

## St. John's Law Review

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Volume 47  
Number 2 *Volume 47, December 1972, Number*  
2

Article 26

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August 2012

### Income Taxation: Controlled Corporations--Allocation of Income

St. John's Law Review

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#### Recommended Citation

St. John's Law Review (1972) "Income Taxation: Controlled Corporations--Allocation of Income," *St. John's Law Review*. Vol. 47 : No. 2 , Article 26.

Available at: <https://scholarship.law.stjohns.edu/lawreview/vol47/iss2/26>

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# TAXATION

## INCOME TAXATION

### *Controlled Corporations — Allocation of Income*

Section 482<sup>1</sup> of the Internal Revenue Code of 1954 confers upon the Secretary of the Treasury or his delegate the broad power to “distribute, apportion, or allocate gross income, deduction, credits, or allowances between” businesses owned or controlled by the same interests if he determines that such action is necessary “to prevent evasion of taxes or clearly to reflect the income” of the business.<sup>2</sup> The Commissioner’s power is discretionary, and his determination is one of fact which, unless shown by the taxpayer to be “arbitrary and capricious,” must be affirmed.<sup>3</sup>

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<sup>1</sup> INT. REV. CODE OF 1954, § 482. The power conferred by section 482 is in no way novel. The general underlying purpose of the section can be traced back to the 1921 Act. See generally 7 MERTENS, LAW OF FEDERAL INCOME TAXATION, § 38.61 (1956) [hereinafter MERTENS]. The identical language of section 482 is found in section 45 of the 1939 Code. Consequently, much of the case law relating to section 45 is of significant value in analyzing section 482 problems. For a history of the development of section 45 see National Sec. Corp. v. Commissioner, 137 F.2d 600 (3d Cir. 1943); Asiatic Petroleum Co. v. Commissioner, 31 B.T.A. 1152 (1935).

<sup>2</sup> Section 482 may be applied regardless of whether or not the controlled organizations, trades, or businesses are incorporated or organized in the United States. “The standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm’s length with another taxpayer.” Treas. Reg. § 1.482-1(b)(1) (1962). See also Local Fin. Corp. v. Commissioner, 407 F.2d 629, 632 (7th Cir.), cert. denied, 396 U.S. 956 (1969); Oil Base, Inc. v. Commissioner, 362 F.2d 212, 214 (9th Cir.), cert. denied, 385 U.S. 928 (1966). Dealings between controlled taxpayers are subject to special scrutiny.

. . . In determining the true taxable income of a controlled taxpayer, the district director is not restricted to the case of improper accounting, to the case of a fraudulent, colorable, or sham transaction, or to the case of a device designed to reduce or avoid tax by shifting or distorting income, deductions, credits, or allowances.

Treas. Reg. § 1.482-1(c) (1962). See also George W. Knipe, 24 CCH Tax Ct. Mem. 668 (1965), aff’d sub nom. Equitable Publishing Co. v. Commissioner, 356 F.2d 514 (3d Cir.) (per curiam), cert. denied, 385 U.S. 822 (1966); Mel Dar Corp. v. Commissioner, 309 F.2d 525 (9th Cir. 1962), cert. denied, 372 U.S. 941 (1963).

Only the Commissioner has the discretionary power to invoke section 482; its use is not a matter of right with the taxpayer nor can he require the Commissioner to do so. Treas. Reg. § 1.482-1(b)(3) (1962). However, the Commissioner may be estopped to deny its use. Interstate Fire Ins. Co. v. United States, 215 F. Supp. 586 (E.D. Tenn. 1963), aff’d per curiam, 339 F.2d 603 (6th Cir. 1964).

