Fairfax Auto Parts, Inc. v. Commissioner: Definitional Requirements of the Multiple Corporation for Purposes of Exclusion from Surtax Exemptions

Jay Nathanson

TAX NOTES

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The United States Court of Appeals for the Fourth Circuit recently has upheld the Treasury Regulations' expansive definition of a brother-sister controlled group. The author views this decision in light of the history and purpose of the sections of the Code and regulations which it construes. He concludes that the court of appeals' construction is much broader than that intended by Congress, and that legislative clarification is necessary.

William Herbert owned one hundred percent of the stock of Fairfax Auto Parts, Inc. [FAP] and fifty-five percent of the stock of Fairfax Auto Parts of North Virginia [NOVA]. Joseph Ofano owned the remaining forty-five percent of the stock of NOVA and had no interest in FAP. In computing their respective tax liabilities for 1971 and 1972 the corporations each utilized a full surtax exemption pursuant to section 11(d) of the Internal Revenue Code.[1] The Commissioner of Internal Revenue determined that the corporations were component members of a brother-sister controlled group as defined by section 1563(a)(2) of the Internal Revenue Code[2] and section 1.1563-1(a)(3) of the Treasury Regulations.[3] Therefore those corporations were required to share a single surtax exemption pursuant to section 1561(a)(1).[4] The Commissioner assessed deficiencies accordingly.[5] With four judges dissenting, the tax court decided that since Joseph Ofano did not own stock in each corporation his stock ownership could not be considered in determining whether or not a controlled group existed.[6] In so holding the tax court declared the section of the Treasury Regulations relied on by the Commissioner invalid. Without considering Joseph Ofano's stock the eighty percent ownership test of section 1563(a)(2) was not met, a brother-

1. *See* text accompanying notes 7-11 *infra.*
2. *See* text accompanying note 26 *infra.*
3. *See* note 42 *infra.*
4. *See* text accompanying notes 21-24 *infra.*
5. *See* note 10 *infra.*
6. Fairfax Auto Parts of N. Va., Inc. v. Commissioner, 65 T.C. 798 (1976).

sister controlled group was found not to exist, and each corporation was permitted a full surtax exemption. On appeal the United States Court of Appeals for the Fourth Circuit *held*, reversed: In determining whether the eighty percent ownership test of section 1563(a)(2) is met, the stock ownership of a "person" may be considered whether or not such person owns some stock in each corporation and section 1.1563-1 of the Treasury Regulations is valid. *Fairfax Auto Parts, Inc. v. Commissioner*, 548 F.2d 501 (4th Cir. 1977), *cert. denied*, 98 S. Ct. 300 (1977).

The *Fairfax* decision is significant because it upholds the expansive definition of a brother-sister controlled group given by the regulations. To appreciate the import of this decision, it is necessary to view the decision in light of the history and purpose of the sections of the Code and regulations which it construes. The decision also is notable because the consequences of meeting the definition of brother-sister controlled group frequently transcend mere surtax exemption considerations.

The taxation of corporate income consists of both a "normal tax" and a "surtax."[7] At the time of the instant case the normal tax was equal to twenty-two percent of taxable income[8] and the surtax was equal to twenty-six percent of taxable income.[9] The first $25,000 of taxable corporate income, however, was exempt from the surtax unless the corporation was found to be a member of a group of multiple corporations to which section 1561 applies.[10]

The surtax exemption of section 11(d) is designed to provide a tax break for incorporators of small businesses.[11] The exemption, however, was subject to the possibility of abuse through the use of the multi-corporate structure.[12] Prior to the enactment of section

7. I.R.C. § 11(a).

8. Tax Reform Act of 1969, ch. 1, § 11(b), 78 Stat. 25 (current version at I.R.C. § 11(b)).

9. I.R.C. § 11(c)(3).

10. Tax Reform Act of 1969, ch. 1, § 11(d), 78 Stat. 25 (current version at I.R.C. § 11(d)). A full surtax exemption, therefore, was worth $6,500 (26% x $25,000). Since the Commissioner determined that the corporations should have shared a single surtax exemption for each of the two years in question, each corporation taking a $3,250 exemption in each year, he assessed a deficiency of $6,500 per corporation.

11. The corporate surtax exemption, as embodied in the present tax structure, was first enacted in 1950. Revenue Act of 1950, ch. 994, § 121(a), 64 Stat. 914. For the legislative history of the Act, see H.R. REP. No. 413, 91st Cong., 1st Sess., pt. 1, at 97 (1969); H.R. REP. No. 749, 88th Cong., 1st Sess. 116-17 (1963), *reprinted in* [1964] U.S. CODE CONG. & AD. NEWS 1425.

12. The term "multiple corporation" means more than one corporation owned by substantially the same interests. The idea of multiple corporations is embodied in the section 1563 definitions of controlled groups of corporations. The concern was that a single large enterprise would break up into many corporations to have a larger portion of its income taxed at the surtax exempt rate. For example, one corporation earning $1,000,000 annually would be taxed $473,500 (22% x $25,000 plus 48% x $975,000) whereas 40 corporations annually

1561 the Commissioner had various ways to attack such abuses. Through the use of sections 269,[13] 1551,[14] 482,[15] 61, and the common law theories of "assignment of income," "disregard of corporate entity" and "sham transaction,"[16] the Commissioner was able to minimize the procurement of additional surtax exemptions through the use of multiple corporations.[17] The efficacy of these devices was limited, however, because a demonstration by the Commissioner of

earning $25,000 each would be taxed only $220,000 (22% x $25,000 x 40). For instances where taxpayers attempted to use "multiple corporations" to evade taxes in such a manner, see James Realty Co. v. United States, 280 F.2d 394 (8th Cir. 1960); Shaw Constr. Co., 35 T.C. 1102 (1961); Aldon Homes, Inc., 33 T.C. 582 (1959).

