acquisition of the subsidiary. If the acquisition takes place after March 14, 1941, subject to the limitations above referred to, the excess profits credit of the acquired corporation may not be applied against the income of the acquiring parent or the March 14, 1941 subsidiaries; nor may the excess profits credit of the latter be applied against the income of the post-March 14, 1941, acquired subsidiary. The same rule applies in case of deduction for losses on sales of capital assets, or on account of worthless securities or debts, or on account of section 117(j) transactions. Furthermore, the parent corporation and its subsidiaries existing as of March 14, 1941, are precluded from deducting from the income of the post-March 14, 1941 acquired subsidiary not only its or their deductions attributable to events arising prior to the acquisition, but also deductions attributable to events arising after the acquisition. In other words, after March 14, 1941, the parent corporation may not acquire a high income earning subsidiary in order to offset the subsidiary's income against its excess profits credit or anticipated or possible loss or those of its subsidiaries existing as of March 14, 1941. Deductions for unused excess profits credits and loss carry-overs and carry-backs arising from such deductions and excess profits credits are similarly limited.

As above noted the amendments relating to post-March 14, 1941 changes in affiliated groups will only apply if the change in membership occurs or the group was formed after March 14, 1941, and without regard to the fact as to whether the group was filing consolidated returns for that period. If there has been no change in membership in the group since March 14, 1941, the filing of a consolidated return for the first time after that date would not constitute a basis for the application of the limitation of the amendments relative to post-March 14, 1941 changes in membership. On the other hand, the provisions relative to loss carry-overs and unused excess profits credits arising prior to the filing of a consolidated return apply to any period prior to the time consolidated returns were filed, irrespective of whether

affiliation existed at the time the loss or unused excess profits tax credit arose. The March 14, 1944 amendments relative to excess profits credits and deductions for losses, etc., are not applicable to changes in membership where the post-March 14, 1941 acquired subsidiary was on said date a member of the same larger chain of corporations of which the affiliated group was a part, assuming that the requisite stock ownership existed in the chain on said date.

These regulations do not depend for their application upon any showing that the acquisition was made in order to obtain tax benefit, except to the extent that, under the regulations dealing with changes in membership after March 14, 1941, the Commissioner may permit the limitations prescribed thereby to be disregarded in the event that the income of the group or its members will not thereby be distorted.

B. ACQUISITION OF ASSETS

This classification covers cases where a corporation directly acquires the assets and business of another corporation in order to obtain some tax benefit incident to such assets or business. Generally speaking, the acquiring corporation acquires the assets with a view in mind of obtaining the benefit of the basis of the assets in the hands of the acquired corporation which is greatly in excess of their fair market value, and proposes to use such basis in order to obtain the benefit of (i) a deduction for: (a) loss on their sale, or in the case of debts and securities when they become worthless,⁴² or (b) depreciation on such basis, or (ii) an increase in its invested capital credit under the Excess Profits Tax Law.⁴³

⁴² Deduction for a loss on account of securities and debts becoming worthless will not be separately considered in view of the fact that, for our purpose, the problem raised thereby is similar to that of the deduction of loss on the sale of a capital asset.

⁴³ §113(a) (7) (8) and (15); §114(a); supplement C of sub-chapter E of chapter 2 of the Internal Revenue Code (§760-61).

In some cases the purpose of the acquisition may be to obtain the benefit of a high excess profits tax credit based on the high base period income of the transferor corporation where the transferor's income has either entirely disappeared or greatly diminished. This type of case will not be separately considered, in view of the fact that the conditions under which the acquiring corporation may claim the benefit of the excess profits tax credit based on income, with some limitations, are substantially the same as those on which the acquiring corporation could claim the transferor's basis of the acquired assets. §§ 740-742. See *infra* note 151.

We shall later see that except possibly in the case of a statutory merger or consolidation the successor corporation on an acquisition of assets may not obtain the benefit of the loss carry-over nor unused excess profits credit of the acquired corporation. For this reason, reference to this type of benefit is omitted in the text.

The right to obtain the stepped-up basis must be predicated on the ground that the property was acquired on a "reorganization," as defined in section 112(g) [section 113(a)(7)], or in a so-called section 112(b)(5) transaction, or as paid-in surplus, or as a contribution to capital [section 113(a)(8)], or on a complete liquidation of a subsidiary under section 112(b)(6) [section 113(a)(15)], or under some special provision of section 113(a) providing for a substituted basis in the case of certain special types of corporate reorganizations, e.g., section 113(a)(17), (20), (21), and (22).⁴⁴ Under this heading we are primarily concerned with the acquisition of assets on a reorganization. Liquidations of subsidiaries, contribution by a parent to surplus of a subsidiary and section 112(b)(5) transactions will be considered under section II-D dealing with acquisitions between controlled corporations.

It is necessary at the outset to distinguish cases where the transaction in form only, and not in substance, complies with the requirement of the "reorganization" provisions but is actually a *sham* "reorganization."

For example, Corporation *A* or its stockholders purchase the stock of Corporation *B* for cash and thereafter *A* acquires the assets of *B* by merger. *A* could claim that the transaction was a tax-free "reorganization," and, accordingly, under the literal provisions of the code⁴⁵ it was entitled to acquire the assets of *B* at their basis in the hands of *B*.⁴⁶ It would make no difference if the stock acquiring corporation caused the assets to be transferred to its subsidiary instead of acquiring the assets itself. However, the transaction as outlined above is merely a sham transaction and is not actually a reorganization.⁴⁷ It is in substance a purchase of assets. Situations of

⁴⁴ See §§111, 114(a), 760-61, and 740-42.

⁴⁵ See §§112(b)(6) and 112(g)(1)(A) and (D).

⁴⁶ See §§113(a)(6) and (15).

⁴⁷ In *Commissioner of Internal Revenue v. Ashland Oil and Refining Co.* (C.C.A. 6th, 1938) 99 F. (2d) 588, *cert. den.* (1939) 306 U. S. 661, it was held that where a corporation acquired the stock of another and then liquidated the acquired corporation that the transaction was in substance an acquisition of the assets of the acquired corporation. See for a similar holding *Prairie Oil & Gas Co. v. Motter* (C.C.A. 10th, 1933) 66 F. (2d) 309. See also *Helvering v. Bashford* (1938) 302 U.S. 454 (ruling that a temporary holding by a corporation of the stock of a second corporation as a part of a plan under which the assets of the second corporation were transferred to a subsidiary of the first corporation should be disregarded). *Cf.* *Chisholm v. Commissioner* (C.C.A. 2d, 1935) 79 F. (2d) 14, and *U.S. v. Gendron Wheel Corp.* (C.C.A. 6th, 1938) 100 F. (2d) 57; *Hay v. Commissioner* (C.C.A. 4th, 1944) 145 F. (2d) 1001, *cert. den.* 65 S. Ct. 868; *Commissioner v.*

this type clearly call for an application of the rule of *Gregory v. Helvering*.⁴⁸

If *A* held the stock of *B* for some period, say several months, and could show that at the time it acquired *B*'s stock it had no intention of liquidating it or otherwise acquiring its assets the transaction would probably be held to be a reorganization.⁴⁹

We are not concerned primarily with sham reorganization. Our primary concern is with cases where there is an actual "reorganization," i.e., where the stockholders of the corporation whose assets are acquired or other equity ownership of such assets have a stockholder's interest in the acquiring corporation so as to satisfy the rule of *Pinellas Ice & Cold Storage Co. v. Commissioner*.⁵⁰

We may take as a typical case the one where Corporation *A* acquires the assets of Corporation *B* by merger and the only consideration received by the stockholders of *B* is *A* stock and the sole purpose of the transaction was so that *A* may have the advantage of the high basis of the assets, which was considerably greater than their fair market value in order that *A* may take a loss on the sale of the assets or claim depreciation on the basis thereof or the high excess profits credit incident thereto.

Mr. Rudick appears to take the position that under the rule of

Court Holding Company, 45-1 U.S.T.C. No. 9215; *Williams v. Commissioner* (1944) 3 T.C. 1001; *Fairfield Steamship Co. v. Commissioner*, 5 T.C. 566, 1945.

⁴⁸ *Supra* note 6.

⁴⁹ *Cf. American Compress & Warehouse Co. v. Bender* (C.C.A. 5th, 1934) 70 F. (2d) 655, See, however, *Bassick v. Commissioner*, (C.C.A. 2d, 1936) 85 F. (2d) 8, *cert. den.* 200 U.S. 592; *Diescher v. Commissioner* (C.C.A. 3d, 1940) 110 F. (2d) 90, *cert. den.*, 310 U.S. 650. In these cases after the formation of the corporation the stockholders sold stock to third parties. It was claimed that nevertheless the transaction was a tax-free reorganization under section 112(b)(5). Section 112(b)(5) requires that the transferors must remain in control of the corporation after the transfer of the assets. In the first case it was held that the sale did not affect the status of the transaction under section 112(b)(5) and in the second and third cases it was held that by reason of the sale the stockholders were not in "control" of the corporation after the transfer of the assets. The pivotal question in these cases was "Was the sale a part of the original plan?" It would seem that the similar question as to whether the acquisition of assets was a part of the original plan would be determinative in the case given in the text. See for cases holding that, under the circumstances indicated in the note, the acquiring corporation does not inherit the transferor's basis, *Heberlein Patent Corp. v. U.S.* (C.C.A. 2d, 1939) 105 F. (2d) 965; *Budd International Corp. v. Commissioner* (C.C.A. 3d, 1943) 143 F. (2d) 784, *cert. den.*, 323 U.S. 802; *Independent Oil Co. v. Commissioner*, 6 Tax Court — (1946) C.C.H. Dec. 14960.

⁵⁰ 287 U.S. 462. See also *Helvering v. Minnesota Tea Co.* (1935) 296 U.S. 378 and *LeTulle v. Scofield* (1940) 308 U.S. 415; *Helvering v. Alabama Asphaltic Limestone Co.* (1942) 315 U.S. 179.

*Gregory v. Helvering*⁵¹ the transaction would fail in its purpose if the stockholders of the *B* Corporation were "receiving a small percentage of the stock" of *A*.⁵² It is respectfully submitted that Mr. Rudick is not correct in his position. In *Gregory v. Helvering* the Court refused to hold that the transaction was a "reorganization" on the ground that in substance it was not a "reorganization" but a distribution of a dividend in kind.⁵³ In other words, that it was a sham transaction. There is no doubt in the hypothetical case that the transaction was a merger and, therefore, not only literally but substantively complied with the requirements of the "reorganization" provisions of section 112(g).⁵⁴ It would be an entirely different thing if the stockholders of *B* received only a nominal amount of their consideration in stock and received the balance of their consideration in cash or in short term notes. Under that state of facts it would probably be held under the decision of *Helvering v. Minnesota Tea Co.*⁵⁵ that the transaction was not a reorganization.⁵⁶ Certainly Mr. Rudick could not argue that if the United States Steel Corporation acquired by statutory merger the assets of a small steel corporation without any view of tax benefit and the stockholders of the merged corporation received a small percentage of the stock of the U.S. Steel Corporation as the entire consideration for the cancellation of their stock on the merger that the

⁵¹ *Supra* note 6.

⁵² Rudick, 58 HARV. L. REV. 196, 221. Mr. Rudick appears inferentially to take the position that if a substantial percentage of *A* stock were received by the stockholders of *B* that the transaction would not be subject to a tax. Cf. Rudick, 58 HARV. L. REV. 196, 220, where it is stated "But if we vary the case so that the former owners of *Y* (the acquired corporation, a subsidiary) obtained a substantial, even though not controlling, interest in *X* (the acquiring corporation), the result might very well be different."

⁵³ *Supra* note 6.

⁵⁴ In *Kelley v. Commissioner* (1946) 14 L.W. 4079 the United States Supreme Court, in upholding the decision of the Tax Court permitting the deduction of interest on obligations issued to stockholders in the same proportion as their stockholder interest and subordinate to the claims of general creditors, but prior in rank to stock interest, said:

"There is not present in either situation the wholly useless temporary compliance with statutory literalness which the court condemned as futile, as a matter of law, in *Gregory v. Helvering*, 293 U.S. 465. The demonstrated possibility of the sale by a holder of the obligations to persons other than stockholders alone proves the differentiation."

⁵⁵ (1935) 296 U.S. 378.

⁵⁶ In *Helvering v. Minnesota Tea Co.* the court said, "and we now add that this interest must be definite and material; it must represent a substantial part of the value of the thing transferred." In other words, the stock interest in *A* received by the *B*'s stockholders must be a substantial portion of the value of the assets of the *B* corporation. This does not mean that the *A* stock that *B*'s stockholders receive must be a substantial portion of the outstanding stock of *A*.

transaction would not be a "reorganization." Certainly, therefore, the percentage of the stock of *A* which the *B* stockholders receive is immaterial as long as it constitutes a substantial part of the consideration received by them. It is difficult to understand on what grounds the courts could hold in any case that the transaction would not comply with the "reorganization" provisions because of its purpose as long as the transaction was in fact and in substance a "reorganization." The correctness of the position here presented may be further supported if it is considered that the rule of *Gregory v. Helvering* would have been applied even though there had been no proof that the transaction had been entered into for the purpose of obtaining tax benefits. Suppose that under the state law dividends could be declared only in cash and dividends in kind could not be distributed. In order to get around this provision of the state law the same transaction that was involved in *Gregory v. Helvering* had been devised. It is respectfully submitted that under such state of facts the courts would have held that the transaction was in substance a dividend in kind and that it was not a "reorganization."⁵⁷

In view of these considerations it is respectfully submitted that if there is an actual reorganization the courts must give effect to it irrespective of the intention of the parties in entering into the reorganization.

It is also submitted that the hypothetical case does not come within the rule of *J.D. & A.B. Spreckels v. Commissioner*⁵⁸ where it was held that Corporation *A*, on a consolidated return of itself and Corporation *B*, could not deduct a loss on the sale by *B* of its plant where *A* had acquired *B*'s stock after a decline in the value of *B*'s plant had already occurred. Even if this case represents a proper application of the statutory provisions respecting consolidated returns it is clearly inapplicable in the instant case. The statutory provisions in regard to consolidated returns are only general in their purport and, therefore, there is considerable latitude in their construction. This is not so in connection with reorganizations. The statutory provisions in

⁵⁷ Cf. *Helvering v. Bashford* (1938) 302 U.S. 454. In this case the *A* corporation acquired for its own stock and other considerations the stock of *B*, *C* and *D* corporations and thereafter had the *B*, *C* and *D* corporations transfer their assets to its subsidiary. The Supreme Court held that the temporary holding of the stock of the *B*, *C* and *D* corporations by the *A* corporation should be disregarded since the *A* corporation was merely holding that stock temporarily and as a conduit. There was no claim that the *A* corporation did this with any tax avoidance intention in mind.

⁵⁸ *Supra* note 22.

regard to the basis of the acquired assets are specific and they provide that the basis of the assets in the hands of the surviving corporation shall be the same as in the hands of the transferor corporation.⁵⁹

It is also submitted that the transaction could not be attacked on the authority of *Helvering v. Horst*.⁶⁰ In this case a taxpayer, reporting on a cash basis, made a gift of *accrued* interest to another and it was held that the *accrued* interest was taxable to the donor when received even though he was on the cash basis. In the hypothetical case under consideration it cannot be said that subsequent loss on the sale of the assets has accrued within the meaning of the *Horst* case because at the time the loss had not as yet been *realized*.⁶¹ Furthermore, any such holding would run counter to the express provisions of section 113(a)(7) above referred to, that the basis of the assets in the hands of the acquiring corporation shall be the same as their basis in the hands of transferor corporation.

The rule of one other case needs to be noted, viz., *Higgins v. Smith*.⁶² Taking this case at its broadest holding, that a loss on a transfer cannot be recognized unless there is a shift in economic interest, it is clear that the cases here under consideration do not fall within this rule. In our hypothetical case it is presumed that the assets will be sold to third parties.

The result in the cases of asset acquisition is to be contrasted with

⁵⁹ §113(a)(7).

⁶⁰ (1940) 311 U.S. 112. See also *Helvering v. Eubank* (1940) 311 U.S. 122. In the *Eubank* case a life insurance agent reporting on a cash basis transferred life insurance policy renewals to a corporate trustee solely so it could collect them. Held taxable to transferor when they were collected in a year subsequent to the year of transfer, despite the fact that renewals are not payable unless the policies are kept in effect. The heavy reliance of the court in its opinion in the *Eubank* case on the stipulated facts as to the purpose of the assignment renders the case of doubtful authority as a precedent.

The above analysis of the *Horst* and *Eubank* cases assumes that the rules there applied did not depend on the relationship of the transferor and transferee, nor on the fact that the income receivable was assigned without transferring in the one case the obligation in respect to which the interest was payable, and in the other case the life insurance agency business out of which the renewals had been earned. Cf. *Lucas v. Earle* (1930) 281 U.S. 111; *Helvering v. Clifford* (1940) 309 U.S. 331; *Burnet v. Leininger* (1932) 285 U.S. 345; see, however, cases cited *infra* note 61.

⁶¹ See *Commissioner v. Montgomery* (C.C.A. 5th, 1944) 144 F. (2d) 313. In this case a profitable contract was assigned to a corporation organized for that purpose. It was held that income arising under the contract on account of services performed subsequent to its transfer was taxable to the corporation and not to the assigning stockholder. On the other hand, if the service had been rendered prior to the transfer, the income paid on account thereof to the corporation would be taxable to the assigning stockholder. *Brown v. Commissioner* (C.C.A. 2d, 1942) 115 F. (2d) 337. See *infra* note 96.

⁶² (1940) 308 U.S. 473, discussed at greater length, *infra* p. 60.

the consolidated return regulations. Under these regulations if the acquisition takes place after March 14, 1941, the acquiring corporation may not deduct from its income the loss on the sale of the subsidiary's assets since such loss would be attributable to events arising prior to the acquisition, nor may it apply the high excess profits credit of the subsidiary against its income.

However, except possibly where the acquisition of assets is by statutory merger or consolidation, *A* would not be entitled to have the benefit of any net operating loss carry-overs or capital loss carry-overs or unused excess profits credit which had been enjoyed by *B*.⁶³ In *New Colonial Ice Co. v. Helvering*,⁶⁴ it was held that a successor on a reorganization is not entitled to deduct the net operating loss of the predecessor corporation. This case arose under the Revenue Act of 1926 and was predicated on the ground that the net operating loss is personal to the corporation realizing the loss. The same rule is probably applicable to the provisions for net operating loss, capital loss carry-over and unused excess profits credit in the code.⁶⁵ It has been held that the same rule is applicable in the case of a statutory merger.⁶⁶ It is questionable, however, whether the rule of these cases would be followed in view of the decision of the United States Supreme Court in *Helvering v. Metropolitan Edison Company*.⁶⁷ In this case it was held that in a statutory merger unlike other types of reorganization the surviving corporation may deduct the unamortized bond discount of the merged corporation on the ground that on a statutory merger the "corporate personality of the transferor is drowned in that of the transferee."

