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Tax Advantages and Disadvantages of Incorporated Pocketbooks

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TAX ADVANTAGES AND DISADVANTAGES OF INCORPORATED POCKETBOOKS*

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I. Introduction

Apart from their use as organizations for the conduct of ordinary business, corporations have been used in the past and probably will be used in the future to avoid or save income taxes. The owner of several businesses, the wealthy holder of securities or real estate, the executor or administrator of a large estate may ask his attorney, "Can I save taxes by incorporating?" This paper discusses some of the possibilities and dangers of this method of tax minimization.

II. Advantages of the Incorporated Pocketbook

A. *Lower rates*

Since corporate income tax rates under the federal revenue law do not exceed 38% and range from 21% to 25% on corporate incomes under $25,000, high bracket taxpayers have much to gain by channeling income through a corporation. Individual tax rates, even with 1948 reductions and income splitting, go as high as 72%, and exceed 38% on net incomes over $58,000. Of course, any saving through lower corporation rates assumes that high individual rates are not paid later on the same income. More will be said of this later.

B. *Income splitting*

In order to split up a large income taxable in higher brackets into smaller incomes taxable in lower brackets a taxpayer may form a corporation and transfer part of his income-producing property or business to it in a tax-free exchange for stock. Or he may divide his income-producing property among several corporations, all with incomes under $25,000. If the property consists of buildings or similar property, one corporation can own and manage one building, thus permitting return of the building to the stockholder-owner through corporate liquidation at capital gain rates. By contrast, if a single corporation owns several buildings and one is transferred to the stockholder-owner, it may amount to a distribution taxable as a dividend. The chief disadvantage of multiple corporations is that the taxpayer may not offset the profits of one against the losses of another, unless a consolidated return is filed, which involves a 2% added surtax and difficulty in changing back to separate returns.

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It may be noted here that formation of a corporation with gifts of stock to members of the taxpayer's family provides a division of income and yet retention of control that is not possible with a partnership or proprietorship form of organization.

C. *Control*

In contrast with unconditional gifts of income-producing property to save taxes, the tax advantages of incorporation may be obtained without losing control of the property. And of course there is no gift tax when the property is transferred to a corporation.

III. Disadvantages and Dangers of the Incorporated Pocketbook

A. *Double taxation of income*

The immediate problem of the incorporated pocketbook is how to get the money out without paying the individual income taxes which the corporation was formed or is used to avoid. If the income is taxed to the corporation and then taxed to the stockholder, the stockholder has clearly lost money by incorporating. Of course, all dividends or distributions from earnings and profits of corporations are fully taxable to the recipient, and corporations have the unfortunate facility of converting all types of income, whether fully or partially tax exempt or capital gains, into ordinary taxable income when disbursed as dividends.

The problem here is the reverse of that faced by many small corporations, i.e., using the corporate form for business purposes without paying higher taxes than competing proprietorships and partnerships. Such corporations seek to avoid the corporation tax by distributing the income of the business to its owners as deductible items—salaries, rent, interest. Here the idea is to pay the corporate tax and avoid the high bracket individual income tax which would attach to salary, rent, interest or dividend payments. The alternative to paying the stockholder salary, rent, interest or dividends is to accumulate earnings in the corporation. If this can be done, there are three methods of realizing the income at a tax saving. First, the stockholder may sell his stock, and the difference between its basis and sale price will be taxed as a capital gain. Second, the corporation may be completely liquidated, at the same tax cost. Third, if sale of the stock or liquidation takes place after the stockholder's death, the corporate profits are realized free of income tax, because the basis of the stock is its fair market value at the date of death.

One possibility for withdrawing earnings at a tax saving is to capitalize the corporation originally partly with bonds and partly with stock and then siphon off the liquid assets by payment of interest and redemption of the bonds. If discount bonds (like Series "E" United States bonds) are used, and no one bondholder owns directly or indirectly more than 50% in value of the corporate stock, the bond interest or increment is taxed as capital gain rather than as ordinary income. However, there are hazards in such "thin incorporations," chief of which is the possibility that the bond "interest" and "redemption" will be held dividends in disguise.