13. Section 269 provides generally that if an individual or corporation acquires control of a corporation and "the principal purpose for which such acquisition was made is evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit or other allowance which such person or corporation would not otherwise enjoy, then the Secretary may disallow such deduction, credit, or other allowance." "Control" for the purpose of this section is 50% stock ownership.

14. Section 1551 discourages the transfer of property by a corporation or control group of individuals to a transferee corporation which was created for the purpose of acquiring such property or was not actively engaged in business at the time of such acquisition. If, after the transfer, the transferors are in control of the transferee corporation during any part of the taxable year of such transferee corporation, the Secretary may disallow the surtax exemption for such taxable year. If the transferee corporation can establish by the clear preponderance of the evidence that the securing of such exemption or credit was not a major purpose of the transfer, the Secretary may not disallow the exemption. I.R.C. § 1551(a).

15. Section 482 provides that in the case of two or more businesses owned or controlled by the same interests the Commissoner "may distribute, apportion, or allocate gross income, deductions, credits, or allowances between . . . such . . . businesses if . . . necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such . . . businesses."

16. These theories, often blended in their application, are based on the assumption that tax law looks at substance over form and taxes the true earners of income. When corporations are formed solely to evade taxes and are devoid of any real business functions the Commissioner has argued successfully that a single corporation is the true earner of all of the income and has taxed it accordingly. Hence functionless corporations are treated as "shams." They are disregarded as corporate entities. Gregory v. Helvering, 293 U.S. 465 (1935); Shaw Constr. Co., 35 T.C. 1102 (1961); Aldon Homes, Inc., 33 T.C. 582 (1959); *cf.* Knetsch v. United States, 364 U.S. 361 (1960) (taxpayer purchased insurance on which the cash value was borrowed almost immediately, the interest being used to decrease income tax indebtedness); Higgins v. Smith, 308 U.S. 473 (1940) (taxpayer deducted loss arising from sale of securities to a corporation wholly owned by the taxpayer).

17. For an explanation of section 269, see B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS, § 15.02, at 15-10, 16-21 (3d ed. 1971) [hereinafter cited as BITTKER]. For an explanation of section 1551, see BITTKER § 15.02. For an explanation of section 482, see BITTKER § 1506.

For a detailed analysis of the use of these sections and the theories of the Commissioner, including the relevant case law, see Carruthers, *The Treasury's Attack Upon the Tax Benefits of the Multi-Corporate Complex*, 28 N.Y.U. INST. FED. TAX. 555 (1970); Golden, *Multiple Incorporation and Multiple Surtax Exemptions*, 26 GA. B.J. 385 (1963-64); Kessler, *Multiple Corporations Under the Revenue Act of 1964*, 3 ILL. C.L.E. 93 (1965); Maier, *Use of Multiple Corporations Under the 1964 Revenue Act*, 42 TAXES 565, 569-80 (1964); *Multiple Corporations Under the Revenue Act of 1964*, 18 VAND. L. REV. 1338 (1964-65); 44 MINN. L. REV. 485 (1959-60); 1970 U. ILL. L.F. 145.

a "tax avoidance purpose" was usually a prerequisite to their application.[18]

The Revenue Act of 1964, through sections 1561[19] and 1563,[20] provided for the first time a mechanical limitation upon the abilities of "multiple corporations" to enjoy the benefits of multiple surtax exemptions.[21] Under these sections if the percentage ownership tests of either a parent-subsidiary controlled group[22] or a brother-sister controlled group are met, the entire group of corporations is required to share a single surtax exemption without further inquiry into whether the structure was motivated by tax avoidance or legitimate business purposes.[23] For purposes of the 1964 Act a brother-sister

18. *See* notes 13, 14, and 16, *supra*. Such a requirement often results in the allowance of multiple surtax exemptions where a "business purpose" can be demonstrated to justify the multicorporate structure. The most common business purposes for multiple incorporation are differences in location, differences in business activities, and limited liability. For a discussion of the possible benefits of multiple incorporation outside of tax considerations, i.e. business purposes, see Worthy, *Multiple Corporations*, 1965 TUL. TAX INST. 136, 136-42. For a discussion of the business purposes advanced in the cases and the success of taxpayers in urging particular business purposes, see Cuddihy, *Obtaining Multiple Deduction and Credits for Multiple Corporations*, 1961 TUL. TAX INST. 564; Ekman, *How Many Corporations Can Conduct a Business?*, 19 N.Y.U. INST. FED. TAX 391 (1961); Emmanuel & Lipoff, *Commissioner v. Corporate Complex: An Expanding Attack*, 15 U. FLA. L. REV. 352 (1962-63); Paley, *Multiple Corporations Face Ever-Increasing Attack; Realty Development Vulnerable*, 18 J. TAX. 130 (1963).

Section 1551 is limited further by being applicable only in the case of transfers. *See* note 14 *supra*. Section 482 has been used primarily to combat less than "arms length" transfers between commonly owned interests. *See* Treas. Reg. § 1.482-1(b)(1) (1954).

19. Revenue Act of 1964, ch. 6, § 1561(a), 78 Stat. 116.

20. Revenue Act of 1964, ch. 6, § 1563(a)(2), 78 Stat. 120.

21. Section 1561 provided *inter alia* that the component members of a controlled group of corporations shall be limited to one surtax exemption under section 11(d), to be divided equally or apportioned if all members consent. Section 1563 defined controlled group of corporations as either a parent-subsidiary controlled group, *see* note 22 *infra*, or a brother-sister controlled group, *see* text accompanying note 26 *infra*. A third and fourth category, "combined groups" and "certain insurance companies," also are mentioned in section 1563. The 1964 Act also provided for a broadening of section 1551. It was made to apply to indirect as well as direct transfers of property and it was also expanded to apply to transfers from controlled groups of individuals as well as corporations in control.