Under the consolidated return regulations, as we have pointed out, the unused excess profits credit and loss carry-over of the acquired subsidiary existing at the time of the acquisition may not, on a consolidated return, be applied against the income of the other members of the affiliated group.

If a corporation possesses a high unused excess profits credit or

⁶³ See §122 (net operating loss deduction), §117(e) (capital loss carryover), §710(c) (unused excess profits tax credit).

⁶⁴ (1934) 292 U.S. 435.

⁶⁵ See MONTGOMERY FEDERAL TAXES ON CORPORATIONS, Vol. 1, p. 696; Vol. 2, p. 212.

⁶⁶ The *New Colonial Ice Co.* rule was held to be applicable in cases of statutory mergers and consolidations in the following decisions: *Permanent Cove, etc., v. Commissioner* (C.C.A. 3d, 1935) 75 F. (2d) 719; *Brandon Corporation v. Commissioner* (C.C.A. 4th, 1934) 71 F. (2d) 762; *Franklin, Receiver v. U.S.* (C.C.A. 3d, 1936) 83 F. (2d) 1010; *National Bank of the Republic of Chicago* (1934) 31 B.T.A. 680.

⁶⁷ (1938) 306 U. S. 522.

loss carry-over and acquires the high income producing assets of another corporation so as to offset its unused credit or loss carry-over against such income, it is clear that it may do so. There is nothing in the code which limits the deduction of the unused credit or loss carry-over to any particular portion of the corporation's income.⁶⁸ This is to be contrasted with the consolidated return regulations, where unused credits and loss carry-overs of a corporation arising prior to the time its income is included in the consolidated return can be applied only against its own income.

C. ACQUISITION OF CONTROL OF CORPORATION TO TRANSFER ASSETS

The transactions falling in this classification may be illustrated by the following example: Corporation *A* purchases for cash the stock of Corporation *B*, the assets of which have little or no market value but which have a high basis in the hands of *B*, and thereafter *A* causes its business, which is earning a substantial income, to be transferred to *B* either by merger or otherwise and thereby the stockholders of *A* seek to enjoy the benefit of the high basis of *B*'s assets either by a deduction for a loss on their sale, or by offsetting *B*'s high excess profits tax credit, against the income from the business transferred by *A*.⁶⁹

Mr. Rudick⁷⁰ suggests that the transaction above described may be vulnerable to attack under the rules laid down in *Higgins v. Smith*,⁷¹ *Griffiths v. Helvering*,⁷² *National Investors v. Hoey*,⁷³ on the ground that the Treasury Department may disregard the separate entity of a corporation "if the corporation is a sham, its only purpose being to escape taxation."⁷⁴ It is respectfully submitted that, while the principle of law announced by Mr. Rudick is correct in a limited sense, it is not correct in the sense in which Mr. Rudick attempts to apply it.

⁶⁸ See Rudick, 58 HARV. L. REV. 196, 221.

⁶⁹ Alternatively *B* might have a substantial loss carry-over or high unused excess profits credit. On the other hand, if it sought to transfer income already earned, such income when realized will be taxable to the transferor. *Brown v. Commissioner* (C.C.A. 2d, 1942) 115 F. (2d) 337. In this case an attorney, who reported income on a cash basis, assigned to a corporation for stock fees theretofore earned by him. Held that the fees were taxable to him when realized. Cf. *Helvering v. Horst* (1940) 311 U.S. 112 and *Helvering v. Eubank* (1940) 311 U.S. 122.

⁷⁰ Rudick, 58 HARV. L. REV. 196, 218-219.

⁷¹ (1940) 308 U.S. 473.

⁷² (1939) 308 U.S. 355.

⁷³ (C.C.A. 2d, 1944) 144 F. (2d) 466.

⁷⁴ 58 HARV. L. REV. 196, 218. Mr. Rudick suggests that if the acquired corporation's stockholders in our example, *B*, retain a substantial interest in *B*, the transaction would not be subject to attack. 58 HARV. L. REV. 219.

It is true that if the entire *function* of a corporation is tax saving it may be disregarded. But, even if the sole motive of acquiring the corporation is tax saving, if it has a business function, it may not be disregarded. A motive to avoid taxation does not make a transaction sham and does not make a corporation which is the vehicle of such transaction a sham corporation. However, since Mr. Rudick relies on this line of reasoning in support of the general implied thesis of his article that, to a large extent, the results under section 129 could have been reached under the rule of the decided cases, it is proposed here to analyze at length the cases cited by him in support thereof.

In the leading case of *Higgins v. Smith*,⁷⁵ a taxpayer sold stock to a wholly owned subsidiary at a loss and the Court held that the loss was not deductible on the ground that there was no change in economic interest. In this case the Court said:

"On the other hand, the Government may not be required to acquiesce in the taxpayer's election of that form for doing business which is most advantageous to him. The Government may look at actualities and upon determination that the form employed for doing business or carrying out the challenged tax event *is unreal or a sham may sustain or disregard the effect of the fiction as best serves the purposes of the tax statute*. To hold otherwise would permit the schemes of taxpayers to supersede legislation in the determination of the time and manner of taxation. It is command of income and its benefits which marks the real owner of property."⁷⁶ (Italics supplied.)

It may be noted that the second circuit court of appeals, after the decision in *Higgins v. Smith*, in a case involving the same taxpayer and the same corporation held that dividends received by the corporation were taxable to the stock holder.⁷⁷ The court, in reaching this conclusion, stated:

"It seems unnecessary to say whether the income of a corporation that is wholly owned by a single stockholder should invariably be taxed as his own. There would be difficulty in adopting such a universal rule when Congress has thought it necessary or proper to establish an elaborate plan for taxing personal holding companies. Cf. Revenue Act of 1938, Title IA §401 *et. seq.*, 26 U.S.C.A. Int. Rev.

⁷⁵ It may be noted that the loss in this case is now specifically denied by statute since the taxpayer was an individual. §24(b).

⁷⁶ (1940) 308 U.S. 473, 477.

⁷⁷ Commissioner of Internal Revenue v. Smith (C.C.A. 2d, 1943) 136 F. (2d) 556.

Acts, page 1129 *et seq.* It is true that there is some language in *Higgins v. Smith*, 308 U.S. 473, 60 S. Ct. 355, 84 L. Ed. 406, and *Helvering v. Clifford*, 309 U.S. 331, 60 S. Ct. 554, 84 L. Ed. 788, which may indicate that the income of a company that is owned by a single stockholder may, if the Commissioner thinks best, be assessed against him rather than the corporation. But in the case at bar we need go no further than to say that *there is no substantial business reason for the creation or continued existence of Innisfail since its only, or at least, its main object was to furnish the owner of all its stock with a means of diminishing his taxes. It not only conducted no business enterprise but had no justification for existence even as a holding company. It ordinarily left its securities in Smith's name and possession, and most of its dealings with him merely took the form of book entries.* We think it clear that the person beneficially entitled to the dividends cannot escape taxation by means of the intervention of a corporation which is a mere personal agency and shows so little justification for existence as Innisfail. The situation resembles that in *Gregory v. Helvering*, 293 U.S. 465, 55 S. Ct. 266, 79 L. Ed. 596, 97 A.L.R. 1355, where the formal steps required by the statute to effect a reorganization were carried out but there was no business justification for the procedure except the saving of taxes. Such a legal formality was held an insufficient shield against the 'fiery darts' of the tax collector" (Italics supplied.)

In other words, it is clear that the corporation in *Higgins v. Smith* was a mere shell and was merely Smith's alter ego and served no business purpose or function whatsoever excepting tax avoidance.

In *Griffiths v. Helvering* the taxpayer had been defrauded in connection with a stock purchase and thereafter the taxpayer entered into an agreement for settlement with the defrauding vendor providing for the repurchase of his stock by the defrauding vendor. The taxpayer transferred the stock to a corporation organized for that purpose which then resold the stock to the defrauding vendor pursuant to the terms of said agreement. Under the agreement between the taxpayer and the corporation, the corporation was to pay the taxpayer for the stock in installments. The taxpayer thereby hoped to take the income realized from the settlement over a period of years rather than one year. It was held that the transaction was vulnerable and that the income from the settlement was immediately taxable to the taxpayer. This was done on the ground that the corporation had no business function and was mere sham.⁷⁸

⁷⁸ This case is similar in purport to the decision of the United States Supreme Court in *U.S. v. Joliet & Chicago R.R. Co.* (1942) 315 U.S. 44. In that case rentals payments

In the *Higgins* and *Griffiths* cases the corporation was organized only for a sham purpose and had no separate business function and the Court, therefore, refused to recognize a separate entity of the corporation.

The rule of *Higgins v. Smith* was clearly limited in the case of *Moline Properties, Inc., v. Commissioner*.⁷⁹ In this case a taxpayer formed a corporation for financing purposes and the taxpayer endeavored to claim that gains realized by the corporation were his own individual gains. The Commissioner taxed the gains of the corporation and the Court upheld the Commissioner. In so doing the Court said:

"The doctrine of corporate entity fills a useful purpose in business life. Whether the purpose be to gain an advantage under the law of the state of incorporation or to avoid or to comply with the demands of creditors or to serve the creator's personal or undisclosed convenience, *so long as that purpose is the equivalent of business activity or is followed by the carrying on of business by the corporation, the corporation remains a separate taxable entity.* *New Colonial Ice Co. v. Helvering*, 292 U.S. 435, 442; *Deputy v. du Pont*, 308 U.S. 488, 494. In *Burnet v. Commonwealth Imp. Co.*, 287 U.S. 415, this Court appraised the relation between a corporation and its sole stockholder and held taxable to the corporation a profit on a sale to its stockholder. This was because the taxpayer had adopted the corporate form for purposes of his own. The choice of the advantages of incorporation to do business, it was held, required the acceptance of the tax disadvantages.

"To this rule there are recognized exceptions. *Southern Pacific Co. v. Lowe*, 247 U.S. 330, and *Gulf Oil Corp. v. Lewellyn*, 248 U.S. 71, have been recognized as such exceptions but held to lay down no rule for tax purposes. *New Colonial Ice Co. v. Helvering*, *supra*, 419, 420. A particular legislative purpose, such as the development of the merchant marine whatever the corporate device for ownership, may call for the disregarding of the separate entity, *Munson S.S. Line v. Commissioner*, 77 F. 2d, 849, as may the the necessity of striking down frauds on the tax statute, *Continental Oil Co. v. Jones*, 113

due a corporation were paid by the lessee directly to the stockholders. It was held that nevertheless the income was taxable to the corporation.

In the *Griffiths* case the income from the settlement was actually "accrued" at the time the settlement was made since the settlement was made before the transfer of the stock to the corporation. Accordingly the taxpayer was merely trying to syphon the income from the settlement which had already accrued through another entity and the principle of the *Joliet & Chicago R. R. Co.* case applies. See also *Chisholm v. Commissioner* (C.C.A. 2d, 1935) 79 F. (2d) 14, which is contrary in holding to the *Griffiths* case.

⁷⁹ (1943) 319 U.S. 436.

F. 2d 558 (40-2 U.S.T.C. #9549). *In general, in matters relating to the revenue, the corporate form may be disregarded where it is a sham or unreal. In such situations the form is a bald and mischievous fiction. Higgins v. Smith* 308 U.S. 473, 477-78; *Gregory v. Helvering*, 293 U.S. 465.” (Italics supplied.)

In *National Investors v. Hoey*,⁸⁰ which is relied on by Mr. Rudick in support of his conclusion, the second circuit court of appeals recognized that the rule of *Higgins v. Smith* had been limited to the *Moline Properties* case. In this case a corporation had several partly owned subsidiaries and pursuant to a plan to unify the business of these subsidiaries with its own business in a single corporation transferred the stock of the subsidiaries to a corporation formed for this purpose. The plan was submitted to the other stockholders of the subsidiaries and was not approved. After about a year period the taxpayer caused the newly formed subsidiary to be dissolved and claimed a loss in the amount of the difference in the value of the subsidiary stock at the time of the transfer and at the time of the liquidation. The second circuit court of appeals held that the only loss which could be deducted was the portion of the decline in value which took place between the transfer to the subsidiary and a reasonable time after the plan had failed. The court held that after the lapse of such a reasonable period the newly formed subsidiary had no business function and should have been liquidated. However, it must be noted that the court allowed the deduction of a loss represented by the decline in value up to the elapse of such reasonable period. In this connection the court said:

“ . . . This language (certain language appearing in *Higgins v. Smith*) we later interpreted as meaning that ‘the Treasury may take a taxpayer at his word, so to say; when that serves its purpose, it may treat the corporation as a separate person from himself; but that is a rule which works only the Treasury’s own favor; it cannot be used to deplete the revenue’. *United States v. Morris & Essex R. Co.*, 2 Cir. 135 F. 2d 711, 713. Again we were wrong; we neglected to observe that the corporate ‘form’ must be ‘unreal or a sham’, before the Treasury may disregard it; we had taken too literally the concluding language that it was the ‘command of income and its benefits which marks the real owner of property’.

“This error was made plain in the third decision of the Supreme Court—*Moline Properties, Inc. v. Commissioner*, *supra* 319 U.S. 436, 63 S. Ct. 1132, 87 L. Ed. 1499. In that case the question was whether the corporation might insist upon the Treasury’s including capital

⁸⁰ (C.C.A. 2d, 1944) 144 F. (2d) 466.

gains within the gross income of its sole shareholder, and the Court decided that it might not. That was the same situation as existed in *Burnet v. Commonwealth Improvement Co.*, *supra*, 287 U.S. 415, 53 S. Ct. 198, 77 L. Ed. 399. The gloss then put upon *Higgins v. Smith*, *supra*, was deliberate and is authoritative; it was that, whatever the purpose of organizing the corporation, 'so long as that purpose is the equivalent of business activity or is followed by the carrying on of business by the corporation, the corporation remains a separate taxable entity'. 319 U.S. 439, 63 S. Ct. 1134, 87 L. Ed. 1499. *That, as we understand it, is the same interpretation which was placed upon corporate reorganizations in Gregory v. Helvering*, 293 U.S. 465, 55 S. Ct. 266, 79 L. Ed. 596, 97 A.L.R. 1355, and which has sometimes been understood to contradict the doctrine that the motive to avoid taxation is never, as such, relevant. In fact it does not trench upon that doctrine; it merely declares that to be a separate juristic person for purposes of taxation, a corporation must engage in some industrial, commercial, or other activity besides avoiding taxation; in other words, that the term 'corporation' will be interpreted to mean a corporation which does some 'business' in the ordinary meaning; and that escaping taxation is not 'business' in the ordinary meaning." (Italics supplied.)

In all these cases the corporation either was originally a sham or had become a sham and had no business function other than that of saving taxes.⁸¹

In other words, the corporation was merely a shell or agency for another corporation or individual and it was held that the income of such agent was the income of the principal.

In the hypothetical case given the acquired Corporation *B* is carrying on as its separate business not only its old business but the former business of *A*. It cannot be held under that state of facts that *B* is a mere sham or a mere shell not having any business function. In the cases above discussed there was something more than a mere tax benefit scheme upon the basis of which the Commissioner could attack the transaction. It was that the corporation served no real business function and, accordingly, could be disregarded as a sham.⁸² This

⁸¹ Cf. *Glenn v. Commissioner* (1944) 3 U.S.T.C. 328 where the separate entity of a corporation formed to assist taxpayer in dealing with his creditors was disregarded.

⁸² Cf. *Commissioner v. Montgomery*, *supra* note 61; see also *Sherwin v. Commissioner* (1942) 46 B.T.A. 330. In this case a corporation sold to its stockholders shares of stock held by it at a large profit. The stockholder purchasers paid but a small amount down on the contract and agreed to pay the balance on or before December 1, 1942, with interest. The board held that the Commissioner could not look through the transaction and include dividends on the stock in the income of the corporation. It was admitted that the transactions were entered into solely for tax avoidance purposes.

added factor is not present in the hypothetical case given. In short, the fact that a corporation is being availed of for a tax benefit scheme does not in and of itself make the corporation a sham corporation. Furthermore, the mere fact that there is no change in economic interest when the *A* transfers its assets to *B* makes no difference.⁸³ Whether or not the stockholders of *B* continue to have an interest in *B* would appear to make no difference in the result.⁸⁴

If *B* is held to be a sham corporation the question arises as to whom *B*'s income is to be taxed. It cannot be taxed to *A* because it is no longer in existence. It certainly cannot be taxed individually to the stockholders of *B*, since they are not individually engaged in business. Mr. Rudick suggests that *B* should be treated as a new entity.⁸⁵ Certainly there is no justification under the cases or code for such a result. Furthermore the Commissioner under section 45 could not attack the transaction here under consideration on the ground that the income from the assets may be reallocated between the transferor corporation and the transferee. As will hereafter be more fully developed under section II-D, section 45 does not authorize the Commissioner to reallocate income accruing after the date of the transfer.⁸⁶ It is submitted, therefore, that prior to the adoption of section 129 this type of transaction was entirely invulnerable from attack and that in this type of transaction in effect the stockholders of *A* could enjoy the benefit of high excess profits credit, the unused excess profits credit, the loss carry-over and the high basis of the assets of *B*.

One other type of transaction in this classification should be noted before closing, *viz.*, where a corporation organized a subsidiary corporation for the purpose of acquiring some benefit under the tax law which it cannot enjoy. Suppose that *A* is a domestic corporation and for the current year all of its business was done in the western hemisphere outside of the United States but that in prior years a large portion of its income was derived in the United States. Under section 109 it would not qualify as a western hemisphere trade corporation since 95% of its gross income would not have been derived during the three-year period "immediately preceding the close of the taxable year"

⁸³ Cf. *Moline Properties case* and *Commissioner v. Montgomery* *supra* note 61; see also *National Investors v. Hoey*, discussed *supra* p. 62.

⁸⁴ Mr. Rudick appears to think that there might be some difference. 58 HARV. L. REV. 196, 219, 221.

⁸⁵ *Ibid.* at 219.