B. *Surtax on improper accumulation of surplus*

As just noted, tax saving by means of a corporation depends on accumulating earnings in the corporation, but the barrier to this practice is the section 102 surtax on corporations improperly accumulating surplus, which will not be covered here. The penalty for accumulating earnings to avoid tax is 27½% of the undistributed section 102 net income under $100,000 and 38½% of this income over $100,000. There may be cases, of course, where a taxpayer can profitably submit his corporation to this surtax rather than have dividends declared.

C. *The personal holding company surtax*

This heavy surtax was specifically designed to eliminate the incorporated pocketbook, and it is probably the principal hazard facing any taxpayer who attempts to use this device. It is also, of course, a real hazard for the small or family corporation conducting a business, and is a danger of which many businessmen are unaware.

D. *Disregard of the corporate entity*

The basic legal principle that a corporation is an entity separate and distinct from the shareholders who own it is also the general rule in tax matters. It has received statutory recognition in the Internal Revenue Code provisions imposing a separate income tax on corporations, exempting specifically enumerated corporations, and treating corporate distributions as a distinct type of income. It has been recognized by the Supreme Court in many cases, beginning with the first income tax decisions.[1]

As old and established as the general rule respecting the corporate entity is the exception, that the corporate entity will be disregarded in certain cases and the income taxed directly to the stockholders. The question, "In what cases?" is not easily answered. A review of the leading Supreme Court decisions may furnish leads toward a solution of the problem.

In two early cases the Court disregarded the separate entity of wholly owned and controlled subsidiary corporations. *Southern Pacific Co. v. Lowe*[2] involved the railroad operation of a subsidiary under a lease agreement with its parent, under which the parent kept the books,

[1] Lynch v. Hornby, 247 U. S. 339 (1918); Eisner v. Macomber, 252 U. S. 189 (1920).
[2] 247 U. S. 330 (1918).

directed the operations and received one-half the earnings over 6% return on the subsidiary's stock. It was held, on the "peculiar facts" of the case, that the subsidiary's dividend, paid by cancelling its debt to the parent, was not taxable income to the parent. In *Gulf Oil Corp. v. Lewellyn*[3] the parent took over the previously accumulated earnings and surplus of its operating subsidiaries, principally in the form of intercorporate debts, and the Court held that no dividend had been paid to the parent, that the transaction was a bookkeeping change only.

The claim that a corporation and the estate of its sole stockholder were the same taxable entity was denied in *Burnet v. Commonwealth Improvement Co.*[4] The stockholder and his corporation had been separately taxed for years, and when the corporation sold securities to his estate at a profit, a taxable gain to the corporation was declared. The reverse of this situation seems to present a different picture, however, because the Supreme Court in *Higgins v. Smith*,[5] with two dissents, refused to allow a loss on the sale of securities by a sole stockholder to his corporation, where the corporation was organized and used to save taxes for the stockholder. The opinion indicated that a taxpayer using a corporation for his business must accept its tax disadvantages, but that the Government need not allow him its advantages where the corporation is "a sham or unreal." Today, of course, losses between a corporation and its sole stockholder are expressly disallowed by section 24(b) of the Internal Revenue Code.

In *Moline Properties, Inc. v. Comm'r.*[6] the Court again thwarted a taxpayer's efforts to identify himself with his wholly owned corporation in the taxation of income. Thompson had organized the corporation in 1928, under pressure from creditors, as a security device in connection with certain mortgaged real estate. After the corporation paid the debts and Thompson regained control, the corporation still held title to the property and carried on minor activities. When the property was sold Thompson contended the gain was his and the corporate existence fictitious. Replying, the Court said: "The doctrine of corporate entity fills a useful purpose in business life . . . 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." In explanation of *Higgins v. Smith* and the exceptions to this general rule, the Court stated that in revenue matters generally the corporate form may be disregarded where it is a sham or unreal; in such situations the form is "a bald and mischievous fiction."

A footnote in the *Moline Properties* opinion mentioned with apparent disapproval several lower court decisions[7] which had disregarded the corporate entity because the corporation simply held legal title to the stockholder's property and carried on little or no business activity.