The effects of section 1561, however, were mitigated by section 1562, which provided that a controlled group could elect to escape section 1561 and each corporate member benefit from a full surtax exemption if they paid an additional six percent on the normal tax up to $25,000.00.

22. A parent-subsidiary controlled group is defined as one or more chains of corporations connected with a common parent corporation through 80% or more stock ownership of each. I.R.C. § 1563(a)(1).

23. While Congress primarily feared that existing medium and large corporations would split up into multiple corporations in order to take advantage of the surtax exemption, it added that even multiple corporations formed to cope with business problems would be penalized. Congress stated that the rule would be applied "where corporations owned and controlled by the same interests engage in different businesses in the same area or conduct the same type business in different geographical locales." H.R. REP. No. 749, 88th Cong., 1st

controlled group was defined as two or more corporations where one individual owns eighty percent or more of the stock of each.[24]

After finding that the eighty percent ownership test by one individual was circumvented easily,[25] Congress, in writing the Tax Reform Act of 1969, broadened the definition of a brother-sister controlled group to:

> Two or more corporations if 5 or fewer persons who are individuals, estates, or trusts own (within the meaning of subsection (d)(2)) stock possessing-
> (A) at least 80 percent of the total combined voting power of all classes of stock entitled to vote or at least 80 percent of the total value of shares of all classes of the stock of each corporation, and
> (B) more than 50 percent of the total combined voting power of all classes of stock entitled to vote or more than 50 percent of the total value of all shares of all classes of stock of each corporation, taking into account the stock ownership of each such person only to the extent such stock ownership is identical with respect to each such corporation.[26]

While it is clear from the statutory language that for purposes of the fifty percent test a person's stock cannot be considered unless he owns stock in each corporation,[27] it is ambiguous whether for purposes of the eighty percent test, a person must own stock in each corporation in order to have his ownership considered.[28]

An examination of the relevant legislative history of section 1563 suggests that a person must own stock in each corporation in order to have his stock ownership considered for purposes of the

Sess. 118 (1963), *reprinted in* [1964] U.S. CODE CONG. & AD. NEWS 1426-27; S. REP. No. 830, 88th Cong., 2d Sess. 150 (1964), *reprinted in* [1964] U.S. CODE CONG. & AD. NEWS 1823-24. Congress was quick to assure that "[o]f course, nothing in this bill is intended as changing the application of sections 269, 1551, or 482 if the multiple corporation form of organization is adopted to avoid taxes." *Id.*

24. Tax Reform Act of 1964, ch. 6, § 1563(a)(2), 78 Stat. 120.

25. *See Hearings on the Subject of Tax Reform Before the House Comm. on Ways and Means*, 91st Cong., 1st Sess., pt. 14, at 5394 (1969).

26. I.R.C. § 1563(a)(2). The Tax Reform Act of 1969 not only broadened the definition of a brother-sister controlled group but made it more significant by repealing section 1562. Thus, section 1561 could no longer be avoided by mere election. *See* discussion of section 1562 at note 21 *supra.*

27. The 50% test says "taking into account the stock ownership of each such person only to the extent such stock ownership is identical with respect to each corporation." If A owned 40% of the stock of corporation X and 20% of the stock of corporation Y, his identical ownership would be only 20%. If A owned 40% of X and 0% of Y, he would have 0% identical ownership and would therefore be excluded from the 50% test.

28. One article has suggested that the language of the 80% test is so ambiguous as to lead to four possible interpretations. Libin & Abramowitz, *Multiple corporations: A surprising interpretation of Sec. 1563(a)(2) in temporary regulations*, 2 TAX ADVISOR 326 (1971).

eighty percent test.[29] When the mechanical multiple corporation tests were first proposed in 1963, a definition for brother-sister controlled group was considered which would have required five or fewer persons to own at least eighty percent of the stock in the corporation not taking account of an individual's ownership to the extent it exceeds twice the percentage ownership in another corporation.[30] Thus each individual would have been required to own some stock in each corporation.[31] When the legislation was reported by the House, the stock ownership requirement had been reduced from five or fewer persons to one person owning eighty percent of each corporation.[32] No explanation for this change appears in the legislative history.

In 1969 the House and Senate Reports mentioned the change in definition of a brother-sister controlled group but failed to explain the reasons for the change or to clearly exemplify the operation of the new definitions.[33] It is mentioned in the House Reports, however, that the definition is intended to be the same as applies to section 1551(b)(2).[34]

Section 1551 provides in relevant part that:

> If . . . *five or fewer individuals who are in control of a corporation transfer* . . . *property* . . . to a transferee corporation, and the transferee corporation was created for the purpose of acquiring such property or was not actively engaged in business at the time of such acquisition, and if after such transfer *the transferor or transferors are in control of such transferee corporation* during any part of the taxable year of such transferee corporation, then for such taxable year of such transferee corporation the Secretary may . . . disallow the surtax exemption. . . .[35]

Section 1551 defines control as:

> [T]he ownership by *the* five or fewer individuals described in such subsection of stock possessing-
> (A) at least eighty percent of the total combined voting power of

29. *Hearings on the President's 1963 Tax Message Before the House Committee on Ways and Means*, 88th Cong., 1st Sess., vol. 4, pt. 1, at 77 (1963).

30. *Id.*

31. *Id.*

32. H.R. REP. No. 749, 88th Cong., 1st Sess. 119 (1963), *reprinted in* [1964] U.S. CODE CONG. & AD. NEWS 1425, 1612.

33. H.R. REP. No. 413, 91st Cong., 1st Sess., pt. 2, at 76 (1969), *reprinted in* [1969] U.S. CODE CONG. & AD. NEWS 1748; S. REP. No. 552, 91st Cong., 1st Sess. 133 (1969), *reprinted in* U.S. CODE CONG. & AD. NEWS 2167.

34. H.R. REP. No. 413, 91st Cong., 1st Sess., pt. 2, at 76 (1969), *reprinted in* [1969] U.S. CODE CONG. & AD. NEWS 1956.