⁸⁶ *Infra* p. 70.

from sources within the United States. However, under section 109 the three-year requirement is not applicable in the event the corporation was not in existence during the three-year period. In order to enjoy an exemption from surtaxes granted under section 15(b) to western hemisphere corporations *A* forms Corporation *B* and transfers its business to *B*. The question arises as to whether this transaction would be considered a sham transaction and hence *B* would not be entitled to enjoy the benefits of the tax exemption. Under Mr. Rudick's reasoning the tax exemption would be denied because Mr. Rudick would apparently hold that *B* is a mere sham. It might be noted that the Treasury Department has recently held that this result will not even follow under section 129.⁸⁷

In view of the foregoing, it is respectfully submitted that prior to effective date of section 129, a corporation, practically without limitation, could acquire the benefit of loss carry-overs, unused excess profits credits, high excess profits credits and anticipated losses on sale of capital assets and worthless securities of another corporation by acquiring the stock of the other corporation and transferring its assets to it. This could be done even though the acquisition was an acquisition for cash and the original stockholders of the acquired corporation had no further interest therein. In this respect the result is unlike cases arising under section II-B, involving the acquisition of assets of another corporation. In such case, as we have seen, the transaction must comply with the reorganization provisions of the code, and the stockholders of the transferor corporation must have a stock interest in the transferee corporation substantially proportionate to the value of the assets transferred. Furthermore, on an asset acquisition there is some doubt as to whether the benefits of a loss carryover and unused excess profits tax credit can be obtained, except, possibly, in the case of a statutory merger or consolidation. These results in acquisitions of this type may be directly contrasted with the results under the consolidated return regulations which prevent the obtaining of these benefits in the cases covered thereby.

D. ACQUISITION BETWEEN CONTROLLED CORPORATIONS—SECTION 45

In this classification we are primarily concerned with acquisition between corporations controlled by the same interests for the purpose of gaining a tax advantage. For example, Corporations *A* and *B* are controlled by the same interests. *A* has little or no income but has

⁸⁷ I.T. 3757, 1945-17-12119.

certain assets which have a low market value but have a high basis in its hands. It proposes to sell these assets but the loss on the sale would not benefit *A* and, therefore, the assets in a tax-free reorganization are transferred to *B* which sells the assets. The Commissioner under section 45 seeks to deny the loss to *B* and allocate it to *A* on the ground that such allocation is necessary to clearly reflect the income of *A* since the assets depreciated in market value while in its hands. Section 45 provides:

"In any case of two or more organizations, trade, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Commissioner is authorized to distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trade, or businesses."

It is clear that under the cases the Commissioner will be successful in his claim.⁸⁸ It makes no difference under section 45 whether in the case given the transaction was entered into in order for *B* to obtain a tax benefit as long as if as a result, *B* would obtain a deduction for a loss to which it is not entitled.⁸⁹ If, however, all of the assets of the transferor are conveyed to the transferee and the transferor is dissolved, there is some question as to whether the transaction would be vulnerable to attack under section 45. Section 45 authorizes the Commissioner to distribute, apportion or allocate the income or deduction, credit or allowance, as the case may be; but if the transferor is no longer in existence, the Commissioner could not distribute, allocate or apportion the loss deduction to it. Section 45 gives no authority to

⁸⁸ *G.U.R. Co. v. Commissioner* (C.C.A. 7th, 1941) 117 F. (2d) 187; *National Securities Corporation v. Commissioner* (C.C.A. 3d, 1943) 137 F. (2d) 600. *cert. den.* 320 U.S. 694. *Cf. Asiatic Petroleum Co. v. Commissioner* (C.C.A. 2d, 1935) 79 F. (2d) 234. Under these cases the loss, to the extent it represents a depreciation in market value arising after the transfer, is deductible by the acquiring corporation. *Cf. National Investors v. Hoey, supra* p. 63.

⁸⁹ *National Securities Corporation v. Commissioner, supra* note 88. In this case Corporation *A* was an insurance company and sold the assets to the *B* Corporation because it was deemed unwise for an insurance company to hold the assets. It was held that nevertheless under §45 that the *B* Corporation could only deduct as a loss the amount of the difference between the value of the stock at the time it acquired it and the sales price and that the difference in the amount of the loss was deductible only by *A*.

the Commissioner to entirely disallow the deduction; where he disallows the deduction to one corporation, he must allow it to another corporation.⁹⁰ It is possible that the Commissioner might successfully argue that in the ordinary case of corporate dissolution, the corporate entity survives, since under many state statutes the corporate entity is continued for purposes of suit, etc. However, if the transferor merges with the transferee, it would seem that the Commissioner would be entirely powerless under section 45 to attack the transaction, since the corporate personality of the transferor on a statutory merger is drowned in that of the transferee.⁹¹

The further question arises as to whether loss carry-overs and unused excess profits tax credits can be transferred from one controlled corporation to another corporation controlled by the same interests. We have seen that loss carry-overs and unused excess profits tax credits may not be transferred from one corporation to the other except possibly on a statutory merger or consolidation.⁹² However, suppose that such a statutory merger between Corporation *A* and Corporation *B* which are controlled by the same interests and there is thereby sought to be transferred to *A* a large carry-over that *B* has. Could the Commissioner under section 45 deny *A* the right to use the carry-over? Under section 45 the Commissioner would be required to allocate the deduction or credit but the deduction or credit would have to be allocated between *A* and *B* and under the merger theory *A* and *B* are now the same corporate identity.⁹³

Let us further suppose that by the same transaction *A* seeks to inherit *B*'s high excess profits credit. The same result would appear to follow. Section 45 merely authorizes the Commissioner to make the allocation to prevent *evasion* of taxes or "clearly to reflect the income" of the respective corporations. In view of the narrow definition of tax evasion it is doubtful whether the Commissioner could hold that this constitutes an evasion of taxes.⁹⁴ Furthermore,

⁹⁰ *General Industries Corp. v. Commissioner* (1937) 35 B.T.A. 615; *National Securities Corp. v. Commissioner* (C.C.A. 3d, 1943) 137 F. (2d) 600.

⁹¹ *Helvering v. Metropolitan Edison Co.* (1939) 306 U.S. 522.

⁹² *Supra* p. 58.

⁹³ *Supra* note 91.

⁹⁴ *Supra* note 1. For cases refusing to set aside under section 45 transactions between affiliated corporations in the absence of proof of evasion, see *Drawoh, Inc. v. Commissioner* (1933) 28 B.T.A. 666; *Wachtel Corp. v. Commissioner* (1945) T.C. Mem. Op. C.C.H. Dec. 14683(M); *Ames Theatre Corp. v. Commissioner* (1945) T.C. Mem. Op. C.C.H. 14966(M); *Seminole Flavor Co. v. Commissioner* (1945) 4 T.C. 215; *Briggs-*

the allowance of an excess profit credit has nothing to do with the corporation's income. This credit is taken after the income has been determined and is allowed merely for the purpose of determining the amount of the tax and does not enter into the computation of the taxpayer's income.⁹⁵ It clearly appears, therefore, that section 45 would not be applicable.

We have thus far considered under this section, relative to acquisitions between controlled corporations, types of transactions which were discussed under section B, *viz.*, direct acquisitions of assets by the corporation to which it is desired to transfer the loss carry-over, unused excess profits tax credit, etc. Suppose, however, the transaction takes the form of a transfer of assets to the controlled corporation which already has the credit, *viz.*, transactions of the kind discussed under section II-C, would the courts set aside the attempted transfer of assets? In this type of case it is the transferor which would have the high income producing assets and it would be the transferee which would have the credit or loss carry-over. The question arises as to whether it would be held that, by reason of the common control, the Commissioner under section 45, or on some other grounds, could set aside the transaction.

The rule appears to be that, if the income has been already earned at the time of the transfer, but for some reason has not as yet been

Killian Co. v. Commissioner (1939) 40 B.T.A. 895. Note also that section 129 uses both terms "avoidance" and "evasion" of taxes.

In Asiatic Petroleum Co. v. Commissioner (C.C.A. 2d, 1935) 79 F. (2d) 234, in its opinion the court takes the position that the term "evasion of taxes" as used in section 45 is synonymous with "avoidance of taxes". However, an examination of the opinion will show that what the court actually held was that the Commissioner properly invoked section 45 and allocated the gain in question to the taxpayer in order clearly "to reflect the income" of the taxpayer. In this case the taxpayer (a domestic corporation) transferred to a foreign subsidiary securities which had greatly appreciated in value prior to the anticipated selling thereof. The foreign subsidiary sold the securities and the court held that the profit on the sale was taxable to taxpayer.

⁹⁵ §711 defines "excess profits net income." In the computation of "adjusted excess profits net income" the excess profits tax credit is deducted from "excess profits net income." See §711(b)(2).

It may be noted in this connection that it was not until 1943 that section 45 was expanded to provide for the reallocation of credits and allowances. Prior to that time it only provided for the reallocation of gross income and deductions. See §128(b) of the Revenue Act of 1943. The Committee reports on the bill concede that no change was affected by this addition. Conference Report on Revenue Bill of 1943, page 18; House Ways and Means Committee Report on Revenue Bill of 1943, H. REP. No. 871, 78th Cong., 1st Sess., p. 50; Senate Finance Committee Report on Revenue Bill of 1943, SEN. REP. No. 627, 78th Cong., 1st Sess., p. 60.

reported, *i.e.*, because the transferor corporation was on a cash basis, despite the transfer, the income will be assessed to the transferor. If an attempt is made to transfer an anticipated gain, representing unrealized appreciation in the value of assets, the transaction is subject to attack under section 45. If on the other hand the income has not as yet been earned, it would appear that the Commissioner is powerless to attack the transaction under section 45, or on any other grounds.⁹⁶ The recent decision of the United States Supreme Court in a case where the husband makes his wife a "partner" in his business, and holding that under the circumstances the entire income of the business was nevertheless taxable to the husband, does not lay down a different rule. In that case, the husband retained control of the income.⁹⁷

⁹⁶ Commissioner v. Montgomery (C.C.A. 5th, 1944) 144 F. (2d) 313. In this case a construction engineer held a contract which he transferred to a corporation which he actually controlled, but a large part of the stock of which was owned by his children. The court held that the income accruing after the transfer was taxable to the corporation and not to the engineer.

A similar result was reached in *Sherwin v. Commissioner* (1942) 46 B.T.A. 330. In this case a corporation transferred to its stockholders shares of stock held by it for investment. The court held dividends on the shares were not taxable to the corporation, even though the stockholders paid but a small amount down and were to pay the balance with interest within 5 years after date of purchase.

If, however, the income had been earned at the time of the transfer, it would be taxable to the transferor. *Brown v. Commissioner*, *supra* note 61; *Judd Plumbing and Heating Co. v. Commissioner* (C.C.A. 5th, 1946) 46-1 U.S.T.C. No. 9177.

In the event it were sought to transfer an anticipated capital gain from one corporation to another in the same controlled group, the transaction would be vulnerable under section 45 and the Commissioner could reallocate the gain to the transferor corporation. *Asiatic Petroleum Co. v. Commissioner* (C.C.A. 2d, 1935) 79 F. (2d) 234, where a parent corporation, in anticipation of the sale of a capital asset at a gain, then held by a domestic corporation, caused the same to be transferred to a foreign corporation which was a member of the group. It was held, nevertheless, on the sale of the capital asset, the gain was taxable to the transferor corporation. *Cf. Fairfield v. Commissioner* (1945) C.C.H. Dec. 14699, where the Tax Court reached a similar result on the basis of *Commissioner v. Court Holding Co.* (1945) 45-1 U.S.T.C. No. 9215. However, gain to the extent of appreciation in value arising after transfer would be taxable to the transferee. See *supra* note 88.

It may be noted that the intention of the parties in transferring the assets from one corporation to the other would be immaterial and, even where the assets were transferred without any intention of obtaining a tax advantage, the amount of the appreciation in value arising, or the amount of the income accrued, prior to the transfer would be taxable to the transferor upon the sale of the asset or the realization of the income, as the case may be. *National Security Corp. v. Commissioner* (C.C.A. 3d, 1942) 137 F. (2d) 600, *cert. den.* 320 U.S. 694.

⁹⁷ *Commissioner v. Tower* (1946) 14 L.W. 4200. In this case, in which the Supreme Court held that the circuit court of appeals should have affirmed the decision of the Tax Court holding that the income of the "husband-wife partnership" should have

It is questionable whether an attempt to transfer the benefit of a deduction for depreciation on low value high basis assets would be subject to attack under section 45. Depreciation in this sense is amortization over its useful life of the cost or other basis of property. Accordingly it is arguable that the deduction of depreciation is subject to attack on the same ground as if the property had been sold, *i.e.*, that any deduction on account of the decline in market value prior to the transfer is allocable to the transferor, whether such deduction is on account of the subsequent sale of the property by the transferee or on account of depreciation thereof while held by the transferee, and that the transferee is entitled to take a deduction for depreciation only on account of the market value of the property at the time of the transfer.

In view of the foregoing, it clearly appears that, in the ordinary type of transaction heretofore discussed, section 45 is of assistance only where it is sought to transfer a loss or gain representing depre-

been taxed to the husband, in answer to the taxpayer's claim that he had a legal right to decrease his income taxes, admitted this principle of law, but stated:

"It would clearly apply, in a situation where a member of a partnership in order to keep from paying future taxes on partnership profits and in order to get into a lower income tax bracket sells his interest to a stranger relinquishing all control of the business. But the situation is different where the taxpayer draws a paper purporting to sell his partnership interest even to a stranger though actually he continues to control the business to the extent he had before the 'sale' and channels the income to his wife, then as showing that the arrangement was made for the express purpose of reducing taxes simply lends further support to the inference that the husband still controls the income from his partnership interest, that no partnership really exists and that the earnings are really his and therefore taxable to him and not to his wife. The arrangement we are here considering was of the type where proof of a motive to reduce income taxes simply further lends strength to the inference drawn by the Tax Court that the wife was not really a partner. See Paul, *Selected Studies in Federal Taxation*, 2d Series, pp. 293-300. To rule otherwise would mean ordering the Tax Court to shut its eyes to the realities of tax avoidance schemes.

"It is the command of the taxpayer over the income which is the concern of the tax laws. *Harrison v. Schaffner*, 312 U.S. 579, 581, 582. An income earned by one corporation is taxable as his if given to another for the donor's satisfaction. *Helvering v. Horst*, 311 U.S. 112, 119. It is for this reason, among others, that we held in *Helvering v. Clifford*, *supra* 335, that transactions between husband and wife calculated to reduce family taxes should always be subjected to special scrutiny for if under circumstances such as those now before us the end result of the creation of a husband-wife partnership, though valid under state laws, is that income produced by the husband's efforts continues to be used for the same business and family purposes as before the partnership, failure to tax it as the husband's income would frustrate the purpose of 26 USCS 22(a). By the simple expedient of drawing up papers, single tax earnings cannot be divided into two tax units and surtaxes cannot be thus avoided."

ciation or appreciation of market value prior to the transfer, or there is a direct attempt to "evade" taxes; but that otherwise acquisitions for tax benefit in such cases are not subject to attack.

It should be also noted that section 45 is applicable only where there is control by the same interests of the two corporations.⁹⁸ It may be further noted that section 45 is not applicable in the case of a transaction between an individual and a corporation unless the individual could, by reason of the peculiar state of facts, be said to constitute a trade or business. Section 24(b), relating to losses on sales by individuals to wholly owned corporations, would not be applicable to this situation, since the section only prevents the deduction by the individual of the loss and does not prevent the individual from transferring the loss, etc., to the corporation.

There are, however, certain types of transactions which are peculiar to controlled corporations. For example, a corporation with a large income and a low excess profits tax credit might transfer several units of its business to various subsidiaries, thereby seeking to obtain the benefit of the specific exemption of \$25,000 for each corporation under the excess profits tax provisions.⁹⁹ A further example may be given where a corporation has paid large excess profits taxes in 1945 and has two businesses, one a loss producing business, and the other a high income producing business. The corporation in 1946 transfers the high income producing business to a subsidiary, retaining the loss producing business, thereby hoping to obtain a refund of the excess profits taxes paid by an excess profits carryback and a net loss carryback.

In the first example given, the court would probably hold that the subsidiaries were merely agents of the parent corporation and that its income was taxable to them. But it would seem that the transaction in the second example would not be subject to attack, since, as was stated, there were two separate businesses and the transferor transferred one entire business to the transferee.

⁹⁸ In *Lake Erie & Pittsburgh Ry. Co. v. Commissioner* (1945) C.C.H. Dec. 14707, taxpayer's stock was owned equally by the New York Central R.R. Co. and the Pennsylvania Ry. Co. Taxpayer owned certain tracks which were jointly used by its shareholders. The shareholders had theretofore paid rental for the use of the tracks. An agreement was entered into for the waiver of the rental in consideration of the waiver of dividends. The court upheld the agreement and held that section 45 was not applicable, since neither the New York Central nor the Pennsylvania Ry. Co. controlled the tax-paying corporation.

⁹⁹ §710(b)(1).

In *Continental Oil Co. v. Jones*¹⁰⁰ the taxpayer was engaged in the manufacture and production of oil. Prior to the effective date of the 1932 Act which imposed a floor tax on such producing corporations on account of gasoline and lubricating oil in stock the taxpayer corporation transferred its stock of gasoline and lubricating oils to two non-operating subsidiaries. Under the Revenue Act provisions the tax was only imposed on stocks held by producing companies. It was held that nevertheless the taxpayer corporation was required to pay the tax on the ground that it really remained the owner of the gasoline and lubricating oils and that the subsidiaries were merely its own agents. A somewhat similar result was reached in *Commissioner v. Laughton*.¹⁰¹ In this case the taxpayer formed a British corporation and then entered into a contract with the corporation to work for it for five years at a given compensation per year. The corporation then in turn entered into a contract with American motion picture producers for taxpayer's services at a greater increase in pay, which was paid to the British corporation. The Board of Tax Appeals held that the compensation paid to the British corporation by American producers was not taxable to the taxpayer. The circuit court of appeals reversed the case with instructions to the board to determine whether or not the transactions constituted a single transaction so that the compensation paid by the American producers was taxable to the taxpayer. In these cases the corporation was held to be but a sham and thereby a mere agent for the taxpayer corporation. The question arises as to whether on the basis of the reasoning of these cases acquisitions for tax benefit under similar circumstances would be condemned. In these cases, the holding was placed on the ground that the corporation was the taxpayer's agent. In absence of such showing of agency the rule would not apply.¹⁰²

Before closing this section, it would be helpful to compare the results under the consolidated return regulations and results of cases of acquisitions between controlled corporations.

Let us suppose that there is an affiliated group of two corporations

¹⁰⁰ (C.C.A. 10th, 1940) 113 F. (2d) 557. See *Ames Theatre Corp. v. Commissioner*, *supra* note 94; *Seninole Flavor Co. v. Commissioner*, *supra* note 94, for cases holding that under circumstances there present a separate business had been transferred so that its income was not taxable to the transferor corporation.

¹⁰¹ (C.C.A. 9th, 1940) 113 F. (2d) 103.