<sup>3</sup> Wisconsin Big Boy Corp. v. Commissioner, 52 T.C. 1073 (1969), aff’d, 452 F.2d 137 (7th Cir. 1971); Grenada Indust., Inc. v. Commissioner, 17 T.C. 231 (1951), aff’d, 202 F.2d 873 (5th Cir.), cert. denied, 346 U.S. 819 (1953); Seminole Flavor Co. v. Commissioner, 4 T.C. 1215 (1945); National Sec. Corp. v. Commissioner, 46 B.T.A. 562 (1942), aff’d, 137 F.2d 600 (3d Cir.), cert. denied, 320 U.S. 794 (1943). However, “[t]he mere existence of common ownership or control is not enough by itself to justify application of Section 482. . . . It must further be determined by the Commissioner that reallocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of the entities.” Plumb and Kapp, *Reallocation of Income and Deductions Under Section 482*, 41 TAXES 809, 813 (1963).

Intended "to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer,"<sup>4</sup> the section is couched in elastic terms, indicating a congressional intent to have it "construed flexibly in the light of the peculiar circumstances of each case."<sup>5</sup> However, this flexibility in terminology and resulting ambiguous limits of application foster judicial disagreement.

In *B. Forman Company v. Commissioner*,<sup>6</sup> the Court of Appeals for the Second Circuit recently took the most liberal approach to the applicability of section 482. Petitioners, McCurdy & Co., Inc. and B. Forman Co., were competing retail department stores. The two were basically close family corporations with no common shareholders or directors. In 1958 they formed the Midtown Holding Corporation with the intent to erect a shopping center. At all times, 50 percent of the stock of Midtown was owned by McCurdy and 50 percent by Forman. In 1959 McCurdy and Forman entered into an agreement which provided, *inter alia*, that each party was to vote its Midtown stock to provide Midtown with a board of directors that would insure the two corporations of equal control. This agreement also called for loans to be made by McCurdy and Forman to Midtown. In 1963, pursuant to their agreement, McCurdy and Forman each loaned \$1,000,000 to Midtown evidenced by three year, interest-free notes. These notes were replaced in 1966 by similar interest-free notes, no interest or principal having been paid on the 1963 notes.<sup>7</sup>

Invoking section 482, the Commission allocated to both McCurdy and Forman interest income at the rate of 5 percent on these notes for the years 1965 to 1967.<sup>8</sup> The Tax Court reversed the Commissioner's

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<sup>4</sup> Treas. Reg. § 1.482-1(b)(1) (1962). Underlying this intent is an assumption that the interests controlling the businesses have "complete power to cause each controlled taxpayer so to conduct its affairs that its transactions and accounting records truly reflect the taxable income . . ." of each of the controlled taxpayers. *Id.* Should this not be the case, the district director has the power to allocate, apportion, or distribute the gross income, credits, deductions, or allowances, or any item affecting the taxable income, so as to arrive at the true taxable income of each controlled taxpayer. The true taxable income is arrived at by applying the criteria of arm's length dealing. *Id.* See also *Central Cuba Sugar Co. v. Commissioner*, 198 F.2d 214 (2d Cir.), *cert. denied*, 344 U.S. 874 (1952).

<sup>5</sup> Cooper, *Section 45*, 4 TAX L. REV. 131, 135-36 (1949). "It is not only dangerous to attempt to make a strict definition of these doubtful elements to be applied in every case, it is impossible to do so." *Id.*

<sup>6</sup> 453 F.2d 1144 (2d Cir. 1972).

<sup>7</sup> The record showed that Midtown was running into great debt and suffering large business losses. While the initial projected cost of the shopping center was \$8,000,000, the actual cost exceeded \$18,000,000. Thus, the court of appeals found the waiver of interest on the loans to be an attempt by petitioners to avoid increasing their taxable income. At the same time, the waiver prevented Midtown from incurring additional business expenses that could only have resulted in greater yearly losses. *Id.* at 1154.

<sup>8</sup> The 5 percent interest charge was eventually found by the court of appeals to be reasonable in light of Midtown's loans from parties other than the petitioners. Also, the

determination, finding a lack of the requisite control since neither McCurdy nor Forman alone could control Midtown and since the two competitors could not be regarded as a single entity.<sup>9</sup> In so doing, the Tax Court reaffirmed its long-standing holding that "where two or more corporations owned by different sets of stockholders control another corporation such other corporation is [not] controlled by the same interests."<sup>10</sup>

Treasury Regulations provide that the arm's length rate to be applied where the creditor is not regularly engaged in making loans shall be:

(i) The rate of interest actually charged if at least 4 but not in excess of 6 percent per annum simple interest,

(ii) 5 percent per annum simple interest if no interest was charged or if the rate of interest charged was less than 4, or in excess of 6 percent per annum simple interest,

unless the taxpayer establishes a more appropriate rate. . . .