35. I.R.C. § 1551(a)(3) (emphasis added).

all classes of stock entitled to vote or at least eighty percent of the total value of shares of all classes of the stock of each corporation, and
(B) more than fifty percent of the total combined voting power of all classes of stock entitled to vote or more than fifty percent of the total value of shares of all classes of stock of each corporation, taking into account the stock ownership of each such individual only to the extent such stock ownership is identical with respect to each such corporation.[36]

The language underscored in the section seems fairly suggestive that Congress intended all members of the controlled group to own stock in the transferee and transferor. It is *the transferors* that must be in control of the transferee—not "any" of the transferors or "some" of them. Control is defined as ownership by "the five or fewer individuals" of stock possessing certain percentages of ownership of each corporation.

In addition, the legislative history of section 1551 makes it clear that each member of the control group has to own some stock in both the transferee and transferor corporations. The House Report states that "section 1551 is extended to include the . . . transfer of property . . . to a transferee corporation . . . by five or fewer individuals who are in control of a corporation, if after such transfer *such* individuals are in control of the transferee corporation. . . ."[37] The report goes on to state that

> Paragraph (2) of section 1551(b) provides that five or fewer individuals are in control if *such* individuals own. . .
> (A) at least 80 percent of the total combined voting power of all classes of stock entitled to vote or at least 80 percent of the total value of shares of all classes of the stock of each corporation, and
> (B) more than 50 percent of the total combined voting power of all classes of stock entitled to vote or more than 50 percent of the total value of shares of all classes of stock of each corporation, taking into account the stock ownership of each such individual only to the extent such stock ownership is identical with respect to each such corporation.[38]

The following example offered in the report is also illustrative:

> *Example*—On January 1, 1964, A owns 65 percent of the only class of stock of corporation X and individual B owns the remain-

36. I.R.C. § 1551(b)(2) (emphasis added).
37. H.R. REP. No. 749, 88th Cong., 1st Sess. A210 (1963) (emphasis added), *reprinted in* [1964] U.S. CODE CONG. & AD. NEWS 1637.
38. *Id.* at A212.

ing 35 percent of the stock. Also, on January 1, 1964, A and B transfer property (other than money) to corporation Y (a newly formed corporation) and receive stock of corporation Y in return. After the transfer, A and B own the stock of corporation X and Y in the following proportions:

	Corporation X	Corporation Y	Identical Ownership
A	65	35	35
B	35	65	35
TOTAL	100	100	70

The transfer of property by individuals A and B to corporation Y is a transfer described in section 1551(a)(3), as amended, since the *same* five or fewer individuals (A *and* B) own more than 80 percent of the stock of corporation X *and* Y *as required* under section 1551(b)(2)(A) and the identical ownership equals more than 50 percent as required under section 1551(b)(2)(B).[39]

It is clear, therefore, that for purposes of determining whether a controlled group exists under section 1551, a person has to own stock in both members of the alleged controlled group. If Congress had not intended this result it would not have used the word "such" individuals in the underscored situation nor would it have stated in the example that the "same" five or fewer must own eighty percent of the stock of "X and Y," "as required" by the statute.

The 1969 Treasury proposals before the House illustrate that the Treasury also contemplated common ownership by all members of the controlled group. The definition of a brother-sister controlled group as proposed by the Treasury was as follows:

> [A] group of corporations would constitute a brother-sister controlled group if (1) the *same five* or fewer persons own at least 80 percent of the voting stock or value of shares of each corporation, and (2) *these* five or fewer individuals own more than 50 percent of the voting power or value of shares of each corporation considering a particular person's stock only to the extent that it is owned identically with respect to each corporation.[40]

The examples which follow the definition, attempting to illustrate it, provide only situations where all members whose stock is included for purposes of the eighty percent test own stock in each corporation.[41]

39. *Id.* at A212-13 (emphasis added).
40. *Hearings on the Subject of Tax Reform Before the House Comm. on Ways and Means*, 91st Cong., 1st Sess., pt. 14, at 5168 (1969).
41. *Id.* at 5169.

The Treasury Regulations, however, took the position that a person did not have to own stock in each corporation in order to be counted in the eighty percent test.[42] These regulations were criticized in many sectors as being inconsistent with the legislative history and the statutory language, outside the intent of Congress, and leading to illogical results.[43] The issue of whether the ownership

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Thus, for example, part (1) . . . is met whether one person owns 80 percent of the voting stock of each corporation, four persons each own 20 percent of the voting stock of each corporation, or one person owns 60 percent of the voting stock of one corporation and 40 percent of another, and another person owns 40 percent of the voting stock of the first and 60 percent of the second.

42. The regulation construes section 1563(a)(2) by adding the words "singly or in combination" as follows: "(3) Brother-sister controlled group. (i) The term 'brother-sister controlled group' means two or more corporations if the same five or fewer persons who are individuals, estates, or trusts own *singly or in combination,* stock possessing. . . ." Treas. Reg. § 1.1563-1(a)(3) (1973). The regulation offers the following example:

Example (1). The outstanding stock of corporations P, Q, R, S, and T, which have only one class of stock outstanding, is owned by the following unrelated individuals:

Individuals	CORPORATIONS P	Q	R	S	T	Identical Ownership
A	60%	60%	60%	60%	100%	60%
B	40%					
C		40%				
D			40%			
E				40%		
TOTAL	100%	100%	100%	100%	100%	60%

Corporations P, Q, R, S, and T are members of brother-sister controlled group. *See* Treas. Reg. § 1.1563-1(a)(3)(ii), *Example* (1).

The disposition of the instant case is contingent upon whether or not Joseph Ofano's stock can be considered for purposes of the 80% test although he failed to own stock in each of the corporations.

