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TAX ESCAPE BY MANIPULATIONS OF HOLDING COMPANY

M. S. BRECKENRIDGE*

There can be no possible doubt that holding companies have been a vehicle of business progress in recent years. They have unified and stabilized management, standardized methods and improved them by pooled information, broadened security markets for small companies and much more.[1] And they do not want champions or advocates. But they have not been an unmixed blessing. Indeed, there is a notion abroad that they, like their contemporary, the automobile, have at times served also as a vehicle in which many ill-disposed persons escape the clutches of the law with large quantities of the peoples' money.

Laying aside the problem of holding company regulation now acute in the railroad,[2] public utility,[3] and insurance[4] fields, it is here proposed to point out and briefly consider two apparent abuses of the holding company device in connection with taxation. So far as North Carolina is concerned, the corporate income tax is admittedly high.[5] A corporation operating in this state might want to show a low taxable net, but in ordinary cases of corporations, as of individuals, there would be no incentive to cut down actual earnings simply to pay less taxes. A merchant, for example, would not deliberately sell at a continuing loss in order to keep from paying an income tax however exorbitant he considered it. There would be no economy in that.

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[1] See Martin J. Insull, *Is Control of Operating Companies Sufficient?* (May 1930) 14 PROCEEDINGS ACAD. POL. SCI. 81; comment (Sept. 4, 1930) 6 PUB. UTIL. FORTNIGHTLY 295, 300.

[2] See 1929 Report I. C. C. 79-83, reprinted with testimony of Commissioner Eastman in vol. 1, part 1, Hearings before the House Committee on Interstate and Foreign Commerce, 71st Congress, 2nd session, H. R. 114, p. 24; Message of Governor of Mass. (Jan. 9, 1930) *U. S. Daily*, p. 7.

[3] Report of Massachusetts Special Commission on Control and Conduct of Public Utilities (1930); Report of New York Commission on Revision of the Public Service Commission Law (1930); Lillienthal, *Regulation of Public Utility Holding Companies* (1929) 29 COL. L. REV. 404; Report of Committee on Intercorporate Relations, Nat. Ass'n. of R. R. and P. U. Commissioners (1930); Greenlaw, *The Regulation of Holding Companies* (1930) 14 PROC. ACAD. POL. SCI. 108; Field, *Substitution of Securities by Holding Cos.* (Aug. 21, 1930) 6 P. U. FORTNIGHTLY 222.

[4] See statement of Dan Boney, Insurance Commissioner of North Carolina (Jan. 7, 1930) *U. S. Daily*, p. 11.

[5] N. C. ANN. CODE (Michie, Supp. 1929) §7880 (317). The rate is 4½%.

But enter the holding company and all is changed. The profits of a domestic subsidiary are of course the parent's gains indirectly in dividends but before these reach the parent they are depleted by local taxation. The losses of the domestic subsidiary are, of course, the parent's losses correspondingly except in transactions between the two companies themselves. Here the subsidiary's losses are the parent's gains directly, and gains on which no tax is paid. A sickly unprofitable local business is ordinarily no cause for rejoicing. But here it is—to the ultimate owners. To illustrate by facts actually disclosed in a fairly recent case:[6] An automobile manufacturing company owns the stock of a sales and distributing company. It sells cars to the subsidiary from without the state at such a figure that the latter cannot possibly make a profit. The local company does a losing business, has no income to report and accordingly pays the state no tax although the buyers pay plenty for their cars. An independent concern would starve on such a diet and quit. Not so the scrawny subsidiary of a well nourished parent, for, of course, the parent keeps the subsidiary alive despite its losses. That, after all, is only a matter of bookkeeping.

There seem to be two possible ways to block this easy escape from taxation; certainly one or the other should be put into constant and active effect. One way is to disregard the corporate existence of the domestic company as a separate personality, treat it as an agent of the foreign company and the latter as engaged in business locally by that means. In that case the parent will be taxable on the income from its local sales, computed upon a basis of cost to the parent less the pro rata selling expense of the units.

No statute seems ever specifically to have directed such a course and where it has been attempted by an administrative body without exact statutory authority it has failed in court.[7] There is nothing now to show that such an act would be held unconstitutional, adopting as it does a well established legal rule applied by the courts where a parent dominates a subsidiary.[8] There is the question of jurisdiction

[6] People v. Gilchrist, 244 N. Y. 114, 155 N. E. 68 (1926).

[7] Proctor & Gamble v. Newton, 289 Fed. 1013 (S. D. N. Y. 1923); *cf.* as to other forms of taxation, Appeal of Callery, 272 Pa. 255, 116 Atl. 222 (1922); Washburn Wire Co. v. Bliss, 42 R. I. 32, 105 Atl. 179 (1908); McCornick v. Bassett, 49 Utah 444, 164 Pac. 852 (1916). And see So. Pac. Co. v. Lowe, 247 U. S. 330, 337-338, 38 S. Ct. 540, 542 (1918).