Treas. Reg. § 1.482-2(a)(2) (1968).

<sup>9</sup> 54 T.C. 912, 922-23 (1970). Although section 482 does not define "control," the treasury regulations do provide some guidelines. Control may be direct or indirect. "It is the reality of the control which is decisive, not its form or the mode of its exercise." Treas. Reg. § 1.482-1(a)(3) (1962). The early judicial view was that section 482 required common "ownership." *John L. Denning & Co. v. Commissioner*, 180 F.2d 288, 291 (10th Cir. 1950) (dictum). See also *Birmingham Ice and Cold Storage Co. v. Davis*, 112 F.2d 453, 456 (5th Cir. 1940).

However, the modern trend seems to take a more realistic view, placing less emphasis on percentage requirements. See *Borge v. Commissioner*, 405 F.2d 673 (2d Cir. 1968), cert. denied, 395 U.S. 933 (1969); *Arch v. Commissioner*, 42 T.C. 114 (1964), aff'd, 358 F.2d 342 (6th Cir.), cert. denied, 385 U.S. 899 (1966); *Hall v. Commissioner*, 32 T.C. 390 (1959), aff'd, 294 F.2d 82 (5th Cir. 1961); *Grenada Indust. Inc. v. Commissioner*, 17 T.C. 231 (1951), aff'd, 202 F.2d 873 (5th Cir.), cert. denied, 346 U.S. 819 (1953). "Control may be determined to be the power to direct operations of the company or establish policy for the organization. If so, it either exists or it does not exist, so that any percentage application would be inconsistent with the definition of control." Hewitt, *Section 482-Allocation of Income and Deductions Between Related Persons-Up to Date*, N.Y.U. 22ND INST. ON FED. TAX. 381, 385 (1964) [hereinafter Hewitt].

<sup>10</sup> *Lake Erie & P. Ry. Co. v. Commissioner*, 5 T.C. 558, 565 (1945). This case presented facts almost identical to *Forman*. Here two corporations, the New York Central and the Pennsylvania Railroads, each owned 50% of the stock of the petitioner, the Lake Erie and Pittsburgh Railway Co. Petitioner was initially formed by the Lake Shore & Michigan Southern Ry. Co. (the New York Cent. R.R. Co. was successor by consolidation to the same) and the Pennsylvania Co. (the Penn. R.R. Co. was successor to the same). Pursuant to an agreement entered into between the New York Central, the Pennsylvania Railroad, and the petitioner, the New York Central and the Pennsylvania Railroad were permitted to use petitioner's terminals without charge. In order to reflect the petitioner's true taxable income, the Commissioner allocated to petitioner a portion of the gross income of both the New York Central and the Pennsylvania Railroad. The Tax Court reversed the Commissioner, finding that neither the New York Central nor the Pennsylvania Railroad controlled the petitioner. Conceding that "together" they did control the petitioner, the court concluded that this amounted to nothing more than saying "that the stockholders of a corporation control it." *Id.*

Although the Commissioner initially acquiesced to this decision, 1945 CUM. BULL. 5, the same was withdrawn in 1965. Rev. Rul. 65-142, 1965-1 CUM. BULL. 223. In so doing, the Commissioner expressed his view that the *Lake Erie* case too narrowly construed section 482. It was contrary to the modern trend and ignored the true reality of the circumstances.