	Fairfax, Inc.	Fairfax of No. Va.	Identical Ownership
William Herbert	100%	55%	55%
Joseph Ofano	0%	45%	0%
TOTAL	100%	100%	55%

43. *See* Bonovitz, *Brother-Sister Controlled Groups Under Section 1563: The 80 Percent Ownership Test,* 28 TAX LAWYER 511 (1974-75); Kringel, *Multiple corporation Proposed Regulations raise more questions than they answer,* 36 J. TAX. 358 (1972); Libin & Abramowitz, *supra* note 28; Thomas, *Brother-Sister Multiple Corporations—The Tax Reform Act of 1969*

requirements under section 1563 and the regulations were met was never litigated before *Fairfax.*[44] Nor was the meeting of the same definitional requirements ever litigated under section 1551. Prior to *Fairfax* the key issue in the area of multiple corporations and the use of surtax exemptions always had been whether the motivation for multiple incorporation was tax avoidance or business oriented.

As suggested previously, the tax consequences of falling into the section 1563(a)(2) definition of a brother-sister controlled group are much broader than the disallowance of surtax exemptions—which was the concern of the instant case. First, section 1563(a)(2) groups must share one $150,000 amount for purposes of computing the accumulated earnings credits under section 535(c)(2) and (3).[45] Second, section 1563(a)(2) groups must share one $25,000 amount for purposes of computing the limitations on the small business deduction of life insurance companies under sections 803(a)(3) and 803(d)(10).[46] Third, all component members of section 1563(a)(2) groups are treated as one taxpayer for purposes of the dollar limitations to the section 179 additional first year depreciation allowance for small businesses.[47] Fourth, section 1563(a)(2) groups must share one $30,000 tax preference income exclusion under section 56.[48] Fifth, the $25,000 investment credit permitted by section 46 must be apportioned by 1563(a)(2) groups.[49] Sixth, the $100,000 amount of used section 38 property eligible for the investment credit permitted by section 48 must be apportioned by controlled groups.[50] Seventh, under ERISA[51] all employees of all corporations which are

Reformed by Regulation, 28 TAX L. REV. 65 (1972-73); 27 TAX LAW. 813 (1973-74). *But see* White, *The Tax Reform Act of 1969; Demise of Multiple Surtax Exemptions—When Too Much of a Good Thing Proved Its Own Undoing,* 16 WAYNE L. REV. 1353, 1368 (1970).

44. In the interim between the tax court decision and its reversal by the court of appeals the tax court was followed in T.L. Hunt, Inc., TAX CT. MEM. DEC. (P-H).

The present decision has subsequently been followed in the eighth circuit. *See* T.L. Hunt, Inc. of Texas v. Commissioner, 562 F.2d 532 (8th Cir. 1977). A subsequent Tax Court case has refused to follow the appellate courts' decision, however. *See* Baloian Co. v. Commissioner, 68 T.C. 620 (1977). The court boldly stated: "Notwithstanding the Fourth Circuit's disagreement with our position on this question, we remain convinced of its correctness." *Id.* at 631.

45. I.R.C. § 1561(a)(2).

46. I.R.C. § 1561(a)(3).

47. I.R.C. § 179(d)(6)(A). Note, however, that for purposes of section 179(d)(7) the 80% test of section 1563(a)(2) is disregarded.

48. I.R.C. § 58(b). For tax years beginning after December 31, 1975, the $30,000 amount is changed to $10,000.

49. I.R.C. § 46(a)(6).

50. I.R.C. § 48(c)(2)(c). Note, however, that I.R.C. § 48(c)(3)(c) and Treasury Regulation § 1.48-3(d)(4), like section 179(d)(7), eliminates the 80% test for purposes of defining a brother-sister controlled group.

51. Employee Retirement Security Act of 1974, § 1015, Pub. L. No. 93-406, 88 Stat. 925.

members of a controlled group are treated as employed by a single employer for purposes of determining qualifications requirements, minimum participation standards, minimum vesting standards, and the limitations on benefits and contribution provisions. Also, if a plan is adopted by more than one member of a controlled group, the minimum funding standard and limits on deductions are determined as if all employers adopting the plan were a single employer.[52] Eighth, members of a controlled group of corporations are treated as one corporation for purposes of section 447 which provides that corporations engaged in farming are to compute taxable income on an accrual method of accounting with the capitalization of certain pre-productive expenses. A corporation meets the requirements of this section if it has less than $1,000,000 in gross receipts for each prior taxable year.[53] Ninth, in determining the amount of investment credit allowable for certain movie and television films, the section 1563(a)(2) definition is used in describing "related persons" which need the Secretary's consent to elect to have the "applicable percentage" under section 46(c)(2)[54] determined by a "ninety percent rule."[55]

Despite the plethora of consequences stemming from the construction given section 1563(a)(2) by the Treasury Regulations, the *Fairfax* court considered only the consequences that related to the instant case—the denial of extra surtax exemptions. The court[56] based its decision upon two foundations. First, Treasury Regulations are to be upheld unless they are unreasonable and clearly inconsistent with the statute. Since the regulations here are supported by both the language of the statute and its legislative history they must be upheld.[57] Second, when Congress expressly applied the section 1563(a)(2) definition to ERISA in 1974, the regulations, already in existence, impliedly were approved and given the full force of the law.[58]

The court reasoned that the language of the statute did not require common ownership by the "five or fewer persons" for pur-

52. I.R.C. § 414(b).

53. I.R.C. § 447(c).

54. This refers to the definition of "qualified investment" for purposes of certain credit allowances under section 46.

55. I.R.C. § 48(k)(3)(D)(i). For another instance where section 1563(a)(2) controlled groups are mentioned, *see* I.R.C. § 382(a)(5)(E).

56. The Court of Appeals wrote a one page *per curiam* opinion adopting the opinion of the dissenting judges in the tax court. For purposes of clarity the dissenting judges' opinion will be referred to as the opinion of "the court."