[3] 248 U. S. 71 (1918). [4] 287 U. S. 415 (1932).
[5] 308 U. S. 473 (1940). [6] 319 U. S. 436 (1943).
[7] Among these cases were North Jersey Title Ins. Co. v. Comm'r., 84 F. 2d

The most recent Supreme Court case in point is *National Carbide Corp. v. Comm'r*,[8] a 1949 decision which reaffirmed and strengthened the *Moline Properties* holding. Four wholly owned and controlled operating subsidiaries paid their parent, under contracts, all profits in excess of 6% on their capital stock, and the parent reported these profits as its income. The Commissioner was upheld in taxing the profits to the subsidiaries. The *Southern Pacific Co.* and *Gulf Oil Corp.* cases were limited to their facts and expressly held not to establish any general revenue principle. The argument that the subsidiaries were mere "agents" of the parent because of the parent's ownership, dominion and direction was termed simply another side to the "practical identity" or "substantial identity" argument for ignoring corporate existence. The Court made clear, however, that a corporate agent may handle the property and income of its principal without being taxed therefor, if the usual incidents of an agency relationship are present. The relations of the agent and principal must not be dependent upon the principal's ownership of the agent.

The principles emerging from these decisions may be summed up as follows: (1) The separate entity of the corporation will be recognized in tax matters if the corporation is formed for a business purpose or engages in business activity in the ordinary sense.[9] (2) Avoiding or escaping taxation is not a business purpose or activity.[10] (3) The corporate entity may be disregarded by the Commissioner where no real business purpose or activity exists, where the corporation is formed or used to avoid taxes, where recognition of the entity would contravene some act of Congress, and where the corporation is a sham or unreal.[11] (4) Complete ownership, control and direction of a corporation by a single stockholder or corporation is not a controlling consideration in determining whether to respect or ignore the corporate entity.

E. *Losses between related taxpayers disallowed*

1. General. Section 24(b) of the Internal Revenue Code, carried over from the 1934 Act, disallows losses from sales or exchanges of property, directly or indirectly, between certain classes of related taxpayers. The individuals affected are: (1) members of a family, (2) trust grantors and their trustees, (3) trustees of trusts having a com-

898 (3d Cir. 1936); Inland Development Co. v. Comm'r., 120 F. 2d 986 (10th Cir. 1941); United States v. Brager Bldg. and Land Corp., 124 F. 2d 349 (4th Cir. 1941); *cf.* Sheldon Bldg. Corp. v. Comm'r., 118 F. 2d 835 (7th Cir. 1941); Brudno v. Comm'r., 138 F. 2d 779 (6th Cir. 1943); Paymer v. Comm'r., 150 F. 2d 334 (2d Cir. 1945).

[8] 69 Sup. Ct. 726 (1949).

[9] See Railway Express Agency, Inc. v. Comm'r., 169 F. 2d 193 (2d Cir. 1948).

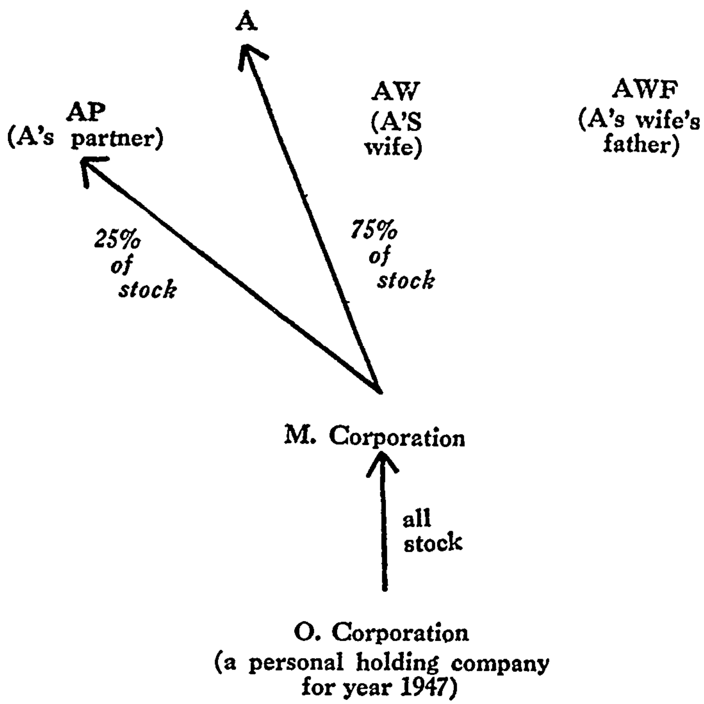
[10] See National Investors Corp. v. Hoey, 144 F. 2d 466 (2d Cir. 1944).