The case has been attacked as an "unduly restricted interpretation of the phrase 'controlled directly or indirectly by the same interests.'" Hewitt, *Section 482-Allocation of Income and Control Among Related Taxpayers*, N.Y.U. 20th INST. ON FED. TAX. 463,

The court of appeals, in finding the Tax Court's holding to be "clearly erroneous,"<sup>11</sup> reversed on the ground "that McCurdy and Forman had the same interests in Midtown."<sup>12</sup> The court first emphasized the "reality of control"<sup>13</sup> and the intent of Congress in enacting section 482. Record ownership was not the only element to be considered since "in order to find control, no percentage requirements are specified nor are any precise requirements necessary."<sup>14</sup>

After finding the necessary element of "control," the court went on to determine that the waiver of interest on the notes was not representative of arm's length dealings. However, petitioners argued that the Commissioner was overstepping his authority by *creating* income, and cited numerous decisions supporting the proposition that related entities need not charge interest on loans.<sup>15</sup> But the court determined that to the extent such decisions would prevent allocation in the present case, they were inconsistent with "economic reality, or with the declared purpose of section 482."<sup>16</sup>

The decision stands for a marked widening of the applicability of

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472 (1962). See also Hewitt, *supra* note 9, at 384-85; Plumb, Jr. and Kapp, *Reallocation of Income and Deductions Under Section 482*, 41 TAXES 809, 812-13 (1963). Compare *Lake Erie & P. Ry. Co. v. Commissioner*, *supra*, with *Texsun Supply Corp. v. Commissioner*, 17 T.C. 433 (1951).

<sup>11</sup> Reversal here required a showing that the Tax Court's decision was clearly erroneous. See *Commissioner v. Duberstein*, 363 U.S. 278 (1960).

<sup>12</sup> 453 F.2d at 1155.

<sup>13</sup> See note 9 *supra*.

<sup>14</sup> 453 F.2d at 1153. By refusing to follow the *Lake Erie* case, the court took a major step forward in the segregation of control from ownership.

<sup>15</sup> See generally 7 MERTENS § 38.63. The purpose of section 482 is to clearly reflect income that actually exists. It has long been held that this does not give the Commissioner the power to create income by allocating interest, rent, *etc.*, where none was charged or received. See *Tennessee-Arkansas Gravel Co. v. Commissioner*, 112 F.2d 508 (6th Cir. 1940); *Huber Homes, Inc. v. Commissioner*, 55 T.C. 598 (1971); *PPG, Indust. Inc. v. Commissioner*, 55 T.C. 928 (1970); *Atchison, Topeka & Santa Fe Ry. Co. v. Commissioner*, 36 T.C. 584 (1961); *Society Brand Clothes, Inc. v. Commissioner*, 18 T.C. 304 (1952); *Smith-Bridgman & Co. v. Commissioner*, 16 T.C. 287 (1951); *Combs Lumber Co. v. Commissioner*, 41 B.T.A. 339 (1940).

<sup>16</sup> 453 F.2d at 1156. The court found support for its conclusion in the Treasury Regulations which clearly confer upon the Commissioner the power to allocate an appropriate amount of interest income where a member of a controlled group makes interest-free loans. See *Treas. Reg. § 1.482-2 (a)* (1968). It should also be noted that under section 482 the Commissioner must make appropriate adjustments to all the parties concerned. See *Treas. Reg. § 1.482-1(d)(2)* (1968).

The court found petitioner's contention that the loans were in fact contributions to Midtown's capital to be without merit. The 1959 agreement specifically provided for loans to be made to Midtown, and there was no evidence that petitioners received additional Midtown stock for the advances. 453 F.2d at 1156.

Additionally, the court affirmed the determination of the Tax Court and the Commissioner that payments by petitioners to Midtown via an agreement that certain kiosks not be built, was not an "ordinary and necessary business expense" under section 162 of the Code. The court determined that the Tax Court was not "clearly erroneous" in finding that such payments were camouflaged capital contributions. *Id.* at 1159.

section 482 in the Second Circuit.<sup>17</sup> In an effort to give effect to economic reality and to expand the usefulness of the statute, the court of appeals overturned an interpretation of "control" that has stood since 1945, and refused to be bound by numerous decisions opposing the creation of income by the Commissioner. While the course other circuits will take on the issue remains to be seen, it appears that section 482 will continue to be a generative force for litigation.<sup>18</sup>