57. 65 T.C. at 807. *See* Bingler v. Johnson, 394 U.S. 741, 749-50 (1969); United States v. Correll, 389 U.S. 299, 307 (1967); Commissioner v. South Texas Lumber Co., 333 U.S. 496, 501 (1948); Colgate Co. v. United States, 320 U.S. 422, 426 (1943); Brewster v. Gage, 280 U.S. 327, 336 (1931).

58. 65 T.C. at 808.

poses of the eighty percent test because the fifty percent test and the eighty percent test are separately stated. The identical ownership test, which requires common ownership, is stated only in conjunction with the fifty percent test. Therefore an individual must have common ownership only for purposes of the fifty percent test.[59] The court cited the following proposal from the Treasury Department in support of its position:

> Brother-sister groups.—A group of corporations in which five or fewer persons own, *to a large extent in identical proportions,* at least 80-percent of the stock of each of the corporations. This provision expands present law by considering the combined stock ownership of five individuals, rather than one individual, in applying the 80 percent test. Even the mild 6-percent penalty under existing law for brother-sister corporations claiming multiple surtax exemptions is largely ineffectual because of the present requirement that one person own 80-percent of the stock of each corporation before the group of corporations is subject to the penalty.
>
> *However, in order to insure that this expanded definition of brother-sister controlled group applies only to those cases where the five or fewer individuals hold their 80-percent in a way which allows them to operate the corporations as one economic entity, the proposal would add an additional rule that the ownership of the five or fewer individuals must constitute more than 50-percent of the stock of each corporation considering, in this test of ownership, stock of a particular person only to the extent that it is owned identically with respect to each corporation.*[60]

From this the court also concluded that:

> [T]he *underscored* words in the first sentence . . . merely indicate that there will be common ownership "to a large extent" among those persons whose ownership is considered for purposes of the 80-percent test. That statement recognizes that there need not be common ownership among all those persons taken into consideration for purposes of the 80-percent test, and the common ownership that is required is specified by the 50-percent test.[61]

59. 65 T.C. at 808-09. The tax court majority impeaches the dissent's statutory construction by arguing that since "five or fewer persons" is the conjunctive subject of both the 80% test and the 50% test, both tests must be satisfied by the same group. Since the members of the 50% group must own stock in each corporation, so must the 80% group members. The tax court majority further argues that the words "each such person" appearing in the 50% test referring to the people in the 80% test mean that all of the people in the 80% test must also be in the 50% test (they must own some stock in each corporation). 65 T.C. at 803.

60. 65 T.C. at 809-10 (emphasis in original). *See Hearings on the Subject of Tax Reform Before the House Comm. on Ways and Means,* 91st Cong., 1st Sess., pt. 14, at 5394 (1969).

61. 65 T.C. at 810.

The court found further support for its position in that at the time of the expansion of section 1563(a)(2), the regulations under section 1551 included an example where someone who owned stock only in the transferor corporation and not the transferee corporation had his stock ownership taken account of for purposes of the eighty percent test.[62] The court reasoned that since the legislative history explicitly states that the section 1551 definition was to be applied to section 1563(a)(2), "it is reasonable to assume that the draftsmen of section 1563 were aware of such regulations and therefore intended for the definition to include the situation described in it."[63]

The legislative history of section 1563(a)(2) is hardly as unequivocal as the court would have us believe. From an examination of the Tax Reform Hearings, it would appear that the Treasury Department itself contemplated in both 1964 and 1969 that a person must own at least some stock in each corporation in order to have his ownership considered for purposes of the eighty percent test.[64]

It is also arguable, even from the legislative history cited by the court,[65] that the eighty percent test must be one of common ownership. It is clear that the 1964 test of one person having to own eighty percent of the stock of each corporation was a test of common ownership.[66] When Congress expanded the eighty percent test to "5 or fewer persons" the intent was to increase the size of the group exercising the common ownership in order to prevent easy avoidance, but not obliterate the requirement of common ownership.[67]

In the regulations' example,[68] none of the persons making up the ownership group have any common control or ownership except for *A*. Reading the eighty percent test in such a manner insures not that the same interests own each corporation but merely that each corporation will be a close corporation. Since the purpose of the section 11(d) surtax exemption is to benefit close corporations[69] such a result is untenable.[70] Furthermore, the two tests read together make most sense as a requirement that those persons exercising the common control are the same persons as those exercising common

62. Treas. Reg. § 1.1551-1(g)(4), example (4) (1967).

63. 65 T.C. at 810.

64. *See* notes 31, 41 & accompanying text *supra*.

65. *See* text accompanying note 60 *supra*.

66. If only a test of control 51% would have been sufficient and 80% unnecessary.

67. *See* text accompanying note 60 *supra*.

68. *See* note 42 *supra*.

69. *See* note 12 and accompanying text *supra*.

70. In the example, B, C, D, and E each have an interest in only one out of the five corporations which they are supposed to control as a group. The touchstone is not that a small group of people control the corporations *together*, but that a small group of people control the corporation.

ownership. Only in this way is it probable that the group will operate as a single economic entity.