[11] See Brown v. Comm'r., 115 F. 2d 337 (2d Cir. 1940); Comm'r. v. Smith, 136 F. 2d 556 (2d Cir. 1943); O'Neill v. Comm'r., 170 F. 2d 596 (2d Cir. 1948), *cert. denied*, 69 Sup. Ct. 747 (1949); *cf.* Gregory v. Helvering, 293 U. S. 465 (1935).

mon grantor, and (4) trustees and their beneficiaries. Other sales and exchanges covered are those (5) between a corporation and the individual owning directly or indirectly more than 50% in value of its outstanding stock, and (6) between two corporations, each of which is more than 50% owned by the same individual, and one of which was a domestic or foreign personal holding company for the preceding taxable year. Losses on liquidation distributions are specifically exempted from the affected transactions.

Section 24(b) defines indirect ownership of stock broadly, so that stock owned by a corporation, partnership, estate or trust is owned proportionally by its stockholders, partners, or beneficiaries, and an individual owns the stock of his partner and his family. "Family" includes spouse, brothers and sisters, ancestors and lineal descendants.

The following example, relating to sales or exchanges during 1948, illustrates the operation of this section:



Losses *are disallowed* between:
1. M. Corp. and O. Corp.
2. A and M. Corp. or O. Corp.
3. A and AW.
4. AW and M. Corp. or O. Corp.
5. AW and AWF.
6. AP and M. Corp. or O. Corp.

Losses *are not disallowed* between:
1. A and AWF.
2. AWF and M. Corp. or O. Corp.
3. A and P.
4. AW and P.

Chief significance of Section 24(b) for ordinary purposes is in the disallowance of losses between members of a family and between a family corporation and its stockholders. Note that losses are *not* disallowed between two operating corporations, even if both are owned or controlled by the same individual, family or corporation.

Where Section 24(b) applies, not only does the seller lose his deduction but the purchaser's basis for the property is his cost, and the loss prior to the sale can never be recovered by way of tax deduction.

2. Sales and exchanges. Several cases have established the principle that in a sale or exchange of a number of blocks of stock between related taxpayers the gains or losses must be computed separately on each block, and the gains reported as income though the losses cannot be deducted.[12] The same principle has been applied to the sale of two adjacent buildings, where the two properties had not been substantially integrated at the time of the sale.[13]

Although Section 24(b) exempts distributions in liquidation of a corporation, a sale of assets to the majority stockholder by a trustee appointed to liquidate the corporation was held not within the exemption and the loss was disallowed.[14]

In keeping with the tendency of the courts in tax matters to look through form to substance, indirect sales or exchanges of several kinds have been declared within Section 24(b) coverage. Where members of a family sold securities on the New York Stock Exchange and other members of the family bought like securities at the same prices the Supreme Court disallowed the losses under the provision on intra-family transfers.[15] If a mortgagee buys at a sheriff's sale and the mortgagor is a member of his family, no loss can be deducted.[16] The same result follows if a husband buys from a bank stock which was pledged by his wife as security on her note.[17] And if the nominal buyer of property is in reality purchasing for a taxpayer within the affected classes any loss on the sale will be disallowed.[18]

3. Stock ownership. Since the statute uses the phrase "more than 50%" it was held that Section 24(b) does not apply if the taxpayer owns directly or indirectly exactly 50% of the corporation's stock.[19]

[12] Lakeside Irrigation Co. v. Comm'r., 128 F. 2d 418 (5th Cir. 1942), *cert. denied*, 317 U. S. 666 (1942); M. F. Reddington. Inc. v. Comm'r., 131 F. 2d 1014 (2d Cir. 1942); Morris Investment Corp. v. Comm'r., 156 F. 2d 748 (3d Cir. 1946), *cert. denied*, 329 U. S. 788 (1946).

[13] Krahl, 9 T. C. 862 (1947).