### *Travel and Entertainment Expense Deduction — Substantiation Requirements*

All revenue acts have allowed the deduction of ordinary and necessary business expenses.<sup>19</sup> The deduction of business expenses and losses constitutes the bulk of statutory allowances in monetary terms. Probably no other deduction provision has historically been a greater source of litigation than the business expense allowance. Among the various deductions allowable as a business expense, perhaps the most fertile ground for litigation has been the traveling expense provision.<sup>20</sup> In

<sup>17</sup> The case seems to follow a trend in the Second Circuit to liberally construe section 482. Another recent example of this is *Phillipp Bros. Chem. v Commissioner*, 435 F.2d 53 (2d Cir. 1970), *aff'g* 52 T.C. 240 (1969). Here the court affirmed the allocation of the entire net income of five commonly controlled foreign sales corporations to the parent New York corporation. The court, again stressing the "reality of control," found "no evidence to show that the foreign sales corporations carried on any substantial business activities." 453 F.2d at 58. *See also* 46 ST. JOHN'S L. REV. 550 (1972).

The older view was that the identity of the businesses had to be preserved and that the Commissioner lacked the authority under section 482 to merge several controlled entities. *See, e.g., Chelsea Products Co. v Commissioner*, 197 F.2d 620 (3d Cir. 1952), *aff'g* 16 T.C. 840 (1951).

<sup>18</sup> Statistics show that in the past, the Commissioner has usually been unsuccessful when attempting to invoke section 482. *See Hewitt, supra* note 9, at 408. However, with this widening of authority in *Forman*, history may be of little value in predicting the validity of the Commissioner's future allocations under section 482.

<sup>19</sup> INT. REV. CODE OF 1954, § 162; INT. REV. CODE OF 1939, § 23(a); Revenue Acts of 1938, 1936, 1934, 1932, 1928, § 23(a); Revenue Acts of 1926, 1924, 1921, 1919, §§ 214(a)(1), 234(a)(1). Prior to 1918, individuals were allowed deductions for "necessary" expenses. Revenue Act of 1916, § 5(a); Revenue Act of 1913, § II(B). No definitive indication of the intended effect on deductibility of the addition of the term "ordinary" is discernible from the legislative history of the 1918 Act. *See H.R. 767*, 65th Cong., 2d Sess. (1918).

<sup>20</sup> INT. REV. CODE OF 1954, § 162(a)(2). What is now section 162(a)(2) was brought into the tax structure by section 214 of the Revenue Act of 1921, 42 Stat. 239. Before 1921, section 214 had allowed a deduction of "ordinary and necessary expenses paid or incurred . . . in carrying on any trade or business," without further specification. Revenue Act of 1918, 40 Stat. 1066. In T.D. 3101, 3 CUM. BULL. 191 (1920), the Treasury Department interpreted the statute to allow deductions of "travelling expenses, including railroad fares, and meals and lodging in an amount in excess of any expenditures ordinarily required for such purposes when at home." *Id.* Mim. 2688, 4 CUM. BULL. 209 (1921), gave guidelines for determining what expenditures were "ordinarily required." Basically, the taxpayer was to compute his pro rata share of the total costs of maintaining a home for all persons in the household. This figure would thus represent the base for determining the excess amount of expenses incurred while not at home. However, the Treasury Department had some difficulty in administering the "excess" provisions of its regulations, and asked

Congress to grant a deduction for the "entire amount" of such meal and lodging expenditures. See Statement of Dr. T. S. Adams, Tax Adviser, Treasury Department, *Hearings on H.R. 8245 before the Senate Comm. on Finance*, 67th Cong., 1st Sess., at 50, 234-35 (1921). The 1921 amendment, inserting section 162(a)(2)'s allowance of a deduction for the entire amount of qualified meals and lodging was therefore instituted to provide "a measure of justice" to commercial travelers. 61 CONG. REC. 5201 (1921) (remarks of Congressman Hawley, member of the Committee on Ways and Means). See also 61 CONG. REC. 6673 (1921) (remarks of Senator Walsh, member of the Committee on Finance). The Revenue Act of 1962, 76 Stat. 960, amended the provisions so that the amount expended for meals and lodging was limited to expenditures "other than amounts which are lavish or extravagant under the circumstances." *Id.* at 976-77.