¹⁰² *Cf. Moline Properties Inc. v. Commissioner* (1943) 319 U.S. 436; *Commissioner v. Montgomery* (C.C.A. 5th, 1944) 144 F. (2d) 313; *National Investors v. Hoey* (C.C.A. 2d, 1944) 144 F. (2d) 466.

which has not theretofore filed a consolidated return and one corporation in the affiliated group has a large loss or carry-over of some kind, but has a low income, and the other corporation has a high income. How could the corporations go about offsetting the loss or credit against income?

If the credit or loss is a loss carry-over or unused excess profits tax credit, if the corporation filed a consolidated return, the loss carry-over or unused excess profits tax credit nevertheless could be deducted only against the income of the corporation having the loss carry-over or credit since, under the facts given, the unused credit or carry-over arose prior to the first taxable year for which its income was included in the consolidated return. However, if the high income producing assets are transferred to the corporation having the loss carry-overs or unused credit, it would appear that the transaction would not be vulnerable to attack under section 45.

Suppose on the other hand that the deduction or credit is an anticipated loss on the sale of a capital assets or a high excess profits tax credit, if the corporations were "affiliated" on March 14, 1941, the consolidated return regulations would not prevent the application of the capital loss deduction or high excess profits credit against the income of the high earning corporation on the filing of the consolidated return, even though consolidated returns had not been filed until subsequent to March 14, 1941. On the other hand, under section 45 the benefit of the loss deduction could not be transferred from the corporation having the loss deduction to the other, but there is no reason why the benefit of an excess profits credit could not be transferred from one corporation to the other. However, if the high income producing assets were transferred to the corporation having the credit or anticipated capital loss, there would be no reason under section 45 why it could not offset its income against such credit or capital loss.

Under the consolidated return regulations, even if a consolidated return for an affiliated group had been filed and another corporation, a member of a larger chain of which the group is a part, becomes a member of the group after March 14, 1941, assuming the requisite stock ownership existed on said date, a capital loss of such member representing depreciation in market value prior to the transfer could be deducted on the consolidated return without limitation. Section 45 would prevent the transfer of the loss deduction in the event the loss producing assets were transferred from one affiliate to another. The same results would obtain where it was sought to transfer a capital

gain based on appreciation in value of the assets prior to the transfer.

It would seem that in the cases where section 45 is broader in its scope than the consolidated return regulations, section 45 would not operate in the cases where consolidated returns are filed because the consolidated return regulations would probably be held to preclude the application of the section beyond the extent provided in such regulations.

III. THE RULE OF SECTION 129

A. INTRODUCTORY

Section 129 of the Internal Revenue Code provides as follows:

"ACQUISITIONS MADE TO AVOID INCOME OR EXCESS PROFITS TAX

"(a) Disallowance of Deduction, Credit, or Allowance. If (1) any person or persons acquire, on or after October 8, 1940, directly or indirectly, control of a corporation, or (2) any corporation acquires, on or after October 8, 1940, directly or indirectly, property of another corporation, not controlled, directly or indirectly, immediately prior to such acquisition, by such acquiring corporation or its stockholders, the basis of which property, in the hands of the acquiring corporation, is determined by reference to the basis in the hands of the transferor corporation, and the principal purpose for which such acquisition was made is evasion or avoidance of Federal income or excess profits 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. For the purposes of clauses (1) and (2), control means the ownership of stock possessing at least 50 per centum of the total value of shares of all classes of stock of the corporation.

"(b) Power of Commissioner to Allow Deduction, etc., in Part.—In any case to which subsection (a) is applicable the Commissioner is authorized—

"(1) to allow as a deduction, credit, or allowance any part of any amount disallowed by such subsection, if he determines that such allowance will not result in the evasion or avoidance of Federal income and excess profits tax for which the acquisition was made; or

"(2) to distribute, apportion, or allocate gross income and distribute, apportion, or allocate the deductions, credits, or allowances the benefit of which was sought to be secured, between or among the corporations, or properties, or parts thereof, involved, and to allow such deductions, credits, or allowances so distributed, apportioned, or allocated, but to give effect to such allowance only to such extent as he determines will not result in

the evasion or avoidance of Federal income and excess profits tax for which the acquisition was made; or

"(3) to exercise his powers in part under paragraph (1) and in part under paragraph (2)."

This section was added by section 128(a) of the Revenue Act of 1943. Section 128(b) amends section 45 to provide for the apportionment of credits and allowances in addition to gross income and deductions. Section 128(c) of the Revenue Act of 1943 provides:

"The amendments made by this section (section 128) shall be effective with respect to taxable years beginning after December 31, 1943. The determination of the law applicable to prior taxable years shall be made as if this section had not been enacted and without inference drawn from the fact that the amendment made by the section is not expressly made applicable to prior taxable years."

We will discuss the provisions of section 129 in the following order:

- (1) Effective dates provisions, including section 128(c) of the Revenue Act of 1943.
- (2) Requisite intent provisions.
- (3) Remedy; power of the Commissioner to allow deductions, etc.
- (4) Meaning of "control, directly or indirectly," "acquisition" and other terms.
- (5) Scope of operative provisions.

B. EFFECTIVE DATE PROVISIONS

Section 129 applies only to acquisitions on or after October 8, 1940, which is the date of the enactment of the Second Revenue Act of 1940 which act first imposed the excess profits tax.¹⁰³ The use of this date clearly indicates that the Congress in adopting section 129 had in mind primarily the preventing of the reduction of excess profits taxes.¹⁰⁴

Under the provisions of section 128(c) of the Revenue Act of 1943, section 129 is applicable only to taxable years beginning after December 31, 1943. In this connection it may be noted that the pro-

¹⁰³ 54 STAT. (1940) 975, 26 U.S.C. (1940) §710.

¹⁰⁴ See the Report of the House Committee on Ways and Means of Revenue Bill of 1943, H.R. No. 871, 78th Cong., 1st Sess. (1943) 49, where it states: "The crux of the devices which have come to the attention of the committee has been some form of acquisition rule after the effective date of the Second Revenue Act of 1940, but the devices take many forms."

visions of section 129 are not applicable to the same taxable years as amendments to the consolidated return regulations issued on March 14, 1944.¹⁰⁵

Section 128(c) further provides that the law applicable to prior taxable years shall not be affected by the enactment of section 129 and that such law shall be applied without any inference drawn from the fact that the section is not made applicable to prior taxable years.

Furthermore, it clearly appears from the committee reports that there was no intention in adopting section 129 to narrow the rules laid down by the decided cases as to taxable years commencing after December 31, 1943, so that if the transaction was condemned under the decided cases but was not condemned under section 129 nevertheless the rules of the decided cases would prevail. This is particularly important in the case of acquisition between the common controlled groups of corporations to which the provisions of section 129 are not generally applicable.¹⁰⁶

C. REQUISITE INTENT PROVISIONS

Section 129 provides for its application in cases where "the principal purpose for which such acquisition is made is evasion or avoidance of federal income or excess profits tax by securing the benefit of a deduction, credit or other allowance, which such person or corporation would not otherwise enjoy." The regulations state, "If the purpose to evade or avoid Federal income or excess profits tax exceeds in importance any other purpose it is the principal purpose. This does not mean that only those acquisitions fall within the provisions of section 129 which would not have been made if the evasion or avoidance purpose was not present. The determination of the purpose for which an acquisition was made requires the scrutiny of the entire circumstances in which the transaction or course of conduct occurred in connection with the tax result claimed to arise therefrom."¹⁰⁷ Similar

¹⁰⁵ T.D. 5340 and T.D. 5341 (1944 Cum. BULL. 295) discussed *supra* p. 46. These amendments to the consolidated return regulations are applicable to years ending on or after December 31, 1943.

¹⁰⁶ See Report of Senate Finance Committee on the Revenue Bill of 1943, SEN. REP. 627, 78th Cong., 1st Sess. (1943) 59; Conference Committee Report on Revenue Bill of 1943, 17; *Cf. Dobson v. Commissioner* (1944) 320 U.S. 489; *Helvering v. Clifford* (1939) 309 U.S. 331, for cases where the Supreme Court in applying some general principle of tax law rejected the argument that the principle had been narrowed by the enactment by Congress of a provision giving effect to the principle in a limited class of cases not covering the case at bar.

¹⁰⁷ Reg. 111, § 29.129-3.

language appears in the Report of the Senate Committee on Finance.¹⁰⁸ Under the regulations it appears that whether the purpose of evasion or avoidance is the principal purpose it is determined by considering circumstances of the transaction rather than inquiring into the mental state of the parties. It may be assumed that the Commissioner in drafting the regulation had in mind that if the most important benefit from the transaction was tax avoidance benefit it will be presumed that the purpose of obtaining such benefit was the principal purpose of the transaction. The rule seems to be a practical one since it would be extremely hazardous, to say the least, to rely upon the statements of the acquiring person or persons as to the matter even though made at the time such transaction was entered into.¹⁰⁹

Section 129 uses not only the word "evasion" but also the word "avoidance." The word "evasion" has some sinister connotation which appears to be absent from the word "avoidance." Indeed the courts without statutory aid would prevent tax "evasion." The word "avoidance" does not have this sinister connotation, so that any reduction in tax liability would come within the term "avoidance of taxes."¹¹⁰

The intent provisions of section 129 are quite different from section 45 and the provisions of the consolidated return regulations relating to deductions, credits, etc. Under section 45 it must merely be shown that the proposed distribution, apportionment or allocation of gross income, deductions or credits is necessary to reflect true income or prevent evasion. Under the consolidated return regulations above referred to, the deduction or credit is excluded from the consolidated return even without proof that it is necessary to reflect true

¹⁰⁸ See Report of Senate Committee on Finance on Revenue Bill of 1943, *supra* note 106 at 59, where it is said: "The House Bill made section 129 operative if one of the principal purposes was tax avoidance. Your Committee believes that the section should be operative only if the evasion or avoidance purpose outranks or exceeds in importance any other one purpose."

¹⁰⁹ *Cf.*, however, cases arising under section 811(c) in regard to transfers in contemplation of death. See 1 PAUL, ESTATE AND GIFT TAXES (1941) §616 *et seq.* It appears under the rule in these cases that the *actual motive* is the determinative factor. See also the recent decision of the U.S. Supreme Court in *Allen v. Trust Company of Georgia* (1946) 14 LAW WEEK 4108.

¹¹⁰ See PAUL, *Restatement of the Law of Taxation Avoidance*, appearing in his STUDIES ON FEDERAL TAXATION (1937) 9. See also *Bullen v. Wisconsin* (1916) 240 U.S. 625. *Helvering v. Gregory*, *supra* note 6. *Cf.* Report of Senate Finance Committee on the Revenue Bill of 1943; SEN. REP. 627, 78th Cong., 1st Sess., 58-60. In the House bill only the term "avoidance" was used. The Senate Finance Committee added the term "evasion." See also *supra* note 94.

income. Only in the amendments to the consolidated return regulations, issued on March 14, 1944, T.D. 5340 and 5341, relating to post March 14, 1941 formations of, and changes in, affiliated groups is there any power of the Commissioner to allow the challenged credit or deduction covered thereby if satisfied that such allowance will not distort the income tax liability of the group or its members. The intent provision of section 129 greatly limits its applicability, as compared with the consolidated return regulations provisions limiting the allowance of deductions and credits.

However, as compared with section 45, the inclusion of the intent provisions is out-balanced by the fact that section 129 is applicable in case of "tax avoidance"; while section 45 is applicable only where the adjustment is necessary to prevent "tax evasion" or reflect true income. We showed in our discussion of section 45 that it is applicable only if (1) the challenged transaction between the corporate parties was fictitious, *i.e.*, it was an evasion; or (2) it was an attempt to transfer by one member of the group to the other the benefit of some loss or gain which was attributable to events preceding the transfer, *i.e.*, it was a distortion of "true income." Section 129 is not so limited.

D. REMEDY: POWER OF COMMISSIONER

Under section 45 the Commissioner is merely given the power to distribute, apportion and allocate gross income, deductions, etc. As we showed in our discussion of section 45, he is given no power to completely disallow the deduction or credit. Under the provisions of the consolidated returns regulations, providing for the limiting of the allowance of deductions for losses and credits, the challenged deduction loss or credit is allowed to the extent of the income, capital gains, etc., of the individual corporation having the deduction loss or credit. However, its disallowance beyond the amount of such income and capital gains, etc., is an effective disallowance under the consolidated returns provisions.

On the other hand, under section 129(a), the challenged deduction, credit or allowance is disallowed *in toto*. It would appear that, since deductions are not a matter of right, such disallowance is constitutional,¹¹¹ particularly where, as here, such disallowance is part of a statutory plan to prevent tax avoidance.¹¹² The provision under

¹¹¹ *Brushaber v. Union Pacific Ry. Co.* (1916) 240 U.S. 1; *Stanton v. Baltic Mining Co.* (1916) 240 U.S. 103; and *Helvering v. Independent Life Ins. Co.* (1934) 292 U.S. 371.

¹¹² *Helvering v. National Grocery Co.* (1938) 304 U.S. 282.

section 129 for the disallowance, rather than the distribution, apportionment and allocation of the deduction or credit, greatly adds to the effectiveness of section 129. It avoids the difficulty of application in the case of a statutory merger or consolidation, which appeared to be present in the application of section 45.

Under section 129(b) the Commissioner is authorized, to the extent that he determines that the same would not result in the evasion or avoidance for which the acquisition was made (1) to allow any deduction, credit or allowance disallowed by section 129 and/or (2) distribute, apportion or allocate any such deduction, credit or allowance between the corporations and properties involved, and allow the deduction, credit or allowance so distributed, apportioned or allocated. This power is clearly to permit the Commissioner to ameliorate the effect of the total disallowance of deductions, credits and allowances provided for by section 129(a).

The Commissioner is also given the authority by section 129(b) (2) to distribute, apportion or allocate gross income between the corporations and properties involved. This authority to distribute, apportion or allocate gross income is not conditioned on a determination by the Commissioner that it will not result in the evasion or avoidance for which the acquisition was made. Inasmuch as section 129 provides only for the disallowance of deductions, credits, or allowances, it is clear that this authority to distribute, apportion or allocate gross income is not given to the Commissioner for the purpose of enforcing section 129, but is given to the Commissioner in connection with his authority to partially allow deductions, credits and allowances otherwise disallowed under section 129. This is the viewpoint taken by the Commissioner in the Regulations.¹¹³

This authority conferred upon the Commissioner by section 129 (b) is entirely different from his authority under section 45. Under section 45 the Commissioner is given the authority to enforce the provisions of the section. On the other hand, under section 129(b) the

¹¹³ See Regulations 111, §29.129-4; also, Report of Senate Finance Committee on Revenue Bill of 1943, *supra* note 106 at 59, where it is stated: "The House bill made Section 129 operative only upon an express finding by the Commissioner. Your Committee has eliminated the necessity for an express finding."

This change made by the Senate Committee was retained in the final bill. It is clear therefrom that the enforcement of section 129 is not dependent upon any finding or determination by the Commissioner. This conclusion supports the statement in the text that the authority of the Commissioner to distribute, apportion or allocate gross income conferred by section 129 is not a power in connection with the enforcement of the section.

Commissioner is given the authority to ameliorate the hardship of a complete disallowance of the challenged deduction or credit. The specific authority given to the Commissioner under section 129(b) is likewise different from the authority to prescribe broad regulations, such as that conferred in connection with the consolidated returns under section 141(b).¹¹⁴

This specific authority given the Commissioner by section 129(b) vested in him the right to deal with individual cases.¹¹⁵ The authority conferred upon the Commissioner in this respect is somewhat similar to his power to allow the deduction of partially worthless debts conferred by section 23(k)(1), which provides that "when satisfied that a debt is recoverable only in part, the Commissioner may allow such debt, in an amount not in excess of the amount charged off in the taxable year as a deduction." It is established by the decisions that the Commissioner may not arbitrarily refuse to give consent to such partial write-off.¹¹⁶ Under these decisions it would follow that the Commissioner may not arbitrarily refuse to allow a deduction credit or other allowance otherwise disallowed where such allowance "will not result in the evasion or avoidance of federal income or excess profits taxes for which the acquisition was made." The Congress in granting this authority to the Commissioner did not, it is submitted, purport to give him *carte blanche* the right to refuse to exercise the authority arbitrarily. An example will serve to illustrate the position here taken.

¹¹⁴ The committee reports do not appear to recognize this distinction. See Senate Report of Senate Committee on Finance, *supra* note 106 at 61; Conference Committee Report on Revenue Bill of 1943, 17.

The committee reports refer also to the broad regulatory powers of the Commissioner under section 141 providing for consolidated returns, but this power has to do with the promulgation of regulations and not to the application of the provisions of the section in individual cases. See the cases of *Helvering v. Reynolds* (1939) 306 U.S. 110; *Helvering v. Wilshire Oil Co.* (1939) 308 U.S. 90; and *Helvering v. Hallock* (1940) 309 U.S. 106, laying down the rules of the general power of the Commissioner to promulgate regulations.

¹¹⁵ It may be noted that in amendments to the consolidated returns regulations (issued March 14, 1944) the Commissioner reserved broad power, such as that conferred by section 129, to allow deductions, *etc.*, where the same will not serve to distort the income tax liability of the group or its members. See T.D. 5340 and 5341 and 1944 CUM. BULL. 295.

¹¹⁶ See *Santa Monica Mountain Power Co. Ltd. v. U.S.* (1938) (C.C.A. 9th, 1938) 99 F. (2d) 450; *Estate of Harris Fahnestock v. Commissioner* (1943) 2 T.C. 756. See also *Commissioner v. Liberty Bank & Trust Co.* (C.C.A. 6th, 1943) 59 F. (2d) 320; 5 MERTENS. LAW OF FEDERAL TAXATION (1942) §30.25.

Corporation *B* has an excess profits tax credit of five million dollars, but has no income. On the other hand, it has some property. Corporation *A* acquired the stock of *B* in 1943 for a million dollars and *A* thereupon transferred its high income producing assets to *B*. Under section 129, the entire excess profits tax credit of five million dollars would be disallowed. Under section 129(b), the Commissioner has authority to allow such credit at least to the extent of one million dollars, since such partial allowance would not "result in the evasion or avoidance of Federal income or excess profits taxes for which the acquisition was made." It is submitted that the Commissioner may not refuse to grant such partial allowance. Accordingly, the provisions of section 129(a) providing for the complete disallowance of the deduction, credit or allowance are subject to the limitation under section 129(b) that such disallowance shall be effective only to the extent that it would result in the specific evasion or avoidance of federal income and excess profits taxes for which the acquisition was made.¹¹⁷

E. MEANING OF TERMS

There are three important terms used in section 129, *viz.*, "control," "directly or indirectly" and "acquisition," the meaning of which must be explored before we are in a position to discuss the scope of section 129.

One of these words, "control," is defined by section 129. The other two terms, to some extent at least, are defined by examples given in the regulations. The importance of these terms will be seen from an outline of the "operative" provisions of section 129.