Another problem with this interpretation is that it would lead to situations where persons who own stock in only one corporation will be surprised to find out that their corporations are part of a controlled group and that their single holdings are contributing to that result. The possibility that upset the tax court majority was as follows:

> Individual A owns 55 percent of corporation X and individual B owns 45 percent thereof. If A were independently to enter into a second business in corporate form the corporations would be component members of a controlled group. We cannot believe that Congress intended to surprise B with such a result.[71]

A similarly unfavorable situation would occur if A already owned one business and then formed a second unrelated business with B. If A owned fifty-five percent of the stock of the second business and B owned forty-five percent of the stock, a brother-sister controlled group would be formed. The law therefore would dictate the absurd proposition that before B goes into business with A he must investigate all of A's other holdings to make sure that A and B together are not running two or more businesses as a single economic entity.[72]

The court's argument that the regulations to section 1551 support the proposition that there is no need for each individual to own some stock in each corporation of the controlled group for purposes of the eighty percent test is also subject to attack. Although one of the examples presented by the regulations to section 1551 on a peripheral point suggests such a conclusion,[73] the rest of the examples

71. 65 T.C. at 805 n.5. The court was unperturbed by this result, rationalizing as follows: If B owned as much as one share of corporation X the definition clearly would apply as it would if A owned 80% of Y and B owned only 20%, although B may be equally surprised. 65 T.C. at 812. These situations, however, are distinguishable from the situation offered by the majority at the tax court level. Even if B were to own only one percent of Y's shares, the fact that B owns at least some stock in each corporation would greatly minimize the chance of B being surprised to find out that the corporations are members of a controlled group or that A has interests in both. In the second situation, although B, owning only 20% in one of the two corporations, may still be surprised to find the two corporations belonging to a controlled group, at least B's stock ownership will not be used to determine such a result.

72. Arguments as to why the statute demands that persons must own stock in each corporation in order to have that ownership considered for purposes of the 80% test are presented by the tax court majority. 65 T.C. at 803-06. *See also* Bonovitz, *supra* note 43, at 516-19, 530; Libin & Abramowitz, *supra* note 28, at 329; Thomas, *supra* note 43, at 79-84; 27 TAX LAW. 813 (1973-74).

73. *See* note 62 *supra*.

under that section seem to support the opposite conclusion.[74] Furthermore, there is no such strong language (i.e. *"singly or in combination"*[75]), in the regulations to section 1551 as there is in section 1563 so as to suggest that a person does not have to own stock in each corporation in order to be considered for the eighty percent test.

Much more persuasive than the argument that the regulations of section 1551 support the proposition that a person must own some stock in each corporation to be considered for purposes of the eighty percent test is that the statute itself and the legislative history support such a proposition.[76] To the extent that the regulations under section 1551 hold to the contrary they are invalid.

The second prong of the court's attack was that by adopting the section 1563(a)(2) brother-sister controlled group definition for purposes of ERISA after the regulations in question came out Congress impliedly accepted them as law. This analysis also is questionable. The rule stated in the cases that the court cites in order to support its proposition is that "Treasury regulations and interpretations, long continued without substantial change, applying to unamended or substantially reenacted statutes, are deemed to have received Congressional approval and have the effect of law."[77]

The "reenactment doctrine" espoused by these cases should not be stated as a *per se* rule, as the court intimates. Although this rule has often been cited by the Supreme Court there have also been instances where the Supreme Court has failed to follow it.[78] Where the reenactment doctrine has been espoused the court usually finds the regulation to be at least reasonable in terms of statutory con-

74. *See* Treas. Reg. § 1.1551-1 (1967) and examples thereunder. Of the eight examples cited throughout only one does not require all of the members of the controlled group to own stock in both the transferee and transferor corporations. It is to be further noted that in the exceptional example, all of those making up the 80% group for the transferee do hold stock in the transferor, whereas one member of the transferors' 80% group fails to hold stock in the transferee.

75. *Compare* Treas. Reg. § 1.1551-1(e)(1)(ii) (1967) *with* Treas. Reg. § 1.1563-1(a)(3) (1967). For commentary arguing that the regulations of section 1551 require common ownership, see Bonovitz, *supra* note 43, at 522-28; Thomas, *supra* note 43, at 76-84; 27 TAX LAW. 813, 815 (1973-74); 2 TAX ADVISOR 326, 329 (1971). *Contra* White, *The new broader sweep of Section 1551: an analysis of IRS' Regulations,* 28 J. TAX. 100, 102-04 (1968).

76. *See* notes 35-39 and accompanying text *supra.*

77. *See* United States v. Correll, 389 U.S. 299, 305-06 (1967); Commissioner v. Flowers, 326 U.S. 465, 469 (1946); Boehm v. Commissioner, 326 U.S. 287, 291-92 (1945); Helvering v. Winmill, 305 U.S. 79, 83 (1938).

78. *See* United States v. Cartwright, 411 U.S. 546 (1973); Burnet v. Chicago Portrait Co., 285 U.S. 1 (1931). For a general discussion of the underlying issues in the area, see *Regulations, Reenactment, and the Revenue Acts,* 54 HARV. L. REV. 378 (1941); *A Summary of the Regulations Problem,* 54 HARV. L. REV. 398 (1941).

struction, policy, and legislative history.[79] In many of the cases cited by the Court the reasonableness of the regulation was not really at issue as in the instant case.[80] Where the regulation appears totally unreasonable to the Court it has been held invalid in spite of being long-continued.[81]

The argument for the reenactment doctrine here is weakened by the fact that the regulation in question was not "long-continued" when the section 1563(a)(2) definition was applied to ERISA.[82] Also, there is no evidence from the legislative history of the relevant section of ERISA that the regulation in question had been considered at all by Congress in its application of section 1563(a)(2) to section 414(1).[83]

It is submitted that regardless of the *Fairfax* decision the statute forces this to be a problem area. The statute is defective not only because it is worded poorly but because the mechanical application that it calls for is not an appropriate response to the problem of multiple corporations and surtax exemptions. The goal of section 11(d) is to aid small corporations by providing a surtax exemption.[84] The broad goal of sections 1561 and 1563 is to deny more than one surtax exemption to multiple corporations which are in fact a "single economic entity."[85] The fact that the multicorporate arrangement is motivated by "business purposes" rather than "tax avoidance purposes" should be no defense to a denial of extra surtax exemptions if the multiple corporations are in fact a single large business. Yet common control and/or ownership do not in and of themselves dictate such a result.

If a third test were added to the statute demanding some "integration of activities"[86] between the corporations, both equity

79. *See* United States v. Correll, 389 U.S. 299, 300-07 (1967).