The Code does not specifically allow a deduction for entertainment expenditures incurred for a trade or business purpose. Deductions authorized by section 162 for travel expenses have, however, tended to include entertainment expenses. If such expenditures are to be deductible they must meet all the tests governing the deductibility of business expenses.

Deductions for travel and entertainment expenses (T & E) have long been a thorn in the side of the Internal Revenue Service. Previous to World War II the issues generally raised concerned per diem allowances for travel. See, e.g., Treas. Reg. 33, arts. 4 and 8 (1937); Treas. Reg. 45, art. 292 (1937). Following the War the T & E problem mushroomed. Administrative action was instituted. In 1952, Internal Revenue agents were instructed to examine carefully T & E deductions on tax returns in an attempt to curb these items. Bureau of Int. Rev. Rul. No. s-2979 (Feb. 26, 1952). In 1954, under Rev. Rul. 54-195, 1954-1 CUM. BULL. 47, guidelines were established for agents in determining the deductibility of T & E expenses so as to stop abuses. Throughout the 1950's various other administrative attempts were made to stem the increase in T & E deductions. See, e.g., Treas. Reg. 101, art. 23(a)-2(c) (1950); Treas. Reg. 103 § 19.23(a)-2(c) (1951); Treas. Reg. 111 § 29.23(a)-2(c) (1952); Treas. Reg. 118 § 39.23(a)-2(c) (1953). These administrative attempts did not, however, meet with much success.

Until 1962, attempts to correct the T & E situation legislatively failed as well. In 1951 a subcommittee of the House Ways and Means Committee was appointed to examine the administration of the tax laws. The chairman of the subcommittee, Congressman Cecil G. King, declared that:

[o]ne of the most flagrant sources of inequity and of corruption has been found in the inadequacies of the existing record-keeping requirements and enforcement of these requirements. While the subcommittee will not sanction unreasonable requirements of record-keeping, particularly in the case of millions of small taxpayers, it has become clear from our investigations that under present law exorbitant unsubstantiated deductions have frequently been claimed for such items of business expense as entertainment and promotion. Without the power to enforce adequate record-keeping, the Bureau of Internal Revenue has been required to allow such deductions on an estimated basis.

Press release of Congressman Cecil B. King, May 16, 1952, in 39 TAXES 947, 950 (1961). The King Bill, H.R. 7893, 82d Cong., 2d Sess. (1952), was not enacted, however, due to strong business and professional pressure. Further proposals for corrective legislation were made by Senator Clark in the 86th Congress. S. 2040, 86th Cong., 1st Sess. (1959); see also 105 CONG. REC. 11897 (1959). None of these proposals were accepted.

In 1961, therefore, President Kennedy recommended new legislation to deal with the T & E problem. In a special message on our federal tax system, the President recounted the widespread abuses which had developed through the use of the expense account:

Too many firms and individuals have devised means of deducting too many personal living expenses as business expenses, thereby charging a large part of their cost to the Federal Government. Indeed, expense account living has become a byword in the American scene.

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Tighter enforcement of present legislation will not suffice. Even though in some instances entertainment and related expenses have an association with the needs of business, they nevertheless confer substantial tax-free personal benefits to the recipients. In other cases, deductions are obtained by disguising personal expenses as business outlays. But under present law, it is extremely difficult to separate out

response to the problem, Congress established section 274 of the Code as part of the Revenue Act of 1962.<sup>21</sup> Under this section travel and entertainment expenses come under close scrutiny<sup>22</sup> and make it increasingly difficult for personal expenditures to be disguised as business expenses.

Among the provisions of section 274 is the requirement that the taxpayer must substantiate travel or entertainment expenses "by adequate records or by sufficient evidence corroborating his own statement" detailing the amount, time, place, and business purpose of each such expense and the taxpayer's business relationship to the persons entertained.<sup>23</sup> Treasury regulations require a written statement and

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and disallow such pseudobusiness expenditures. New legislation is needed to deal with the problem.