Section 129 applies in cases of the "acquisition" "directly or indirectly" of the (1) "control" of a corporation by any person or persons (hereinafter called the "corporate acquisition provision") or (2) property of a corporation by another corporation where the basis of the property in the hands of the acquiring corporation is determined

¹¹⁷ The situation is to be directly contrasted with section 45. Under section 45, if the Commissioner exercises an authority, the only question is as to whether the case comes within the purview of the operative provisions of section 45. *Leseine v. U.S.* (N.D. Cal. 1943) 43-2 U.S.T.C. 9510. In such case the question is as to whether the Commissioner is properly enforcing section 45. On the other hand, the Commissioner may refuse to invoke the provisions of section 45 and the taxpayer has no right to compel the Commissioner to invoke the provisions of said section. See *First Securities Corporation of Memphis v. Clements* (C.C.A. 6th, 1939) 103 F. (2d) 1011, *cf.* *Burnett v. Commonwealth Improvement Co.* (1932) 287 U.S. 415; *Moline Properties Co. v. Commissioner* (1943) 319 U.S. 436.

by reference to the basis in the hands of the transferor corporation except in cases where either the acquiring corporation or stockholders immediately prior to such "acquisition" "directly or indirectly" "controlled" the transferor corporation (hereinafter called the "asset acquisition provision") (for convenience the asset acquisition provision and corporate acquisition provision are collectively referred to as the "operative provisions").

Control:

"Control" is defined by section 129 as meaning the *ownership* of stock "possessing at least fifty per centum of the total combined voting power of all classes of stock entitled to vote *or* at least fifty per centum of the total value of shares of all classes of stock of the corporation." (*Italics supplied*). This definition of "control" therefore, is important in two respects. On one hand it defines the limits of the corporate acquisition provision and on the other hand it defines the limits of the exceptions to the asset acquisition provision.¹¹⁸ The definition of "control" taken by itself is fairly clear though some questions arise in connection therewith.

A somewhat similar definition of "control" appears in section 112(h) where this term is defined for the purpose of the definition of "reorganization" [section 112(g)] and in connection with section 112(b)(5) transactions. Section 112(h) defines "control" as meaning the ownership of stock possessing eighty per centum or more of the total combined voting power of all classes of stock entitled to vote *and* eighty per centum or more of all other classes of stock. In addition to the difference in the percentage requirement there are two important differences between the definition of "control" in section 112(h) and in the definition of the word in section 129.

(1) In section 112(h) the test is the *number* of shares held. In section 129 the test is the *value* of the shares acquired. (The difference becomes important if the corporation has outstanding two or more classes of shares having different values, *e.g.*, one class having a value of one dollar per share and the other, one hundred dollars per share.)

¹¹⁸ This circumstance is of some practical significance in that it will probably require the Commissioner to take a somewhat middle ground in construing the definition of "control." If he places a broad construction on this term while such construction would, of course, broaden the corporate acquisition provision, it would, on the other hand, narrow the scope of the asset acquisition provision by broadening the exception thereto.

(2) In section 112(h) the two conditions given (*viz.*, the amount of voting power and non-voting shares held) are in the conjunctive and both must be met. In section 129 the two conditions given (*viz.*, the voting power or the value of the shares acquired) are in the disjunctive and either condition may suffice.

The change in section 129 enumerated in (1) above appears to be a refinement of the corresponding provision in section 112(h).

The courts will undoubtedly strictly construe the definition of "control" appearing in section 129 and hold that the term "stock" refers to securities commonly called "stock" and not to other securities which (1) by force of circumstances, such as insolvency, may represent the equity interest in the assets of the corporation, or (2) carry the right to subscribe for stock.¹¹⁹

It may be assumed that "voting power" and "stock entitled to vote" have reference to the power, and to stock possessing the power, to vote on all general corporate matters generally submitted to the stockholders (including the right to vote for the election of directors) and not merely the limited power to vote on certain transactions, such as is generally conferred on all classes of stock "non-voting" as well as "voting," e.g., amendment of articles, sale of entire assets, etc. However, the question arises as to whether a class of stock entitled to exercise general voting power only under certain conditions (such as the failure of the corporation to declare and pay dividends on the stock for a designated period) should be considered "stock entitled to vote." It is submitted that if the condition is not fulfilled, the stock should not be considered as being entitled to vote.¹²⁰ It may be noted

¹¹⁹ See *Helvering v. Southwest Consolidated Corporation* (1942) 315 U.S. 194, holding that stock purchase warrants are not "stock" as that term is used in the definition of "control" in the reorganization provisions; and *Helvering v. Cement Investors* (1942) 316 U.S. 527, holding that the bondholders of an insolvent corporation were not holders of its "stock" within the meaning of said term.

¹²⁰ The decision in the *Southwest Consolidated Corp.* case, *ibid.*, would appear to be authority for the statement in the text. In that case it was held that a stock purchase warrant was not itself stock because the holder of the warrant could not exercise the rights of a stockholder as long as he remained a warrant holder. Similarly it would seem that stock not entitled to vote until a certain number of dividends have been passed cannot itself be held to be voting stock until the dividends have been passed.

Cf. the loose language used in section 129 with the definition of "voting security" contained in section 2(17) of the Public Utilities Holding Company Act of 1935, 49 STAT. (1935) 803, 15 U.S.C. (1941) §1090, where "voting security" is defined as meaning any security currently entitling the owner or holder thereof to vote in the direction of management of the affairs of a company, *etc.* One or more of the terms "voting stock," "voting power," "stock entitled to vote" is also used in the definition of "reorganization" appear-

that the standards of "voting stock," and "voting power" used in section 129 are more precise than the undefined term "control" used in 113(a)(7). Section 113(a)(7) provides that its substituted basis provisions shall be applicable in the case of reorganizations taking place after December 31, 1917 and prior to January 1, 1936 only if "immediately after the transfer an interest or control in such property of 50 per centum or more remained in the same persons or any of them."

As the alternative requirement under the definition of control the draftsmen of section 129 did not adopt the standard "interest" used in section 113(a)(7), but instead used the standard of value, which term imports a meaning of "worth."¹²¹ The comparative market values of different classes of stock in the same corporation may have little significance in the determination of the respective interests in the assets and business of the corporation represented thereby, since such comparative market values may depend upon comparative dividends rates and other factors. By using the term "value," inappropriate as it would appear to be, as a standard for the determination of "control" in section 129 the draftsmen avoided, at least in connection with the definition of the term "control," certain rather difficult questions which might have arisen if the standard used had been "interest." If the standard of "interest" had been used, considerable difficulty would have arisen in cases where a corporation has outstanding two or more classes of stock, and the persons in question did not acquire all classes of such stock, or acquired amounts in each class but not in the same proportion as the respective amounts thereof outstanding. It would be very difficult to determine the exact percentage "interest" of each class of stock.¹²² In view of the fact that the corporation is a

ing in section 112(g); in the definition of *control* appearing in section 112(h); and in the definition of *affiliated group* appearing in section 141(d) in connection with the consolidated return provisions. No case has been found construing these terms as used in these sections. For views similar to those expressed in the text see PAUL, *STUDIES OF TAXATION* (3d series) 62 *et seq.*

¹²¹ While the draftsmen did not use the term *fair market value*, which is used in section 113(a)(14) relating to the basis of property acquired before March 1, 1913, nevertheless the term *value* is used in section 811 referring to the valuation of property for estate tax purposes. The term *value*, therefore, would appear to be a word of art and would refer to worth of property.

¹²² *Otis & Co. v. Securities & Exchange Commission* (1945) 323 U.S. 624. In this case it was held that a reorganization plan proposed under the death sentence provisions of section 11(b)(2) Public Utilities Holding Company Act of 1935 was "fair and equitable," where it allowed participation in the new corporation by junior common stock-

going concern it would be erroneous to give exclusive consideration to the liquidation rights of the respective classes of securities. Furthermore, book value of the stock might be highly misleading. Again, the question would arise as to whether bonds or unsecured indebtedness of the corporation can represent an interest in its property.¹²³ It was probably with these problems in mind that the draftsmen of section 129 used the standard "value" of stock, importing as it does "worth," rather than using the standard employed in section 113(a) (7) of "interest" in property of the corporation.¹²⁴ However, we shall see in connection with our discussion of the term "directly or indirectly" that the draftsmen have postponed and not avoided, this troublesome problem.

Directly or Indirectly:

The difficult question of construction arises, not so much in connection with the definition of "control" as from its use in section 129 with the term "directly or indirectly." If in section 129 the definition of "control" is substituted for the word "control," we, in effect, have a provision relating to direct or indirect ownership of stock.

What is the meaning of "indirect ownership" of stock? It may be assumed that it includes beneficial ownership of stock held in trust by a nominee, custodian or agent or by a partnership,¹²⁵ but that it probably does not include stock owned in good faith by a member of one's family. Certainly the word "indirectly" does not import the provisions of the code applicable in certain limited circumstances where for such limited purposes a person is deemed to own stock held by members of his family.¹²⁶ The difficult question, however, arises as to whether ownership of stock of a corporation would constitute indirect ownership of the assets owned, including stock held, by the

holders even where the senior preferred stockholders did not receive securities having a present value equal to the preferred full liquidation preference.

¹²³ See G.C.M. 7422; see also *Palm Springs Hotel Corporation v. Commissioner* (1942) 315 U.S. 185, 188, Footnote 1; *W. Lehigh Metals Co.* (1946) 6 T.C. C.C.H. Dec. No. 15003.

¹²⁴ The definition of "control" was added by the conference committee to add precision to the term. Conference Committee Report on Revenue Bill of 1935, 17.

¹²⁵ Even without modifying the word "indirect," the term "ownership" would have been construed to include the types of equitable ownership referred to in the text. *C/* cases arising under reorganization provisions. *Schuh Trading Co. v. Commissioner* (C.C.A. 7th, 1938) 95 F. (2d) 404; *Federal Grain Corp. v. Commissioner* (1929) 18 B.T.A. 242; *Handbird Holding Corp. v. Commissioner* (1935) 32 B.T.A. 238.

¹²⁶ Rudick, 58 HARV. L. REV. 196, 211.

corporation.¹²⁷ Mr. Rudick, without the citation of authorities, categorically states: "Since the statute refers to a direct or indirect acquisition or control, it can reasonably be interpreted to mean that acquisition of a corporation . . . which controls another corporation is the acquisition or control of the subsidiary corporation."¹²⁸ It may be noted that the general counsel had ruled that the term "interest in the property," as used in section 113(a)(7) includes indirect ownership.¹²⁹

While it is not entirely clear, apparently the Senate Finance Committee had the same view as Mr. Rudick. In its discussion of this section the committee refers to a case where an 80 per cent owned subsidiary in a chain of affiliated corporations is liquidated in a section 112(b)(6) liquidation. The committee states that the parent, prior to the liquidation, controlled, within the meaning of section 129, each corporation in which the liquidated subsidiary owned a controlling interest of 50 per cent or more.¹³⁰ However, in the Senate Finance Committee's version of section 129 the term "control" was not defined. The regulations appear to take a similar position. See Regulations 111, section 29.128-1(d), where it is stated that not only Corporation *C* but also the stockholders of Corporation *C* taken as a group and also any stockholders of Corporation *C* owning 50 per cent of *C*'s stock are "in control" of *B*, a wholly owned subsidiary of *C*, and also of *Y*, a wholly owned subsidiary of *B*. The correctness of this construction of the term "indirectly" as used in section 129 is subject to serious doubt in the light of the decided cases,¹³¹ but in

¹²⁷ See PAUL, *STUDIES IN FEDERAL TAXATION* (3d series) 64, where the position is taken that such a type of ownership would not be included within the scope of the word "acquisition" as used in the definition of "reorganization" in section 112(g).

¹²⁸ Rudick, 58 HARV. L. REV. 196, 211.

¹²⁹ See G.C.M. 7472.

¹³⁰ SEN. REP. NO. 627, 78th Cong., 1st Sess. (1943) at 60.

¹³¹ Cf. the so-called commodities clause of the Interstate Commerce Act [41 STAT. 475, 49 U.S.C. (1940) §1(8)] providing that it should be unlawful for any railroad company to transport any article (with certain exceptions) mined or produced by it "in which it may have any interest direct or indirect." The courts have held that if a railroad company owns stock in an independent corporation which was not the mere *alter ego* of the railroad company, it was not thereby the indirect owner of commodities held by such corporation. *U.S. ex rel. Attorney General v. Delaware & Hudson Co.* (1909) 213 U.S. 366; *cf. U.S. v. Elgin, J. & E. Railway Co.* (1936) 298 U.S. 492; *cf. however*, the decision of the United States Supreme Court in *Palm Springs Hotel Corporation v. Commissioner* (1942) 315 U.S. 185, where it was assumed for the purposes of section 113(a)(7) that the creditors of an insolvent corporation had an interest in its property. (See 315 U.S. 185, 188, note 1.) However, in section 129 the word used in connection

view of the wide authority given by the courts to regulations, particularly when supported, as here, by a committee report, the construction adopted by the regulations will probably be upheld.¹³²

It may be noted that, generally speaking, indirect ownership of a corporation as construed by the regulations can be acquired in one of two ways: (1) persons acquiring control of a parent corporation may be deemed to have "indirectly" acquired control of its 50 per cent owned subsidiaries; or (2) a subsidiary in a chain of corporations may acquire the stock of another corporation and the parent corporation, its stockholders and each corporation in the chain in between the parent and the acquired subsidiary may be deemed to have "indirectly" acquired control of the acquired corporation.¹³³ It is conceded that by including under the term "indirectly" the ownership of stock held by subsidiaries that the Commissioner has greatly broadened the application of section 129. But, on the other hand, he has greatly narrowed the application of the section in connection with transactions between common controlled corporations.

However, by attributing to the term "indirectly" the broad meaning given to it by the regulations, numerous problems in respect to its application will arise and to a large extent the comparatively precise meaning given to the term "control" by its definition in section 129 has been undone. Before considering these problems, it may be pointed out that the higher federal courts (at least in cases arising from the Tax Court) will probably consider that the question is one of fact and that the determination of the "fact" of "control" by the lower court is binding.¹³⁴

The first question arises as to which security holders of a corporation would be deemed to "indirectly" own its assets. Under some cir-

with "indirect" is "ownership" and not merely the word "interest." Certainly to common lawyers the word "ownership" has an extremely strict meaning, though perhaps the term "interest" in the hands of a "fireside equity" lawyer can be given a somewhat broader meaning. *Cf.* G.C.M. No. 7472, where the terms "interest" and "ownership" are contrasted.

¹³² *Helvering v. Griffiths* (1943) 318 U.S. 371.

¹³³ See Regulations 111, §29.129-1.

¹³⁴ See decision of the United States Supreme Court in *Kelly v. Commissioner* (1946) U.S.D.C. No. 9133, and the decision of the third circuit court of appeals in *Bazley v. Commissioner* (1946) U.S.D.C. No. 9135. *Cf.* opinion of the Court in *Allen v. Trust Co. of Georgia* (1946) 14 Law Week 4108. The latter case originally arose in the federal district court. The Supreme Court in affirming the judgment of the lower court, that the release of the power involved was not a transfer in contemplation of death, examined at length into the facts of the case and did not appear to give the same conclusive weight to the holding of the district court as to the holding of the Tax Court in the *Kelley* case.

cumstances at least, when a corporation is insolvent, it would appear that the creditors might be held to indirectly "own" its assets.¹³⁵ Therefore, if for some reason an insolvent corporation acquired the stock of a subsidiary of another corporation, its creditors may be deemed to have acquired "control" of such corporation. Likewise, persons acquiring the obligations of an insolvent corporation may be deemed to have acquired "control" thereof for the purpose of section 129. On the other hand, it may be assumed the creditors are not the owners of the property of a corporation unless it is insolvent.¹³⁶

However, it would appear that the preferred stockholders, as well as the common stockholders, must be considered as indirect owners of the assets of a solvent corporation. The second question which arises is: How is the percentage of indirect ownership of the assets of a corporation (including stock of other corporations held by it) represented by each class of the outstanding stock of the corporation to be determined?

This question must be determined where the corporation has two or more classes of stock and the acquiring persons have not acquired stock of all classes, or have acquired stock of all classes but not in the same proportion as the respective amounts thereof outstanding.

Under our discussion of the definition of the term "control," we saw that the draftsmen of section 129 avoided several difficult questions of application by using the standards of "value" and "voting power" of stock, rather than the loose terms "interest" and "control" in property found in section 113(a)(7). Reference particularly was made to cases where a corporation has outstanding two or more classes of stock. It was there pointed out that the relative market values of the respective classes of stock are without significance in a determination of their respective interests in the property of the corporation, since such market value may largely depend on the dividend rates of the respective classes of stock, *etc.*

On the other hand, such respective interests in a going concern may not be determined solely by reference to the respective rights of the classes of stock on liquidation,¹³⁷ although the amount of such liquidation price should certainly be given some weight in the determination

¹³⁵ Cf. *Helvering v. Alabama Asphaltic Limestone Co.* (1942) 315 U.S. 179 and *Palm Springs Hotel Corporation v. Commissioner* (1942) 315 U.S. 185. In the *Palm Springs* case it was assumed that the creditors had an interest in the property within the meaning of section 113(a)(7) when a corporation was insolvent, 315 U.S. 185, 188, note 1.

¹³⁶ See cases cited *ibid.* See also *supra* note 123.

¹³⁷ See *Otis & Co. v. Securities and Exchange Commission*, *supra* note 122.

of the interest represented by the stock in the assets of the corporation. As a matter of fact, in many cases a preferred stock may have one price on voluntary liquidation and another price on involuntary liquidation. It would also seem that the book value of the stock would not be conclusive, since that usually represents original investment plus (or minus) the accumulated earnings of the stock. Even if book value be adjusted to reflect asset value appreciation and depreciation and also goodwill, the conflict between the liquidation price and book value (which will rarely be the same where a preferred stock is outstanding) must be resolved. To this difficult question must be added the possibility above referred to of a stock having two liquidation prices, one on voluntary, and the other on involuntary, liquidation.

Under the circumstances of such conflict, who can say what portion of the assets of a corporation is owned by each class of stock? The question as to "value" is comparatively easy of solution, since it involves an application of the comparatively objective standard of the amount for which a willing buyer would buy, and a willing seller would sell, the stock. It is submitted that the question as to the *exact* portion of the underlying assets of a corporation (including stock held by it) which is "indirectly" owned by each class of its outstanding stock is so extremely difficult as to defy application in some not too extraordinary situations. The difficulty is that indirect ownership by the stockholders of the property of a going concern has no objective significance.

These questions are multiplied when, not merely two corporations are, but a whole chain of corporations is, involved.