[8] See Ballentine, *Separate Entity of Parent and Subsidiary Corporations* (1925) 14 CAL. L. REV. 12; People v. Gilchrist, *supra* note 6, at p. 123, 155 N. E. at p. 71.

over the parent corporation, however, as a weak point both practically and legally in such an undertaking.[9]

On the other hand there is the expedient already written into the statute books in several states, of taxing the subsidiary on what it could show as earnings if it were given a square deal by the parent—if, in other words, it operated on a normal business contract and not a one-sided arrangement thrust upon its impotent legal person by the dominant parent.[10]

The North Carolina statute reads as follows:

"When any corporation liable to taxation under this act conducts its business in such a manner as either directly or indirectly to benefit the members or stockholders thereof or any person interested in such business by selling its products or the goods or commodities in which it deals at less than the fair price which might be obtained therefor, or where a corporation, a substantial portion of whose capital stock is owned either directly or indirectly by another corporation, acquires and disposes of the products of the corporation so owning a substantial portion of its stock in such a manner as to create a loss or improper net income for either of said corporations, or where a corporation, owning directly or indirectly a substantial portion of the stock of another corporation, acquires and disposes of the products of the corporation of which it so owns a substantial portion of the stock, in such a manner as to create a loss or improper net income for either of said corporations, the Commissioner of Revenue may determine the amount of taxable income of either or any of such corporations for the calendar or fiscal year, having due regard to the reasonable profits which, but for such arrangement or understanding, might or could have been obtained, by the corporation or corporations liable to taxation under this act, from dealing in such products, goods or commodities."[11]

The Wisconsin and New York acts are similar.[12]

The procedure thus outlined was attempted in New York against the Studebaker corporation but the theory of the case was not exactly worked out and the effort to tax the subsidiary was mixed up with

[9] See Cannon Mfg. Co. v. Cudahy Packing Co., 267 U. S. 333, 45 S. Ct. 250 (1925). *Cf.* Industrial Research Co. v. Gen. Motors Corp., 29 F. (2d) 623 (N. D. Ohio, 1928).

[10] *Cf.* U. S. v. Lehigh Valley R. R., 254 U. S. 255, 41 S. Ct. 104 (1920). And see as to motion picture companies, Report of N. C. Tax Comm. (1930) 146.

[11] N. C. ANN. CODE (Michie, Supp. 1929) §7880 (322) 6.

[12] Wis. Stat. (1927) 71.25; N. Y. Tax Law (1930) §211, 10. Neither of these laws, however, specifically includes a clause, like that in the N. C. act, covering a corporation which owns the stock of another and acquires its products at an abnormal price—the situation in the Palmolive Case later mentioned herein.

the expedient suggested above of taxing the parent itself. Accordingly the attempt failed.[13] But the ever alert Wisconsin authorities have recently brought the matter to the fore again in cases presenting two types of the "rich parent, poor subsidiary" relationship. One, like the Studebaker case before mentioned, is where the foreign parent sells goods to the domestic subsidiary, or to a subsidiary authorized to do local business, at a high figure. The other, represented by the recent Palmolive Case is where the foreign parent buys products from a controlled domestic manufacturer so cheaply as to leave no substantial profit for that unit of the business.

In both types of cases the state has been sustained by the United States District Court in ignoring the inter-company contract, making an independent calculation of profits from the Wisconsin business, and assessing a tax upon these calculations.[14]

Counsel's contention in the earlier case was that the two corporations were separate entities and that the contract between them must be respected even though it allowed the Buick Motor Company, the distributor, to make only a paltry $2500 annual profit on the sale of Buick automobiles in a highly profitable area. The contract of two legally independent parties determined what the income of the distributor was and a tax commission had no power to say it was something else. The adverse decision on this contention was not upon a disregard of the separate corporate entity of the two contracting parties. It was on the ground, rather, that the state cannot be concluded by an arrangement contracting away in advance the profits from a domestic business, and that inferences may be drawn from the sale of goods, not for a price but to yield a flat and meager profit determined beforehand, on resale.

It seems easier, however, to arrive at the result by treating the wholly dominated subsidiary as a device to evade the local taxing statute and so disregarding the separate corporate personalities to whatever extent is necessary in order to make the statute effective. And it was along this line that the opinion of Lindley, D. J., in the Palmolive Case proceeded.

The important thing for present purposes, however, is that legislation substantially like that already existent in North Carolina, and if anything less exact and comprehensive, has been sustained, and that a form of tax evasion which undoubtedly flourishes abundantly in

[13] People v. Gilchrist, *supra* note 6.

[14] Buick Motor Co. v. City of Milwaukee, 43 F. (2d) 385 (E. D. Wis. 1930); Palmolive Co. v. Conway, 43 F. (2d) 226 (W. D. Wis. 1930).

states other than Wisconsin has been there frustrated. The Buick and Palmolive cases should give added impetus to the local enforcement and resulting larger revenues to the state.