80. Commissioner v. Flowers, 326 U.S. 465 (1946); Boehm v. Commissioner, 326 U.S. 287 (1945); Helvering v. Winmill, 305 U.S. 79 (1938).

81. *See* United States v. Cartwright, 411 U.S. 546 (1973).

82. The 1972 regulations were permanent for only two years when ERISA was passed. Section 1563(a)(2) had not been reenacted. For a case from the Fifth Circuit where a regulation was not accorded great weight because it was not long-continued, see Kurzner v. United States, 413 F.2d 97, 112 (5th Cir. 1969).

83. *See* H.R. REP. No. 807, 93d Cong., 2d Sess. 50-51 (1974); S. REP. No. 383, 93rd Cong., 1st Sess. 43-44 (1973). This should be compared with United States v. Correll, 389 U.S. 299, 306-07 n.20 (1967) where the regulation in question was mentioned and approved by the House and Senate.

84. *See* note 12 *supra*.

85. *See* note 23 *supra*.

86. The idea of an "integration" test in this area was developed in Surrey, *Income Tax Problems of Corporations and Shareholders: American Law Institute Tax Project-American Bar Association Committee Study on Legislative Revision*, 14 TAX L. REV. 1, 37-43 (1958-59). Surrey's proposal was espoused in *Multiple Corporations Under the Revenue Act of 1964*, 18 VAND. L. REV. 1338, 1360-62 (1964-65). It was criticized in *Multiple Incorporation to Obtain*

and effectiveness would be increased. Consider the following examples in support of this proposition. In the instant case, FAP and NOVA would meet the integration test since they do the same type of business in the same area and are run by the same people.[87] If they meet the control and ownership requirements they should be forced to share a single surtax exemption.

Contrast the instant case with the example that the tax court majority was troubled with.[88] X owns fifty-five percent and Y owns forty-five percent of the stock of an incorporated auto shop. If X went out and bought a restaurant by himself, and chose to incorporate, the two corporations would be forced to share a single surtax exemption under the *Fairfax* rule. If the suggested test applied each corporation would get a full surtax exemption. Although the fifty percent test is met and so is the eighty percent test under one view, there is no integration of business activities.

One final example will illustrate this. Three doctors incorporate their medical practice, each taking one-third of the stock. If they decide to invest in a real estate venture and incorporate their activities, each doctor taking the same one-third in that venture, the two corporations would become a controlled group and would be forced to share a single surtax exemption under sections 1561 and 1563 irrespective of the outcome in *Fairfax*. No doubt it is within the purpose of section 11(d) to encourage the enterprising doctors to go into a small business with their excess capital. The fact that the medical practice and the investment venture are totally unintegrated should save the two corporations from being taxed as though it were one large business.[89]

It is undesirable for the law in the field to remain as *Fairfax* leaves it. The regulations' interpretation of section 1563, as approved in *Fairfax*, is probably much broader than what Congress intended. It leads to results that Congress could not reasonably have envisioned. The statute quite simply could be altered by Congress so as to leave no doubt.[90] It is further submitted that in addition to

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Additional Accumulated Earnings Credits and Surtax Exemptions, 44 MINN. L. REV. 485, 510-11 (1959-60).

Section 1561 is criticized as providing only an arbitrary test in *Reform of Multiple Surtax Exemptions*, 1970 U. ILL. L.F. 145, 154-56.

87. 65 T.C. at 799-801.

88. 65 T.C. at 805 n.5.

89. The bottom line is that whenever one person owns two or more businesses that are incorporated, that person will be automatically penalized no matter how totally unrelated those businesses are. Whenever one person owns controlling stock in more than one corporation, the same result will occur as long as the rest of the stock of the corporations is owned by a small number of persons.

90. If Congress intended the stock ownership of a person to be considered for purposes

clarifying the eighty percent test Congress should consider a retreat from a purely mechanical approach so as to effectuate the policies behind the surtax exemption under section 11(d) and its disallowance to multiple corporations under section 1561, without such a preponderance of unwarranted spillover effects.

JAY NATHANSON

Funding of Marital Deduction Trusts Through Equalization Clauses: Confusing Concepts of Terminable Value and Terminable Interest

In a recent decision, the Tax Court concluded that an interest passing to a surviving spouse under a trust instrument qualified for a marital deduction where the interest was vested indefeasibly on the date of death but might have no value. The author suggests that the Internal Revenue Service attack upon this estate plan was based upon mistakenly equating terminable interest with terminable value—a confusion which has existed at least since the issuance of Revenue Procedure 64-19 in 1964.

In 1967 settlor-decedent ("Settlor"), Charles W. Smith, transferred the bulk of his assets to a revocable inter vivos trust.[1] Article IV of the trust instrument directed itself to trust distributions. It provided in pertinent part that the corpus was to be divided into two separate portions if the Settlor's wife survived him. The spouse was given a general power of appointment over the first portion, which was intended to qualify for the marital deduction. The remainder passed to a residuary, non-marital trust. The funding of each was determined by an equalization clause.[2] The Trustee filed the estate

of the eighty percent (80%) test regardless of some stock ownership in each corporation, they could have added the four words added by the regulations, i.e., "singly or in combination." *See* note 42 *supra*. If Congress intended it to be necessary to own some stock in each corporation, they could have adopted the language proposed by the 1969 Treasury Proposals by adding the two words "same" and "these." *See* note 40 & accompanying text *supra*.

1. On June 7, 1920, the date of death, decedent's estate was valued at $3,492,764.32. Of this amount $3,288,519.99 was held in the trust.

2. The clause in pertinent part read as follows:

(b) There shall then be allocated to the Marital Portion that percentage interest in the balance of the assets constituting the trust estate which shall when taken together with all other interests and property that qualify for the marital deduction and that pass or shall have passed to Settlor's said wife under other provisions of this trust or otherwise, obtain for Settlor's estate a marital deduction