[14] Mathews v. Squire, 59 F. Supp. 827 (W. D. Wash. 1945).

[15] McWilliams v. Comm'r., 331 U. S. 694 (1947); *accord*, Comm'r. v. Kohn, 158 F. 2d 32 (4th Cir. 1946).

[16] Zacek, 8 T. C. 1056 (1947).

[17] Cooney, 1 T. C. M. 55.

[18] Nordling v. Comm'r., 166 F. 2d. 703 (9th Cir. 1948), *cert. denied*, 335 U. S. 817 (1948).

[19] Hewitt Rubber Co., 6 T. C. M. 1258 (1948).

But where a corporation sold land at a loss to a stockholder owning more than 50% of its stock and in the transaction the corporation bought in part of its stock, thus reducing the purchaser's holding to less than 50%, the loss was disallowed.[20]

In a recent case involving the Morgan partners, the Second Circuit held that since a partnership is not a taxable entity, a sale of partnership assets to a corporation organized by the partners to take over the partnership business was a transaction between the partners as individuals and a corporation owned by them, and therefore no loss could be deducted.[21]

4. Section 24(b) is not exclusive. Even though a sale or exchange is not between related taxpayers as defined by Section 24(b), a loss on the transaction may be denied by the courts upon broad judicial principles. In *Crown Cork International Corp.*[22] a parent corporation sold certain stock at a loss to its wholly owned subsidiary. The Tax Court found that there was no real business purpose for the sale, that the principal motive was tax saving, and that the transaction was a sham and unreal. It disallowed the loss and was affirmed on appeal by the Third Circuit. This case should be a warning to all closely associated corporations which are not specifically covered by Section 24(b).

F. *Reallocation of income and deductions among related businesses*

I. R. C. Section 45 authorizes the Commissioner to reallocate income, deductions, credits or allowances among two or more organizations, trades or businesses owned or controlled directly or indirectly by the same interests, if he determines that such reallocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of the organizations, trades or businesses.

1. General. Relatively few cases have arisen under this section although it and its predecessors have been in the revenue law for twenty-eight years. The section is designed to prevent manipulation of related businesses to evade taxes, and to place controlled taxpayers on a tax parity with uncontrolled taxpayers. Its coverage is broad. Sole proprietorships, partnerships, corporations, trusts and estates are included in the definition of "organizations."[23] "Control" is defined as any kind of control, direct or indirect, whether or not legally enforceable.[24] Obvious examples of businesses affected by this law are parent and subsidiary corporations, two corporations owned by the same indi-

[20] W. A. Drake, Inc. v. Comm'r., 145 F. 2d 365 (10th Cir. 1944).
[21] Comm'r. v. Whitney, 169 F. 2d 562 (2d Cir. 1948), *cert. denied*, 335 U. S. 892 (1948).
[22] 4 T. C. 19 (1944), *aff'd* per curiam, 149 F. 2d 968 (3d Cir. 1945).
[23] U. S. Treas. Reg. 111, §29.45-1 (a) (1).
[24] U. S. Treas. Reg. 111, §29.45-1 (a) (3).

vidual or family, a corporation and a partnership consisting of its stockholders.

When the Commissioner reallocates income or deductions under Section 45, and presents the facts on which reallocation is based, the burden is then on the taxpayer to show error under the law or abuse of discretion.

2. Section 45 prohibits:

(a) Arbitrary prices or charges in everyday transactions. Prices should be reasonable, consistent, and similar to prices charged outside businesses or individuals.

(b) Confusion and intermingling of accounts. Shifting of profits, making of fictitious sales, year-end adjustments dependent on income, and failure to keep separate accounts are some of the conditions likely to bring about the application of Section 45.

(c) Sale of assets at cost to shift gain. In *Asiatic Petroleum Co. v. Comm'r*,[25] a domestic corporation sold certain appreciated property at cost to a foreign corporation owned by the same interests. The foreign corporation immediately resold the property at a profit. The Commissioner was upheld in allocating the profit to the domestic corporation.

(d) Sale of assets at cost to shift loss. In *G. U. R. Co. v. Comm'r*,[26] X Corporation sold at cost certain stock which had greatly depreciated in value to Y Corporation, which was owned by the same person. Three years later Y sold the stock in the market at a loss. The Commissioner reallocated to X all the loss except that occurring during the three years in which Y held the stock, and was upheld by the court.