The other notable tax abuse to be considered herein comes about through the statutory privilege of deducting interest on indebtedness from one's taxable income. When the Federal Excise Tax of 1909 was enacted corporations were allowed to deduct interest only on an amount of indebtedness up to the amount of their outstanding capital stock.[15] It was felt that any other arrangement would enable corporations to defeat the statute entirely by borrowing a large part of their capital and having in consequence a heavy annual interest bill for deduction on their tax return.[16] That reason would apply with equal force to any state income tax law and yet the limitation seems not usually to have been inserted. Whether the states which allow the deduction of all interest payments are in fact heavy losers by their liberality seems not to be shown by any available statistics. That they are losers to some extent seems almost certain. The Federal Income Tax Law, after some amendments of this limiting provision,[17] was finally changed so as to impose no limitation at all. All interest can be deducted alike by corporations and individuals except when e principal indebtedness was incurred to purchase tax free securities.[18]

The explanation seems to have been that the later excess profits tax did away with the need for the older protection afforded by the limitation on deductions.[19] With that tax now repealed there would

[15] 36 Stat. 112, §38.

[16] Robinson, *The Federal Corporation Tax* (1911) 1 AM. ECON. REVIEW 691, 712 also pointing out weaknesses in the statute and easy methods of evasion (1) by high interest rate bonds, (2) by inflated capital account.

[17] See Ivy Courts Realty Co. v. U. S., 20 F. (2d) 348 (C. C. A. 2, 1927). See remarks of Mr. Calder seeking removal of the limitation as to public utility obligations approved by a state commission, 50 CONG. REC. 1308.

[18] 26 U. S. C. §986. *Cf.* 2 Hem. Ann. Miss. Code (1927) §5660 (2).

[19] See brief of W. E. Humphrey, representing Northwestern Mortgage Companies, Hearings before Senate Committee on Finance (1918) 65th Cong. 2nd Sess. on H. R. 12863, p. 628, concerning the provision of the revenue act allowing deduction of interest paid by the corporation on indebtedness not exceeding the amount of its capital stock. "This law cannot be justified on any principle of taxation and the only reason for its justification, if any, in incorporating it into the law of 1916, was to prevent corporations from decreasing the amount of their capital stock and increasing the amount of their bonded indebtedness in order to secure the additional interest allowance. But such reason, if it ever existed, has ceased, for under the excess-profits law there is no longer any inducement for a corporation to take such action, as they would thereby be the losers."

seem to be a revival of the need for the original check on deductible interest.

North Carolina has no such thing as an excess profits tax and every argument which existed in 1909 for a limitation on deductible interest in case of the Federal Government would now seem to exist here and in most other income taxing states. Whether the limitation should be like that of the 1909 or 1913 Federal Law or a more severe one authorizing a deduction of interest only on sums borrowed for working capital, or whether no deduction of interest at all should be allowed is a question of some difficulty.[20] The last is the rule now in effect as to public utilities in North Carolina.[21] The proposal of the State Tax Commission is that the deduction "be limited to interest on a sum not greater than the book value of their capital stock."[22]

But, however it may be where no holding company is concerned and where the interest payments represent the hire for money borrowed from outside capital, it is a much more emphatic case for statutory modification when the bonded indebtedness is owned by a parent corporation and the so called business expenses in the form of interest are paid into the identical hands which receive the dividends on the reporting company's stock. A domestic corporation is entirely dominated through stock ownership by a foreign company. It has no bonded indebtedness and must accordingly pay a tax on its entire earnings before the profits are remitted out of the state in dividends to the parent company. Let it now retire half or more of its capital stock by substituting bonds and a deduction of interest paid into the very same pockets is allowed before the state income tax is paid. What matters it to the parent what form its ownership takes? Money which the local business has produced and which the foreign owner of the corporation has received thus escape taxation solely because of the different label put on the payment.

If the tax commission's recommendation is acted upon, the holding company will be caught in the sweep of the wider tax policy adopted. But even then there is strong reason for thinking that where holding

[20] The Wisconsin Act fixes a slightly different rule: "interest paid during the year in the operation of the business from which its income is derived." WIS. STATS. (1927) 71.03 (2). N. D. COMP. LAWS ANN. (Supp. 1925) 2346 a 30, is somewhat similar.

[21] N. C. ANN. CODE (Michie, Supp. 1929) §7880 (318); N. C. Pub. Laws (1929) c. 345, §312. See Atlantic Coast Line v. Daughton, 262 U. S. 413, 43 S. Ct. 620 (1923).

[22] Report of the N. C. Tax Commission (1930) 35. *Cf.* Mo. Rev. Stat. (1927 Supp.) §13111; but see Mo. Laws (1929) p. 431. And see Robinson, *supra* note 16.

and affiliated companies are involved the problem should be treated as a distinct one and that a sound tax policy demands an entire prohibition of interest deductions in such cases.[23] At any rate if the recommendations of the Commission are not made law, this one leak in the tax line should be stopped. To do so effectively will require consideration of the domination of companies doing business in North Carolina not only directly as here discussed but indirectly through affiliated companies and individuals.[24]

[23] The matter bears some resemblance to claiming deductions for excessive salaries paid to officers. See note, 68 A. L. R. 696; Mendelson Bros. Paper Co. v. Commissioners of Int. Revenue, 44 F. (2d) 372 (C. C. A. 7, 1930).

[24] Some pioneering in the matter of defining affiliated interests has been done in connection with statutes on holding company regulation. See N. Y. Laws (1930) ch. 760.