In addition to these problems arising under the broad construction of "indirectly," there is the problem of dilution of interest arising in a vertical chain of corporations. Thus, for example, to take a simple case: If *A* Corporation owns 80 per cent of the stock of *B* Corporation, all of one class; and *B* Corporation owns 50 per cent of the stock of *C* Corporation, likewise all of one class, does *A* "indirectly" control *C*? It would seem that *A* "indirectly" owns only a 40 per cent interest in *C* and fails to meet the 50 per cent requirement of the definition of the term "control." It may be noted that, even where there is ownership of 80 per cent existing between each member of a vertical chain, a parent has barely a 41 per cent interest in the fourth line subsidiary, *i.e.*, *S*₄ in the chain (*P-S*₁-*S*₂-*S*₃-*S*₄).

The Senate Finance Committee had a different view in the example first given in respect to this point and took the position that in-

direct control existed in such case.¹³⁸ However, the definition of "control" was added in conference after the bill had been passed on in the Senate Finance Committee.¹³⁹ For this reason, it is submitted that the Senate Finance Committee's view on this matter is without a great deal of weight. The regulations appear to be silent on the point.¹⁴⁰

If it is desirable to use the concept of "indirect ownership," a more precise formula like the one employed in the definition of "affiliated group" in section 141, consolidated return provision, could have been used. Section 141 provides that each member of the affiliated group (other than the parent) must be connected by a 95 per cent stock ownership with another member or members of the affiliated group, and the parent must have a 95 per cent ownership in at least one member of the group.

"'Indirect control' by one corporation (or person or persons) of a second corporation could be defined as the direct 'control' by one corporation (or person or persons) of another corporation which 'controls' or two or more other corporations which 'control' directly or 'indirectly' (within the meaning of the definition) the second corporation." Under such definition (i) indirect ownership would exist only where there was *stock* ownership; (ii) the troublesome question of determining "interest" in assets of a corporation represented by a stock would be eliminated; and (iii) the difficulties of dilution in a vertical chain would also be eliminated.

Acquisition:

The term "acquisition" presents two comparatively simple problems. Suppose that the *A* Corporation on October 7, 1940, owned 40 per cent of the stock of the *B* Corporation, consisting of only one class, and on or after October 8, 1940, (the effective date of section 129) *A* acquired an additional 10 per cent of *B*'s stock. Under these circumstances can it be said that *A* Corporation has acquired ownership of 50 per cent of the *B* Corporation on or after October 8, 1940. Under the regulations *A* Corporation would be deemed to have acquired 50 per cent of the stock of the *B* Corporation on or after October 8, 1940.¹⁴¹

¹³⁸ *Supra* p. 87.

¹³⁹ Conference Committee Report on Revenue Bill of 1943, 17.

¹⁴⁰ Regulations 111, §29.129-1. The regulations avoided the problem by assuming 100% stock ownership between parent and subsidiaries in giving examples dealing with the question of indirect ownership.

¹⁴¹ See Regulations 111, §29.129-1. See, also, to the same effect Conference Commit-

The further problem arises in connection with the word "acquisition" as to whether it refers only to the purchase or other similar acquisition of outstanding stock owned by another person or whether it also refers to the receipt of stock of a new corporation formed by the acquiring person or persons and issued to such person or persons in connection with such organization. The regulations have answered this question in the affirmative and take the position that the stock of such new corporation so obtained is acquired within the meaning of section 129.¹⁴² The report of neither the House Committee on Ways and Means nor the Senate Committee on Finance nor the Conference Committee on the Revenue Bill of 1943 appear to throw any light on this question. However, the construction of the term "acquisition" to include stock issued to the acquiring person or persons on the formation of a new corporation does not appear to be a strained construction of the term.¹⁴³

Other Terms:

The exception to the asset acquisition provision excludes from the operation of this provision cases where the transferee corporation was controlled, directly or indirectly, "immediately prior to such acquisition," by such acquiring corporation or stockholders. The question arises as to the meaning of the term "immediately prior to such acquisition." For example, A purchases all of the stock of B and a short time after such stock acquisition liquidates B with a view in mind of obtaining the advantage of B's basis of such acquired assets. Under those circumstances can it be said that A "immediately prior" to the asset acquisition was "in control" of B so that the transaction would be excluded from the operation of the asset acquisition provision under the provisions of the exception clause? It is submitted that it would be held that A immediately prior to the asset acquisition

tee Report on Revenue Act of 1943, 17; *cf.* Commissioner v. Dana (C.C.A. 3d, 1939) 103 F. (2d) 359 and Pulfer v. Commissioner (C.C.A. 6th, 1942) 128 F. (2d) 742.

¹⁴² See Regulations 111, §29.129-1(d) where it is stated: "Thus, if A, on October 7, 1940, 'owned certain assets and transfers on October 8, 1940,' such assets to a newly organized Corporation Y in exchange for all the stock of Corporation Y, an acquisition within the meaning of such phrase is made on October 8, 1940." See also Regulations 111, §29.129-3, example two, where it is stated: "A corporation with large profits transfers the assets of each of its branches or departments to newly organized corporations in order to secure the benefit of the examples provided in section 710(b)(1)."

See also I.T. 3757, 17 I.R.B. (1945) 3, where the Commissioner has sought to limit in the case of newly formed western hemisphere corporations the broad application of this construction of the term "acquisition."

¹⁴³ Rudick, 58 HARV. L. REV. 196, 209.

was not in control of *B* within the meaning of that phrase as used in section 129.¹⁴⁴ The transaction would also come within the corporate acquisition provision. Furthermore, it is doubtful whether it would be necessary to apply section 129 to the transaction. The courts would probably hold that that transaction constitutes a direct asset purchase of *B*'s assets, and that the basis of such assets in the hands of *A* was the cost to it of *B*'s stock and not the basis of such assets in the hands of *B*.¹⁴⁵

Another problem arises in connection with the exception clause to the asset acquisition provision. For example, *A* Corporation has ten stockholders, one of which, *W*, owns only one per cent of the stock of *A*, but owns all of the stock of the *B* Corporation. *A* acquired by merger all of the assets of *B* in order to obtain the advantage of the high basis of said assets in the hands of *B*. Under those circumstances can it be said that the exception clause excludes this transaction from the operation of the asset acquisition provision since one of the stockholders of *A* certainly was in control of the transferee corporation immediately prior to the asset acquisition? The regulations do not appear to cover this case.

It is submitted that the example given does not fall within the exception clause. While probably it would not be necessary that the stockholders of *A* own stock in *B* in the same proportion as the stock in *A* it would seem that in the example given there has been too great an economic shift in these assets by reason of the merger to bring the case within the purposes of the exception clause.¹⁴⁶

¹⁴⁴ Cf. cases *Bassick v. Commissioner* (C.C.A. 2d, 1936) 85 F. (2d) 8, *cert. den.* (1936) 299 U.S. 592; *Diescher v. Commissioner* (C.C.A. 3d, 1940) 110 F. (2d) 90, *cert. den.* (1940) 310 U.S. 650. These cases arose under section 112(b) (5) and construed the phrase immediately after the transfer. See for other cases, *supra* note 49.

¹⁴⁵ *Prairie Oil & Gas Co. v. Otter* (C.C.A. 10th, 1933) 66 F. (2d) 309; *Commissioner v. Ashland Oil & Gas Co.* (C.C.A. 6th, 1938) 99 F. (2d) 588, *cert. den.* (1939) 306 U.S. 661.

¹⁴⁶ Cf. *Weicker v. Hulbert* (C.C.A. 10th, 1939) 103 F. (2d) 105, construing the portion of the definition of "reorganization" relating to transfers by a corporation of all or part of its assets to another corporation where the transferor corporation or stockholders or both are in control of the transferee corporation after the transfer of assets and holding that where the minority stockholders of the transferor obtain such control that the requirements of the provision are not met. Cf. also *Commissioner of Internal Revenue v. Bankers Farm Mortgage Co.* (C.C.A. 7th, 1944) 145 F. (2d) 772. This case arose under the provisions of section 113(a) (7) of the Revenue Act of 1932 providing that the substituted basis provision set forth therein should be applicable in case of reorganizations only if "immediately after the transfer an interest or control in such property of fifty per centum or more remained in the same persons or any of them." The court in construing this provision said: "We are unable to accept this contention

Section 129 provides for the disallowance of a "deduction, credit or other allowance." The report of the House Committee on Ways and Means states "the term 'deduction, credit or allowance' has reference to any provision which has the effect of diminishing the tax liability resulting from the gross amount of any item of income or the aggregate of the gross of any or all items thereof."¹⁴⁷

Regulations 111, section 29.129-1(a) defines the term "allowance" as referring to "anything in the internal revenue law which has the effect of diminishing tax liability" and as including "among other things, a deduction, a credit, an exemption or an exclusion."

"Deductions," of course, refer to loss deductions, deductions for depreciation and other similar items covered by section 23, and net operating loss deductions, specifically covered by section 122, and capital loss carry-overs provided for by section 117(e).

"Credit" refers to items like excess profits credits deductible under section 710(b)(2).

"Adjustment" apparently refers to items such as unused excess profits credit adjustments deductible under section 710(b)(3). (The term "adjustment" is also used in connection with adjustments of tax liability for prior years under section 734 and sections 3801-3804, providing for adjustment of tax liability in case inconsistent posi-

[the contention of Commissioner that the transaction did not comply with the provisions of section 113(a)(7)]. It fails to appreciate or accept the qualifying phrases, "or any of them," which modified the statutory requirement that a fifty per cent interest in such property "remain in the same persons." We construe the modifying phrase to mean that if *A* and *B* held 90 per cent at the beginning of the reorganization and *A* held 60 per cent after the reorganization was effected, there would be a statutory continuity of interest. No other good reason for the existence of the modifying phrase "or any of them" has been suggested or occurs to us. It cannot be ignored in applying this statutory test to the fact in the instant case." It should be noted that the court relied heavily on the phrase "or any of them" not appearing in section 129.

However, it would seem, as stated in the text, that the exception clause of the asset acquisition provision does not require that all of the stockholders of *A*, the acquiring corporation, own stock of *B*, the transferor corporation, or that such stock of *B* be held by the stockholders of *A* in substantially the same proportion as their stock holdings in *A*. This requirement is specifically made in the case of section 112(b)(5) transactions where it is provided that "in the case of an exchange by two or more persons this paragraph shall be applicable only if the amount of the stock and securities received by each is substantially in the proportions to their interest in the property prior to the exchange." In the absence of a specific provision of this kind it would seem that the conditions of such strict requirement need not be met.

See in connection with a similar problem, PAUL, *STUDIES ON FEDERAL TAXATION* (3d series) 75. See also Rudick, 58 HARV. L. REV. 196, 212.

¹⁴⁷ Report of House Committee on Ways and Means on Revenue Bill of 1943, H.R. REP. 871, 78th Cong., 1st Sess. (1943) at 49.

tions are taken. However, it is unlikely that section 129 would be applicable in connection with such adjustments, since, among other things, such adjustments when favorable to the taxpayer depend upon the taking of an inconsistent position by the Commissioner.)

"Exemptions" apparently refer to exemptions of various persons from taxation, such as those granted by section 101; and "exclusions" refer to exclusions from gross income, such as the exclusions provided for in section 22(b). Possibly in an appropriate case exclusion would also refer to non-recognitions of gain or loss, provided for in section 112(b) and partial non-recognition of gain or loss in the case of sale of capital assets, provided for in section 117(b).

F. SCOPE OF OPERATIVE PROVISIONS

A brief examination of the operative provisions of section 129 will show that, except in the case of transactions between common controlled corporations and carry-backs, they will prevent taxpayers from gaining anticipated benefits in the more usual cases of acquisitions to obtain tax benefits. In this brief examination we shall postpone and separately consider cases involving:

- (1) Transactions within a common controlled group of corporations (including transactions between individual stockholders and corporations controlled by them).
- (2) Formation of new corporations.
- (3) Carry-backs.

We shall illustrate our examination with a few examples.¹⁴⁸

1. *Asset Acquisition Provision:*

Corporation *B* possesses a high excess profits tax credit based on high earnings during the base period, but has little current income. In 1944 *B* merged into Corporation *A*, which has a high income, but a small excess profits tax credit; *A* and *B* not having theretofore been affiliated, but *B*'s stockholders receiving *B*'s stock on the merger. This transaction consists of the acquisition of assets by one corporation (*A*) from another corporation (*B*) and the basis of such assets to *A* (the acquiring corporation) depends on the basis to the transferor (*B*). [Section 113(a)(7)]. (*A* would claim the benefit of *B*'s excess profits tax credit under the provisions of sections 740-743).

¹⁴⁸ In all of the examples it will be assumed, unless otherwise indicated, that (1) the principal purpose of the acquisition is the evasion or avoidance of federal income or excess profits taxes, and (2) the acquisition took place on or after October 8, 1940.

Therefore, under section 129, *A* will be denied the right to avail itself of the excess profits tax credit of *B*.

Similarly, if *B* had assets having a high basis to it, but a low market value, a capital loss deduction on account of the sale of the assets would be disallowed, as well as an excess profits tax credit based on invested capital. Losses on account of stock securities, etc., becoming worthless would also be disallowed. Furthermore, a deduction for depreciation based on the high basis of the assets would be disallowed. (Depreciation, in view of section 129(b) relating to the power of the Commissioner to allow deductions, etc., would probably be allowed, based on the actual value of the assets at the time of the merger.) Furthermore, if *B* possessed any carry-overs, the deduction of such carry-overs would likewise be disallowed.

The application of the asset acquisition provision does not depend upon the amount of the stock of the acquiring corporation received by the transferor corporation or its stockholders as long as it or they have some interest in the acquiring corporation. In the example given, if on the merger substantially all of *A*'s stock had gone to *B* or its stockholders, nevertheless the asset acquisition provision would have been applicable.

However, as above indicated the transferor corporation or its stockholders (or at least the persons who are the equity owners of the assets of the transferor corporation at the time of the transfer) as above indicated, must have some interest in the acquiring corporation after the transfer. This result follows from the requirement in the asset acquisition provision that the basis to the acquiring corporation of the assets acquired must depend on their basis to the transferor corporation. This "substituted" basis must depend on section 113(a)(7) (relating to reorganization) or section 113(a)(8) relating to section 112(b)(5) transactions or contributions to paid-in surplus or capital, or to some other similar provisions in section 113(a) relating to reorganizations and other similar transactions. In a reorganization it is well established under the continuity of interest doctrine that the transferor corporation, its stockholders or the equity owners of its properties must have or acquire some stock interest in the acquiring corporation.¹⁴⁹ On a section 112(b)(5)

¹⁴⁹ *Pinellas Ice Co. v. Commissioner* (1932) 287 U. S. 462; *Helvering v. Minnesota Tea Co.* (1935) 296 U.S. 378; *LeTulle v. Scofield* (1940) 303 U.S. 415; *Helvering v. Alabama Asphaltic Limestone Co.* (1942) 315 U.S. 179. See also §113(a)(22). Cases of section 112(b)(6) liquidations are omitted, since these would be excluded from operation of the asset acquisition provision by its exception clause.

transaction the transferor after the transfer must hold voting stock entitled to exercise 80% of the voting power and must own 80% of all other classes of stock. Clearly contributions to paid-in surplus or capital can be made only by stockholders. It is not suggested that the requirement in regard to basis was included in the acquisition provisions so that the above results would follow; the reason for the requirement lies in another direction and the above results are entirely accidental. The reason for the requirement is to limit the applicability of the asset acquisition provision to deductions, credits or allowances which are "inherited" by the acquiring corporation from the transferor corporation and depend on some factor peculiar to the transferor corporation, such as the transferor's cost of assets, loss sustained or credits not used by the transferor corporation, or the earning history of the transferor corporation during the "base" period, etc.

It is apparent that this requirement was included in the asset acquisition provision generally to restrict the application of said provision to the types of deductions, credits and allowances to which the corporate acquisition provision would be applicable. The asset acquisition provision was added by the Conference Committee after the Senate Finance Committee had limited the section to corporate acquisitions and was a compromise between the broad provision originally included in the House bill and the entire elimination of the provision by the Senate Finance Committee.

This requirement in the asset acquisition provision—that it will be applicable only in cases where the basis of the assets of the acquiring corporation depends upon the basis thereof to the transferor—does not limit the applicability of the provision in the usual cases of acquisition for tax benefit. These usual cases consist of the acquisition of assets to obtain the advantage of (1) the high basis of property which has a low market value or is worthless; (2) high excess profits tax credit of a corporation having low income; and (3) carry-overs.

Clearly, an acquiring corporation can enjoy the high basis of the transferor of property acquired only when its basis depends on the basis of the transferor. The same is true of the acquisition by the transferee of the high excess profits tax credit of the transferor. If the credit is based on invested capital, then the acquiring corporation will acquire such high excess profits tax credit only because it inherits the transferor's basis of the assets acquired.¹⁵⁰

¹⁵⁰ See section 718(a)(2) providing that for the computation of equity of invested capital, property acquired shall be included in an amount equal to its basis (unadjusted)

If the high excess profits credit of the transferor is based on income, then the transferee corporation will acquire the credit of the transferor corporation only if the acquisition was of a kind in which the basis of the transferor of the property acquired depends upon the basis thereof to the transferor.¹⁵¹

The only possible case in which the transferee corporation would acquire the carry-overs of the transferor corporation would, as we have shown, be upon a statutory merger or statutory consolidation. Such a statutory merger or consolidation would be a "reorganization" under section 112(g)(1)(A) and, accordingly, the basis of the property acquired by the acquiring corporation would depend upon its basis to the transferor corporation [section 113(a)(7)].

We have indicated that the types of deductions, credits or allowances to which the asset acquisition provision is generally applicable depend on some factor peculiar to the transferor, such as the transferor's basis of the assets acquired; losses sustained, or credits not used, by the transferor; and the earnings history of the transferor during the "base period," etc. We have shown that the benefits of such deductions, credits or allowances are secured in asset acquisitions only when

for determining loss upon sale or exchange. (See also §§760 and 761.) Clearly, therefore, unless the acquiring corporation inherits the transferor's basis to the assets acquired, it will not inherit the transferor's high excess profits tax credit based on invested capital. Unless there is such a "substituted basis" of the assets acquired, their basis for loss would be cost. §113(a).

¹⁵¹ See §§740 and 742. Under the provisions of these sections the transferee corporation (therein called the "acquiring corporation") is entitled to compute its excess profits tax credit by reference to the base period net income of the transferor corporation (therein called the "component corporation") only if,

(A) The acquiring corporation acquires substantially all of the property of the component corporation in consideration, in whole or in part, for all its stock of all classes (excepting qualifying shares); or

(B) The acquiring corporation acquires substantially all the properties of the component corporation and the sole consideration for the transfer (excluding indebtedness assumed) is its voting stock; or

(C) Before October 1, 1940, the acquiring corporation acquired the property of the component corporation as paid in surplus or as a contribution to capital; or

(D) The acquiring corporation acquired the property of the component corporation in a section 112(b)(5) transaction.