(e) Tax-free transfer of assets to shift gain or loss. In *National Securities Corp. v. Comm'r*[27] a parent corporation transferred securities to its subsidiary in exchange for the latter's stock. Under the Internal Revenue Code provision on tax-free exchanges, the basis of the securities remained unchanged. When the subsidiary sold the securities at a loss, the Commissioner allocated the loss to the parent and was sustained. The Court held that the application of Section 45 was not restricted by the specific carry over basis provisions of the Code.

3. Limitations on the Commissioner's authority under Section 45.

(a) Reallocation is permitted only if necessary to prevent evasion of taxes or clearly to reflect the income of the related organizations. The Commissioner does not have power to reallocate the income and deductions of all related businesses. Because many controlled taxpayers have shown that their transactions were genuine and were made in arm's length dealings, the Commissioner has actually lost more Section 45 cases in the courts than he has won.

[25] 79 F. 2d 234 (2d Cir. 1935).

[26] 117 F. 2d 187 (7th Cir. 1941).

[27] 137 F. 2d 600 (3d Cir. 1943), *cert. denied*, 320 U. S. 794 (1943).

(b) Section 45 gives the Commissioner no power to disallow deductions. He may only allocate, distribute and apportion them.[28]

(c) Nor can the Commissioner allocate income which does not exist. In *Tennessee-Arkansas Gravel Co. v. Comm'r*[29] A Corporation leased equipment to B Corporation, which was controlled by the same interests, for one year at $1,000 a month, but charged B no rent for the second year. The Court refused to sustain the Commissioner's action in allocating $12,000 income to A Corporation for the second year, since A had actually received nothing under the lease.

(d) The fact that another and different financial or commercial arrangement could have been made does not justify the application of Section 45, in the absence of other reasons.[30]

4. Section 45 allows:

(a) Use of subsidiary or affiliate corporations or partnerships to perform different functions of a controlled enterprise. Example: A manufacturing company may produce goods, one or more separate companies may sell them, and a real estate company may hold title to the factory and other property. Several cases of corporations dealing with partnerships consisting of their stockholders have cleared the Section 45 hurdle. This, of course, permits tax savings because of the lower rates on corporate incomes of less than $25,000 and because of the single taxation of partnership income.

(b) Formation of a Western Hemisphere trade subsidiary or affiliate. Example: A manufacturing company selling to countries in the Western Hemisphere can create a subsidiary to handle this foreign trade exclusively, thus qualifying the subsidiary for the surtax exemption provided by Code Sections 109 and 15(b).

(c) Sales between related companies which create tax losses. Section 45 does not authorize the Commissioner to disallow such losses.[31] *But,* the sale must be at market value and unconditional; the loss will be disallowed under Section 24(b) if either corporation is a personal or foreign personal holding company; and under the principle of *Gregory v. Helvering*[32] the loss may be denied if there is no business purpose for the transaction other than tax avoidance. In *Crown Cork International Corp. v. Comm'r.*[33] the court disallowed a loss on a sale of securities by a parent to its wholly owned subsidiary, relying on the reasoning of the *Gregory* case.

5. Conclusions.

(a) The principle of *Gregory v. Helvering, supra,* definitely flavors

[28] General Industries Corp. v. Comm'r., 35 B. T. A. 615, Acq. 1937-1 CB 10.
[29] 112 F. 2d 508 (6th Cir. 1940).
[30] Koppers Co. v. Comm'r., 2 T. C. 152 (1943).
[31] General Industries Corp. v. Comm'r., 35 B. T. A. 615 (1937).
[32] 293 U. S. 465 (1935).
[33] 4 T. C. 19 (1944), *aff'd* per curiam, 149 F. 2d 968 (3d Cir. 1945).

the courts' thinking in Section 45 cases. If transactions between related corporations or businesses have no other purpose than tax avoidance, the Commissioner's reallocation of income or deductions is likely to be upheld. Of course, a tax saving motive is not fatal if good business reasons exist for the particular transaction.

(b) Separate books and accounts, clearly and accurately reflecting income, expenses and operations, should be maintained for every business. If two related businesses use the same facilities, a fair apportionment of the expenses should be made. It is highly desirable to execute written contracts covering transactions bettween related companies.

(c) The simplest formula for keeping out of Section 45 trouble is to apply in every case the standard of an uncontrolled and independent business dealing at arm's length with another uncontrolled and independent business. If all related corporations will apply this standard to their intercorporate transactions, the Commissioner will have difficulty in reallocating income or deductions under Section. 45.[34]

G. *Acquisitions made to avoid income taxes*

Section 129 was added to the Internal Revenue Code in 1943 in order to stop the tax avoidance device of buying up corporations having losses, excess profits credits or a large invested capital base, in order to improve the tax situation of the purchaser. The practice was resorted to for avoidance of excess profits taxes much more than income taxes, and its place in the income tax picture has not yet been worked out through court interpretation. However, it should be checked by every purchaser of a corporation or a corporate business.

It covers two types of situations. One is where an individual, partnership or corporation acquires control of a corporation in order to secure the benefit of a deduction, credit or allowance which the acquiring individual, etc., would not otherwise enjoy. The other situation is where one corporation acquires property of a corporation not previously under its control, the property having a substituted basis in the hands of the acquiring corporation, in order to secure the benefit of a deduction, credit or allowance which the acquiring corporation would not otherwise enjoy. If the principal purpose of either acquisition is to evade or avoid federal income or excess profits taxes, Section 129 denies to the acquiring individual, partnership or corporation the benefit of the deduction, credit or allowance, but the Commissioner is given broad power to allow part of the deduction, etc., or to reallocate income and deductions among the corporations or properties involved so as to nullify the tax avoidance purpose and effect.

[34] In this discussion of Section 45 of the Internal Revenue Code I acknowledge my indebtedness to two excellent articles: Holzman, *Arm's Length Transactions and Section 45*, 25 TAXES 389 (May 1947), and Swartz, *Transactions between Related Corporations*, 26 TAXES 941 (October 1948).

The Treasury regulations under Section 129 explain that it codifies and emphasizes the general principle of *Higgins v. Smith*[35] and other judicial decisions making ineffective any arrangements which bear no reasonable relationship to the ordinary conduct of business and distort the tax liability of an individual or corporation.

The Bureau has ruled that Section 129 does not prohibit the formation of a Western Hemisphere trade corporation, even though the principal purpose of such formation is to take advantage of the tax exemption granted these corporations.[36]

The Tax Court has held that the tax avoidance purpose must exceed in importance any other purpose to constitute the principal purpose of an acquisition covered by Section 129,[37] and that the section prohibits the use of the deductions, credits and allowances by the acquiring individual or corporation but not by the corporation whose control was acquired.[38]

IV. Conclusion

Although the incorporated pocketbook, with income splitting and lower corporation rates, seems to offer opportunities for tax saving, the dangers and disadvantages surrounding it make its use as a tax saving device much less attractive in practice than it appears in theory. In order to reduce an individual's income tax by realizing income through a corporation, the corporation must have sufficient reality, business purpose and activity to prevent disregard of the corporate entity; the earnings and profits must be accumulated and realized without taxable dividends; the Section 102 surtax must be paid or avoided; the personal holding company danger must be guarded against; account must be taken of Section 24(b)'s disallowance of losses between related taxpayers and Section 45's reallocation of income and deductions between controlled businesses; and acquisitions of corporations or businesses must be checked for the application of Section 129.

The difficulties and dangers which confront any user of an incorporated pocketbook arise from the basic fact that the taxpayer's purpose in organizing or utilizing the corporation is tax avoidance, not the conduct of ordinary commercial, financial or industrial activities. As we have seen, this purpose is fundamentally at odds with the statutory and judicial principles upon which liability for federal taxes is determined. For this reason, adventurers in this field should proceed with skill and caution and with a healthy respect for the hazards to be overcome.

[35] 308 U. S. 473 (1940).
[36] I. T. 3757, 1945 C. B. 200.
[37] Commodore Point Terminal Corp., 11 T. C. 411 (1948).
[38] Alprosa Watch Corp., 11 T. C. 240 (1948).