The transaction referred to in "A" would be a "reorganization" under section 112(g)(1)(D). The transaction referred to in "B" would be a "reorganization" within section 112(g)(1)(C). And, accordingly, in these two transactions the basis of the property acquired in the hands of the acquiring corporation would depend upon its basis in the hands of the transferor corporation. §113(a)(7).

In the transactions referred to in "C" and "D" the basis of the property acquired in the hands of the acquiring corporation would depend upon its basis in the hands of the transferor corporation. §113(a)(8).

the acquisitions conform to the requirement contained in the asset acquisition provision as to "inherited basis" (*viz.*, that the basis to the acquiring corporation of the assets acquired must depend upon their basis to the transferor).

There are other allowances, such as the exclusion from gross income of interest on municipal bonds, the benefit of which may be obtained as an incident to particular classes of property acquired and do not depend for their enjoyment upon any factor peculiar to the transferor. The benefit of such allowances may be secured in acquisitions in which the "inherited basis" requirement of the asset acquisition provision is not fulfilled. For example, municipal bonds are purchased for cash by one corporation from another. The basis of the bonds to the acquiring corporation would not depend on their basis to the transferor corporation and, accordingly, the asset acquisition would not apply. Suppose, however, such bonds were acquired in a merger and that, therefore, the literal requirements of the asset acquisition provision were fulfilled. Does section 129 apply because of this accidental factor in such case? It is submitted that section 129 does not apply. Section 129 is applicable in cases of an assets acquisition or corporate acquisition where the principal purpose of the acquisition is the "evasion or avoidance of taxes" by "securing the benefit of a deduction, credit or allowance which *such [acquiring] person or corporation would not otherwise enjoy.*" The italicized clause in the last quoted provision from section 129 was added by the Senate Finance Committee.

The term "otherwise" contained in said clause may refer to:

(1) The particular acquisition involved. In such event the italicized clause would mean "which [benefit]¹⁵² such (acquiring) person

¹⁵² In the text it is assumed that the antecedent of the word "which" appearing in the clause is "benefit". This is in accordance with the regulations (See Regulations 111, §29.129-3). Mr. Rudick takes the position that the antecedent of the word "which" is "credit, deduction or allowance" and that accordingly in view of the quoted clause the deduction, credit or allowance must be acquired in the particular acquisition. Rudick, 58 HARV. L. REV. 196, 212.

In this case there is a choice of antecedents between the word "benefit" on the one hand and "deduction, credit or allowance" on the other hand. It is submitted that the Regulations are correct in taking the position that the antecedent is "benefit". In the above quoted clause the phrase "such person or corporation" is the subject and the word "enjoy" is the verb, and the word "which"—and similarly its antecedent—is the object of the verb "enjoy". It is only in a colloquial sense that a person *enjoys* a deduction, credit or allowance. In a more exact sense, a person *enjoys* a benefit. Accordingly, it is submitted that the word "benefit" is the more appropriate selection as the antecedent of the word "which".

or corporation would not enjoy [if it had not been for said particular acquisition]." This construction would give no meaning whatsoever to said clause, since the first part of the above quoted provision expressly provides that the benefit must be "*secured*" by the particular acquisition in question. Certainly such redundancy will not be attributed to Congress, particularly in a case where, as here, the clause was added to the original bill.

(2) The type of acquisition referred to in section 129, *i.e.*, an asset acquisition or a corporate acquisition. In such event the italicized language would mean "which [benefit] the [acquiring] person or corporation would not enjoy [other than on an asset acquisition or corporate acquisition]." If this is the proper construction of the term "otherwise"—and it is submitted that it is—it follows that section 129 would not be applicable to the allowances here under consideration, since the benefit thereof could be acquired other than on an asset or corporation acquisition, *e.g.*, by the purchase for cash.

Furthermore, section 129 is only applicable where the principal purpose of the acquisition is the evasion or avoidance of taxes by securing the benefit of a deduction, credit or allowance. (Indeed under section 129(b), as we have seen, the acquisition must result in such evasion or avoidance, or otherwise section 129 is not applicable). In other words, the acquiring person or corporation must be, or anticipate being, subject to a tax liability which he or it seeks to evade or avoid by securing the benefit of some deduction, credit or allowance. In the case of the allowances here under consideration the taxpayer in effect acquires some income, all or part of which is excluded from taxation. It does not by such acquisition evade or avoid any tax liability which it otherwise would be required to pay or bear the economic burden of. Its tax liability will not be reduced thereby and in the

If Mr. Rudick is correct in his position, the first argument set forth in the text could not be sustained, since as construed by him the word "otherwise" as used in said clause refers to the particular acquisition.

Mr. Rudick employs this argument in support of his conclusion that the acquisition by a corporation of high income producing assets to offset against an already possessed deduction, credit or allowance does not come within the operation of section 129. Mr. Rudick argues that, since in such case the deduction, credit or allowance is already possessed, the requirement of said clause above referred to, as construed by him, is not met. (The same conclusion can be reached on other grounds hereinafter set forth in the text, *infra* p. 101.) Mr. Rudick's argument fails if the antecedent of the word "which" is "benefit", since in the case under consideration the "benefit" of the deduction, credit or allowance would not have been enjoyed if it had not been for the acquisition of the income producing assets. A taxpayer does not enjoy a deduction, etc., unless he has income against which he may offset the deduction. *Cf.* §22(b)(12).

event of only a partial exclusion or credit [such as the 85% dividend credit—section 26(b)], its tax liability will be increased by the acquisition. Under such circumstances, the required purpose of evasion or avoidance of taxes is not present and section 129 is not applicable.

Since the allowance or credit in connection with any class of property will not be greater in amount than the amount of the income therefrom, the second argument here advanced, as well as the first argument, will be applicable to the allowances and credits here under consideration.

The Treasury Department in its definition of "allowances" has indicated that it will take a position contrary to that above set forth. The term "allowances" has been defined by the regulations as including "exclusions," which latter term refers to the items excluded from gross income under section 22(b).

We have so far considered cases where *A*, which has a high income, is the acquiring corporation and *B*, which possesses the challenged credit or deduction and little or no income, is the transferor corporation and *A* the transferor corporation (*i.e.*, *A* merges into *B*) we have a case where *B* is acquiring income to offset against its already possessed credit or deduction. The question arises as to whether the transaction is within the operation of the asset acquisition provision. (It is assumed that *A*'s stockholders on the merger do not obtain control of *B*. If *A*'s stockholders did obtain control of *B* on the merger, the transaction would be a corporate acquisition, since *A*'s stockholders would thereby secure the benefit of *B*'s credit).

In such case *B* (the acquiring corporation) could have acquired the benefit of the high income producing assets by purchasing them. Furthermore, by such acquisition *B* is not evading or avoiding any taxes which it would otherwise have been required to pay. Indeed, unless the credit or deduction it possesses is large enough to entirely offset the acquired income, *B* may be required to pay additional taxes by reason of the acquisition.

It therefore follows, it is submitted, that, for the reasons set forth in connection with the acquisition of credits and allowances not depending on some factor peculiar to the transferor, section 129 is not applicable to the acquisition of high income producing assets to be offset against an already possessed deduction, credit or allowance, even though such assets are acquired in a transaction complying

with the requirements of the asset acquisition provision. Mr. Rudick has reached the same conclusion for different reasons.¹⁵³

The Treasury Department has not indicated its position on this question in the regulations promulgated under section 129. However, as we have already pointed out, in the amendments to the consolidated returns regulations issued on March 14, 1944, in respect to changes in, and formations of, affiliated groups subsequent to March 14, 1941, the Treasury Department has provided for the disallowance of losses and certain other deductions sustained by the parent corporation or by other corporations which were members of the affiliated group on March 14, 1941, against the gains or income of a post-March 14, 1941, acquired subsidiary. It is significant that these amendments were issued 18 days after the enactment, over presidential veto, of the Revenue Act of 1943, which contains section 129.¹⁵⁴

The asset acquisition provision applies only where the benefit is enjoyed by the person acquiring the property and does not apply to cases where the benefit is enjoyed by the person transferring the asset. For example, if a parent corporation sells stock to a subsidiary at a loss, the transaction would not be within the operation of the asset acquisition provision. The acquiring corporation would not receive the benefit of the loss. The Senate Finance and Conference Committees took the position that this type of transaction was adequately covered by the established rule of the cases such as *Higgins v. Smith*.¹⁵⁵

¹⁵³ Rudick, 58 HARV. L. REV. 196, 212. It might be noted that the example given by Mr. Rudick in this connection does not fall within the operation of section 129 for other reasons. Mr. Rudick gives an example—a case where a corporation purchases the stock of another corporation and then liquidates the corporation thus acquired. It is clear that this transaction would not be treated as a corporate acquisition because of the transitory nature of the holding of the stock of the acquired corporation and, furthermore, the transaction would be treated as a cash purchase by the acquiring corporation of the assets of the acquired corporation. Since in such case the basis to the acquiring corporation of the assets acquired would depend on the price paid for the stock and not upon their basis to the transferor corporation the transaction would not come within the asset acquisition provisions. See for discussion of similar transactions *supra*, paragraph II-B and *infra* note 157. See for an outline of Mr. Rudick's argument on this point *supra* note 152. Mr. Rudick states that "it is unlikely that the principal purpose of the acquisition [of a corporation having high income producing assets] was tax avoidance." Rudick, 58 HARV. L. REV. 196, 212. It is the position set forth in the text that no purpose of such acquisition, principal or otherwise, would be for tax avoidance within the meaning of section 129.

¹⁵⁴ Revenue Act of 1943, 58 STATS. (1943) 47 was enacted over presidential veto on February 25, 1944.

¹⁵⁵ SEN. REP. No. 627, 78th Cong., 1st Sess. (1943) 59; (1940) 308 U.S. 473.

The asset acquisition provision will likewise not operate to deny non-recognition of gain provided by section 112(b). If the acquisition is a liquidation of a wholly owned subsidiary under section 112(b)(6), the transaction is excluded from the operation of the asset acquisition provision by the exception clause thereto providing that said provision shall not be applicable where the acquiring corporation or its stockholders were in control of the transferor immediately prior to the acquisition. If the non-recognition is based on some provision of section 112(b) other than section 112(b)(6), the basis of the property acquired by the person or corporation whose gain is not recognized does not depend upon the basis of the transferor, but on the basis of the property exchanged by such acquiring person or corporation [section 113(a)(6)]. The provision for "inherited" basis under section 113(a)(7) is generally applicable to the corporation which is receiving property for its stock and the non-recognition provisions of section 112(b) do not, and do not need to, apply to such corporation, since it would not ordinarily realize any gain on such exchange.

Furthermore, section 129 is only applicable where "the principal purpose for which such acquisition was made is evasion or avoidance of federal income or excess profits tax by *securing* the benefit of a deduction, credit or other allowance." Under this provision it is clear that the challenged deduction, credit or other allowance must be "*secured*" by, *i.e.*, result from, the acquisition. On the other hand, the gain not recognized under section 112(b) is an incident to the acquisition and accordingly its non-recognition is not the result of the acquisition.

We will discuss the exception clause to the asset acquisition provision and the failure to include acquisitions by corporations from individuals in our discussion of common controlled corporations.

2. *Corporate Acquisition Provision:*

Corporation *B* has a high excess profits tax credit based on the high current earnings during its base period, but has little current income. Corporation *A* has a high income, but a small excess profits tax credit; *A* and *B* were not theretofore affiliated. In 1944 *A* acquires all of *B*'s stock and causes *B* to acquire its (*A*'s) assets. In this case *A* acquires "control" of *B*, and *A*'s stockholders "indirectly" acquire control of *B*; or, if *A* liquidates and transfers the acquired stock to its stockholders, then *A*'s stockholders directly acquire control of *B* on

the liquidation. In this case, either *A* or its stockholders have secured the benefit of *B*'s high excess profits tax credit, which it, or they, would not otherwise have enjoyed and under section 129(a) will not be allowed to further avail itself of its high excess profits tax credit.

In the case given, if *A*, instead of acquiring *B*'s stock, had merged into *B* and on the merger *A*'s stockholders received 50% or more of *B*'s stock consisting all of one class, the transaction would likewise be within the corporate acquisition provision, since *A*'s stockholders have acquired control of *B* and have thereby secured the benefit of a credit which they would not otherwise have enjoyed.

It should be noted that *A* or its stockholders have secured only the *economic* benefit of *B*'s excess profits tax credit, since in the examples neither *A* nor *A*'s stockholders acquire *B*'s high excess profits tax credit for the computation of its, or their, excess profits taxes. But it is clear that such economic benefit is within the purview of section 129.¹⁵⁶ Furthermore, neither *A* nor its stockholders are directly avoiding the payment of any taxes, but are only avoiding the economic burden of the taxes. This would appear to be sufficient. It may also be noted that in this case, in turn, *B*, which originally possessed the credit, is being disallowed such credit by reason of the change in the stockholders. We have heretofore indicated under subdivision III-D that such disallowance is constitutional.

Likewise, the deduction of any carry-over possessed by *B* would be disallowed and also the deduction for bad debt losses, capital losses, depreciation on account of assets having a low value but a high basis in the hands of *B*, etc., would be disallowed.

If in the examples given *A* merely acquires a majority of *B*'s stock and *A* then transfers its assets to *B*, it is arguable that the remaining original stockholders of *B* are being unduly prejudiced by the operation of section 129 as a result of a transaction in which they had no part. For example, if in such case *B* had a high excess profits credit but had some income, the entire disallowance of the credit under section 129 would certainly be unduly prejudicial to *B*'s original stockholders. However, it is submitted in such case under section 129(b) the excess profits credit, at least to the extent of the income from the business and assets originally possessed by *B*, will be allowed.

We have heretofore taken the position that if a corporation acquires the stock of another corporation and thereafter acquires the

¹⁵⁶ See example (1) given in Regulations 111, §29.129-3.

assets of such corporation by merger or liquidation, the transaction will be deemed to be an acquisition of assets by such acquiring corporation,¹⁵⁷ and that the temporary holding of the stock by the acquiring corporation will be disregarded. If we be mistaken in this position, in an appropriate case, the corporate acquisition provision would of course be applicable.

In our discussion of the asset acquisition provision, we took the position that section 129 was not applicable to cases where the benefit of some deduction, credit or allowance was acquired which was not peculiar to the transferor. The same argument of course applies in the case of similar deductions, credits or allowances obtained on a corporate acquisition.

For example, if Corporation *A* buys all the stock of Corporation *B*, whose sole assets are tax-free bonds, and thereafter *A* transfers all of its assets to *B*, in such case, *A* could obtain the benefit of the tax exemption if it had purchased the bonds. Furthermore, in such case *A* is not evading or avoiding any taxes by reason of the acquisition.

Likewise in connection with the asset acquisition provision we discussed the case where a corporation acquires high income producing assets to offset against an already possessed deduction, credit or allowance, and we took the position that in such case section 129 was not applicable for similar reasons. Similarly section 129 would not be applicable where such acquisition is made by means of a corporate acquisition, rather than by means of an asset acquisition.

We will postpone until our discussion under new corporations, cases where a corporation acquired control of another corporation in order to itself obtain some benefit peculiar or incident to such control.

In the examples given if it be assumed that *A*, instead of transfer-

¹⁵⁷ If *A* had acquired *B*'s stock for cash and thereupon caused *B* to transfer its assets to it, the transaction would have been considered an acquisition by *A* of *B*'s assets for cash and *A* would not have secured the benefit of *B*'s high excess profits tax credit. See discussion under point II-B and point III-E, *supra*.

If *A* acquired all of *B*'s stock solely in consideration of its own stock and thereupon caused *B* to transfer its assets to a subsidiary, *C*, *B*'s high excess profits tax credit or *B*'s high basis to its low market value assets would not be enjoyed by *C* since the transaction would not fall within sections 740-743; nor would it be a reorganization. The acquisition of *B*'s stock by *A* would be considered transitory and would be disregarded and the acquisition by *C* of *B*'s assets would not fall within the definition of "reorganization" since *B*'s stock was not given in connection with the transaction. Cf. *Helvering v. Bashford* (1938) 302 U.S. 54. See also Rudick, 58 HARV. L. REV. 196, 212, for a somewhat different view of the first transaction herein referred to.

ring its assets to *B* or causing *B* to transfer its assets to it, included *B* in a consolidated return, the same results as those above given would follow.

In some respects the provisions of section 129 are somewhat broader than the consolidated return regulations limiting the allowance of deductions and credits. As we have seen above, these provisions are not applicable to the deduction for depreciation and apparently under section 129, in an appropriate case, the allowance for depreciation may be disallowed in whole or in part. Apparently the Treasury Department did not think it necessary to cover depreciation in the consolidated return regulations provisions limiting the allowance of deductions and credits. Furthermore, section 129 provides in terms for the complete disallowance of the challenged deduction or credit. On the other hand, the consolidated return regulations provisions merely provide for limiting the allowance of the challenged deduction or credit against the income of the individual corporation actually possessing the deduction or credit. In all probability, however, in view of the provisions of section 129(b) (relating to the power of the Commissioner to allow deductions, credits, etc.), in the situation under discussion, the deduction or credit would be allowed, at least to the extent of the income or gain of the individual corporation possessing it.

There are other respects, however, where the consolidated return regulations provisions are substantially broader than section 129. In the first place, as pointed out above, the consolidated return regulations provisions are operative irrespective of any showing of intent.

Furthermore, as we have heretofore seen, the corporate acquisition provision is not applicable if prior to October 8, 1940, the acquiring person or persons were directly or indirectly in control of the acquired corporation, even though as a result of the acquisition there is a shift of control within the controlled group. For example: *S*₂ has a high excess profits tax credit and *A* desires to include its income with that of *S*₂ in the consolidated return. In order to do this, it would be necessary for *A* to acquire *S*₂'s stock [see section 141(d)]. This acquisition by *A* would not be within section 129, since *A*, prior to October 8, 1940, already indirectly controlled *S*₂ and, therefore, did not acquire such control on or after October 8, 1940. However, if the acquisition took place after March 14, 1941, it would fall within the 14, 1944, under T.D. 5340 and T.D. 5341 unless the requisition 95% stock ownership was existing on March 14, 1941.

Under these amendments to the consolidated return regulations if in the event of a change in the membership of the affiliated group after March 14, 1941, losses of the new subsidiary attributable to events preceding the date it became a member of the group are deductible only against its own income. Clearly under section 129 if a corporation acquires another corporation or its assets to obtain the benefit of some anticipated loss it is clear that the loss must already be known and, therefore, the events to which it is attributable must already have occurred. In this respect section 129 would be similar to the amendments to the consolidated return regulations.

We have above pointed out that the corporate acquisition provisions are not applicable to cases where a corporation acquires high income producing assets of another corporation in, say a reorganization, for the purpose of offsetting its income against its already possessed credit or deduction. As above pointed out, the consolidated return amendments require a parent and its March 14, 1941, subsidiaries in the case of a change in the membership after that date to deduct their losses against their own income and hence losses of the parent corporation and its March 14, 1941, subsidiaries would not be deductible against the income of the post-March 14, 1941, acquired subsidiary irrespective of the time to which such losses are attributable. Similar provision is contained in the amendments of the consolidated return regulations in regard to excess profits tax credit which is not covered by section 129, as above indicated.

In addition, the provisions of the consolidated return regulations limiting the deduction of carry-overs do not depend on whether there has been any change in the affiliated group or any acquisition of control after any given date. These provisions are applicable, as we have seen, as long as no consolidated return covering the corporations in question was filed for the period during which the carry-over arose.

If in a particular case where a consolidated return has been filed a deduction, credit or allowance would be disallowed under section 129, but would not be disallowed under the consolidated return Regulations, the interesting question arises whether section 129 would apply. In view of the fact that, by not providing for the disallowance of the deduction, credit or allowance, the consolidated returns regulations are in effect providing for the allowance thereof, it is difficult to determine whether the regulations or section 129 would prevail in the event of such conflict.

3. *Comparison of Asset Acquisition and Corporate Acquisition Provisions:*

The asset acquisition provision and the corporate acquisition provision as set forth in section 129 are in the disjunctive and it would appear, therefore, that if a transaction falls within either provision, it is subject to section 129 provided that the other requirements of the section are fulfilled.¹⁵⁸

The original House bill was much broader than the bill as finally adopted. On the other hand, the original Senate bill was much narrower than the bill finally adopted. The original Senate bill included only corporate acquisitions. The Conference Committee added the provision in regard to asset acquisitions.

From the foregoing discussion it would appear that the asset acquisition provision is much broader in operation than the corporate acquisition provision. In the corporate acquisition provision we ordinarily will have a case where the stock of the acquired corporation is acquired for cash and there is considerable reason why the acquiring person should be denied a tax benefit from such acquisition where the securing of such tax benefit is the principal purpose of the acquisition. The requirement in the asset acquisition provision, that the basis to the acquiring corporation of the assets acquired must depend on their basis in the hands of the transferor corporation, largely conforms this provision to situations similar to those where a corporation is acquired. But on the other hand as an incident to this requirement, as we have above seen, generally speaking the asset acquisition provision will apply only in cases where the transferor corporation or its stockholders own stock in the acquiring corporation after the acquisition. Therefore, the asset acquisition provision does in effect limit the reorganization provisions and other parallel provisions of the code providing for substituted bases where the principal purpose of the reorganization or some other transaction is to obtain tax benefit. This, it is submitted, is a great extension beyond the rule of *Gregory v. Helvering*.¹⁵⁹ This result of section 129 certainly goes beyond the intentions of the Senate Finance Committee which was overruled in the Conference Committee.¹⁶⁰

In another respect the asset acquisition provision is substantially

¹⁵⁸ Cf. Rudick, 58 HARV. L. REV. 196, 208, note 54.

¹⁵⁹ (1935) 293 U.S. 465.

¹⁶⁰ SEN. REP. No. 627, 78th Cong., 1st Sess. (1943) 60. Conference Committee Report on Revenue Bill of 1943, 17.

broader than the corporate acquisition provision. The corporate acquisition provision is applicable only if 50% or more of the stock of the acquired corporation is acquired by the acquiring person or persons. On the other hand, the asset acquisition provision, as we have seen, is applicable irrespective of the amount of the change in the ownership of the stock of the acquiring corporation. The only limitation in this respect is the exception clause to the asset acquisition provision under which there is excluded from the operation of this provision cases where the acquiring corporation or its stockholders were in control of the transferor corporation immediately prior to the acquisition.

However, if the corporation having the high income producing assets or its stockholders are to acquire less than 50% of the stock of the corporation possessing the desired deduction, credit or allowance, the application of section 129 can be avoided by having the second mentioned corporation acquire the assets of the first mentioned corporation. The transaction would not be a corporate acquisition because less than 50% of the stock of the second mentioned corporation would be acquired by the new interests and the transaction would not be an asset acquisition, since the second corporation is merely acquiring high income producing assets which, as we have seen, is not within the provisions of section 129.

4. Transactions Within a Common Controlled Group:

The Senate Finance Committee admittedly limited section 129 so that it would apply in only limited respects in connection with transactions within a common controlled reorganization. This was done on the ground that such transactions were already taken care of by section 45.¹⁶¹

We have heretofore shown in our discussion on the point the limited operation of section 45. Comparison of section 129 and section 45 has heretofore been made. In any event, it is clear from this discussion that the Senate Finance Committee is mistaken in its position that section 129 is much broader in operation than section 45. The Senate Finance Committee indicates that section 129 will be applicable in certain cases of inter-corporate transfers but gives no reason why the section should be applicable in these particular cases.¹⁶²

¹⁶¹ SEN. REP. No. 627, 78th Cong., 1st Sess. (1943) 60, 61. See also Conference Committee Report on Revenue Bill of 1943, 17.

¹⁶² SEN. REP. No. 627, 78th Cong., 1st Sess. (1943) 61.

For example, in a vertical line of corporations if a subsidiary is shifted up the line, then the corporate acquisition provision of section 129 would not be applicable since each corporation, which is in direct or indirect control of the subsidiary after the shift, prior to such shift was likewise in direct or indirect control of such subsidiary and, accordingly, none of such corporations acquired control of the subsidiary. If, on the other hand, there is a shift downward in a vertical chain, a corporation may acquire the control of the subsidiary which prior to the shift was not in direct or indirect control thereof. Likewise if the chain in question consists of several vertical groups, a shift of the subsidiary from one vertical group to another would fall within the operation of the corporate control provisions since corporations which had not theretofore directly or indirectly controlled the subsidiary would be in control of it after the shift.

The operation of the asset acquisition provision in view of the exception clause is similar. The exception clause to the asset acquisition provision excludes from the operation of said provision cases where the acquiring corporation or its stockholders immediately prior to the transfer were directly or indirectly in control of the transferor corporation. In a vertical chain if there is a transfer of assets upward, then the acquiring corporation will have been in direct or indirect control of the transferor subsidiary immediately prior to the transfer. On the other hand, if there is a transfer downward, this would not be so because in such case prior to the transfer the acquiring corporation would have been a subsidiary of the transferor corporation and its stockholders would have been either the transferor corporation itself or a subsidiary of the transferor corporation and hence not in control of the transfer. (The transferor corporation is not in "control" of itself within the meaning of section 129 since it does not own its own stock). However, under the asset acquisition provision if there is a single horizontal line of subsidiaries all of whose stock is owned by a common parent, a transfer of assets by one subsidiary to another would be excluded from the operation of the asset acquisition provision since immediately prior to the transfer the stockholder of the acquiring corporation, *viz.*, the common parent, was also in control of the transferor corporation. However, the asset acquisition provision would be likewise applicable in cases where there are several vertical groups of corporations in the same chain and there is a transfer from a corporation in one group to a corporation in another group, and the common parent corporation does not own the stock of the acquiring corporation.

As above indicated, neither the Senate nor Conference Committees give any reason why certain acquisitions within common controlled groups are subject to section 129 and why others are excluded from its operation. As a matter of fact, in any particular case the transaction could probably be engineered so as to fall outside the operation of the section. In a common controlled group there is no reason why a particular result must be accomplished by a transfer which is up or down or sideways or which is an asset or a corporate acquisition. Accordingly, it would be a very rare case indeed where the transaction could not be so arranged as to fall outside the section. Certainly section 45 should be amended so as to make its operation parallel to section 129. The only amendment which was made to section 45 at the time of the adoption of section 129 was the addition of the items of credits and allowances to those gross income or income deductions already covered by the section.¹⁶³ The Committees did not feel that this section added anything to section 45.¹⁶⁴

From the above consideration the reason why the asset acquisition provision is limited to acquisitions from corporations and does not include acquisitions from individuals is clear. In view of the requirement of the asset acquisition provision that the basis to the acquiring corporation of the assets acquired must depend upon their basis to the transferor it is clear that on acquisition from individuals the transaction would have to come within section 112(b)(5), in other words, in cases where the individuals were in control of the acquiring corporation, Congress undoubtedly felt that these transactions would have come under section 45 and, accordingly, that there was no reason to include acquisitions of assets from individuals.

5. *New Corporations:*

Two of the three examples given by the regulations illustrating the operation of section 129 are cases where persons form a new corporation for the purpose of obtaining a tax advantage therefrom. In one of the examples given, example (2) in the regulations, a corporation transfers portions of its assets to a newly organized corporation in order to secure an additional \$10,000 exemption from excess profits taxes given by section 710(b)(1). In the other example, example (3) in the regulations, a corporation with high earning assets transferred the high earning assets to another corporation and retained

¹⁶³ §128(b) Revenue Act of 1943.

¹⁶⁴ SEN. REP. No. 627, 78th Cong., 1st Sess. (1943) 61. H. R. REP. No. 871, 78th Cong., 1st Sess. (1943) 50.

loss producing assets for the purpose of securing refunds through unused excess profits carry-backs or loss carry-backs.¹⁶⁵ These two examples represent two different types of tax benefit derived from corporate acquisitions.

In the first example [example (2) in the regulations] the new corporation is formed to obtain the benefit of some deduction, credit or allowance to which such new corporation is entitled. The deduction, credit or allowance may be enjoyed by corporations generally, as in the example given, or may be peculiar to the type of corporation formed, such as exemptions under section 101. It must be admitted that such corporate acquisitions fall clearly within the literal provision of section 129, but it is submitted that such acquisitions do not come within the intention of the provisions of section 129.

The unsoundness of the action of the Treasury Department in taking the position that this type of case comes within the provisions of section 129 has already been reflected by a ruling that section 129 is not applicable in the case of transfers to a newly formed western hemisphere corporation.¹⁶⁶ It is difficult to see how the case covered by the regulations differs in substance from example (2) given in the regulations above referred to¹⁶⁷ if it be assumed in such example that the assets transferred constitute a separate business. If the assets did not constitute a separate business and were merely a part of the business retained by the transferor corporation, then under established principles of tax law the new corporation would be considered merely an agent of the transferor corporation and income of such new corporation would be taxable to the transferor corporation.¹⁶⁸ If, however, as above assumed, the business transferred is a separate business, these principles of agency would not apply.

Section 109, relating to western hemisphere corporations, defines western hemisphere trade corporations as being domestic corporations whose business is done in the western hemisphere outside the United States and 95% of whose gross income was derived from sources outside the United States "*for the three-year period immediately preceding the close of the taxable year (or for such part of such period during which the corporation was in existence.)*" (Italics sup-

¹⁶⁵ See Regulations 111, §29.129-3, examples (2) and (3).

¹⁶⁶ I.T. 3757; 1945-17-12119.

¹⁶⁷ This is the first of the two examples referred to in the text.

¹⁶⁸ See subdivision II-E *supra*. In the example given the regulations refer to a transfer of branches or departments but it is not clear whether the branches constitute an independent business.

plied.) In the case covered by the ruling the transferor corporation apparently had not satisfied the three-year requirement since it had only recently commenced to have a substantial part of its business outside the United States. In order to avoid the three-year limitation which by the terms of section 109 is only applicable in corporations which have been in existence for three years, assets were transferred to a new corporation. Obviously the new corporation was organized and the transfer was made for the purpose of obtaining the surtax credit given to western hemisphere corporations by section 15(b). It is difficult to distinguish this case from a case where a corporation with two separate businesses in order to get two separate excess profits tax exemptions under section 710(b)(1) transfers one of its businesses to a newly formed corporation. In the one case the corporation desires to avoid the three-year limitation and avail itself of the exception therefrom in the case of newly formed corporations. In the other case the corporation desires to avail itself of a separate credit for a new corporation and a separate business. In each case the transferor corporation found itself at a disadvantage and sought to rectify the disadvantage by forming a new corporation.

There are numerous cases under the codes where special benefits are given to special status corporations, such tax-exempt corporations under section 101, foreign corporations under section 231, regulated investment companies under Supplement Q and personal service corporations under Supplement S. Furthermore, there are special exemptions given to corporations such as the dividend received credit under section 26(b). If corporations are formed and transfers are made to them in order to obtain these special benefits, it is submitted that the transaction should not fall within section 129. These are the types of benefits which are directly offered by the code to corporations qualifying therefor.¹⁶⁹ It is submitted they do not come within the intention of section 129.¹⁷⁰

Furthermore, if the corporation is one of a chain of corporations, the transfer can probably be made to some unused subsidiary and the transfer would be excluded from the operations of section 129.

The above remarks are subject to the qualification that if the transaction is not real but sham and fictitious, it will be subject to

¹⁶⁹ Generally speaking, the transaction would not come within the asset acquisition provision. See *supra* p. 110.

¹⁷⁰ SEN. REP. NO. 627, 78th Cong., 1st Sess. (1943) 60.

attack under the established rule of the cases discussed under Division II-E above.

In the second example above given [example (3) in the regulations] the stock acquiring corporation is itself obtaining some deduction, credit or allowance by reason of the corporate acquisition. In said example the stock acquiring corporation is able to obtain an unused excess profits carry-back by reason of the corporate acquisition. The stock acquiring corporation can transfer its assets to the acquired corporation without losing its economic interest therein and, as a result of such transfer, the stock acquiring corporation is enabled to obtain the benefit of the unused excess profits credit adjustment. While this benefit is an indirect result of such acquisition, it would seem to fairly fall within the terms of the corporate acquisition provision and to be properly subject to section 129.

One other example of a similar type of acquisition may be given. Suppose Corporation *A* desires to sell its business, which consists of inventory and other assets. In the event it sold its assets directly, its profits on account of the sale of the inventory would probably be considered an ordinary gain. In order to convert this gain into a capital gain, the corporation acquires a new corporation and transfers its assets (including inventory) to the new corporation for stock and thereafter sells the stock to a purchaser, with the view in mind that the gain derived from the sale of stock would be treated as a long term capital gain. (In view of the fact that the transfer of assets to the new corporation would probably be a section 112(b)(5) transaction, under section 117(h) the period of the holding of the assets transferred would be included in determining the length of the period the stock is deemed to have been held for the purpose of the capital gains provisions.)

In such case the corporate acquisition provisions of section 129 would be applicable and the partial non-recognition of the gain provided by section 117(b) would be disallowed. (This transaction is subject to the further hazard that it might be treated as a sale of assets. The stock purchaser would be required to liquidate the corporation in order that the assets be held at a basis equivalent to the purchase price of the stock, rather than at the low "inherited" basis at which the new corporation would have acquired the assets. The courts might therefore hold that the temporary holding of the assets by the new corporation was merely a sham and should be disregarded).

It may be further noted that the examples given are not limited

to new corporations and would also apply where the stock of the corporation was purchased from third persons and availed of for the purposes set forth in the examples.

6. Carry-backs:

We have postponed for separate treatment the question of carry-backs. The Senate Finance Committee in its report on the Revenue Bill of 1945 has stated that it is proposed to give further consideration to the necessity or desirability of retroactive legislation in connection with unused excess profit carry-backs.¹⁷¹

In the preceding section we referred to example (3) of the regulations which has to do with carry-backs. In that case a corporation of high earning assets transferred them to a newly organized subsidiary retaining assets likely to produce losses for the purpose of securing refunds for the utilization of the unused excess profits carry-back or a net operating loss carry-back.

If example (3) given in the regulations be changed so that the income producing assets, instead of being transferred to a newly formed corporation, were transferred to an already existing corporation which was owned by the transferor corporation or by the same interests, the transaction would not come within section 129. The asset acquiring corporation is not obtaining any tax benefit. It is the transferor corporation that is obtaining the tax benefit and, accordingly, the transaction would not fall within the purview of the section.

There are undoubtedly numerous war corporations which have paid high income excess profit taxes and whose business has now ceased. The Congress while repealing the excess profits tax act has continued the unused excess profits tax carry-back for an additional year for the purpose of aiding reconversion.¹⁷² Obviously it was not the intention of the Congress to give corporations such as these the benefit of an excess profits carry-back. If these corporations did not acquire any new business, the courts might hold that they had ceased to be taxable entities under the doctrine of *National Investors Corporation v. Hoey*.¹⁷³ In order to avoid the ruling of this case the war corporation could purchase a few assets and transact some incidental business, at least for the year 1946. To a somewhat lesser extent the same problem arises in connection with a net operating loss carry-

¹⁷¹ SEN. REP. No. 655, 79th Cong., 1st Sess. (1945) 29.

¹⁷² *Ibid.* 28.

¹⁷³ (C.C.A. 2d, 1944) 114 F. (2d) 466.

back. A corporation is organized for a temporary purpose and makes a substantial profit and then its business is over. The corporation continues to do some type of curtailed business in order to avail itself of the net operating loss carry-back and to get back some of the taxes paid when it was doing its real business.

On the other hand, section 129 would be applicable in cases where a corporation operating at a loss in order to avail itself of the unused excess profits tax credit carry-back and net operating carry-back created thereby acquired a corporation, which has paid excess profits taxes in a prior year, but had little or no current income. Thus, if Corporation *A* was operating at a loss or making little income and Corporation *B* had paid high excess profits tax for 1945 but had no current income and in 1946, *A* acquired all the stock of *B* and merged into *B*, the transaction would come within the corporate acquisition provision. In such a case *A* would have acquired control of *B* in order to obtain the benefit of *B*'s excess profits carry-back. If the benefit of a carry-back may be transferred by merger, the same result would follow if *B* merged into *A*, *B*'s stockholders receiving *A*'s stock on the merger. The transaction would fall within the asset acquisition provisions.

However, it is clear that section 129 is not broad enough in scope to meet the various problems which may arise in connection with carry-backs.

IV. CONCLUSION

From the foregoing discussion it appears that the enactment of section 129 has done a great deal to correct abuses and that it has made a substantial change in the law. However, it appears that the Treasury Department is seeking to extend the application of the section far beyond the purposes of Congress in enacting it. In some of these cases it is submitted, for the reasons above set forth, that the attempted extension will fail because it is not supported by the literal provisions of section 129. However, in other such cases the attempted extension is supported by the literal provisions of section 129 and it is unlikely that the courts will deny the application of the section to such cases, even though they fall far beyond the purposes of Congress in enacting it. On the other hand, section 129 appears to be deficient in excluding from its operation, transactions between members of the same common controlled group.