PRESIDENT KENNEDY'S MESSAGE TO CONGRESS, OUR FEDERAL TAX SYSTEM, H.R. Doc. No. 140, 87th Cong., 1st Sess. 12-13 (1961).

<sup>21</sup> 76 Stat. 960, 974-77 (1962).

<sup>22</sup> To be deductible, any entertainment activity must fit either of the two categories established by section 274(a)(1)(A). The taxpayer must either establish that (1) the activity was *directly related* to the active conduct of his trade or business or (2) that the activity was *associated with* the active conduct of his trade or business in the case of an item directly preceding or following a substantial and bona fide business discussion (including business meetings at a convention or the like). The deduction may not exceed the portion of the expenditure which is directly related to or associated with the active conduct of the taxpayer's trade or business. See S. REP. No. 1881, 87 Cong., 2d Sess. 29-30 (1961).

The regulations define "directly related" in detail. If an expenditure is otherwise deductible, it shall be considered directly related to the taxpayer's trade or business if it comes within one of the following categories:

(1) The expenditure is one wherein the taxpayer made or committed himself to the expenditure at a time when he had more than a general expectation of deriving some income or benefit (other than good will) at some indefinite future time; and during the entertainment period to which the expenditure related, the taxpayer actively engaged in a business meeting or other bona fide business transaction other than entertainment, for the purpose of obtaining income or some other business benefit; and, under the circumstances, the principal character of the combined business and entertainment activity was the active conduct of the taxpayer's trade or business; and, that the expenditure was attributable to the taxpayer and a person or persons with whom the taxpayer engaged in the active conduct of his trade or business during the entertainment, or with whom he would have so engaged but for circumstances beyond his control;

(2) The expenditure was directly in the furtherance of the taxpayer's trade or business and occurred in a clear business setting;

(3) The expenditure was made directly or indirectly by the taxpayer for the benefit of an individual, other than an employee, and such expenditure represented compensation for services rendered or was paid as a prize or award;

(4) The expenditure was made with respect to a facility used by the taxpayer for furnishing food or beverages in circumstances generally conducive to business discussion, to the extent allocable to the furnishing of such food or beverage.

Treas. Reg. § 1.274-2(c) (1969). The Regulations also discuss when an activity is *associated with* the active conduct of the taxpayer's trade or business. See Treas. Reg. § 1.274-2(d) (1969). See also Rev. Rul. 63-144, 1963-2 CUM. BULL. 129.

<sup>23</sup> INT. REV. CODE OF 1954, § 274(d). This section was in response to the great confusion caused by the *Cohan* rule. In *Cohan v. Commissioner*, 39 F.2d 540 (2d Cir. 1930), George M. Cohan had expended substantial sums in traveling and in entertaining. However, he kept no records of these expenditures. The Commissioner and the Board of Tax Appeals, 11 B.T.A. 743 (1927), refused to allow any deduction. However, the Second Circuit



other corroborating evidence detailing each element of the expenditure if adequate records have not been maintained.<sup>24</sup>

This term in *Hughes v. Commissioner*<sup>25</sup> the court affirmed the Tax Court's decision disallowing the taxpayer's entertainment expenses for failing to meet the substantiation requirements of section 274. Hughes was a television stage manager who frequently bought food for his aides' consumption at cafeterias and occasionally bought them drinks at local bars. Hughes did not keep records of the expenses thus incurred, nor did he retain many receipts.<sup>26</sup> On his tax returns for 1963 and 1964, the taxpayer claimed an estimated total expenditure each year as a business expense deduction. These deductions were disallowed by the Commissioner as not complying with the requirements of section 274(d) and the treasury regulations thereunder.

In affirming the Tax Court decision, the court indicated that evidence offered by the taxpayer did not constitute adequate records substantiating the expenses. Hughes offered no proof of the business purpose of the expenses, nor did he present corroborative testimony establishing the business relationship of the taxpayer to the persons entertained. Furthermore, the claimed deductions lacked sufficient substantiation of the taxpayer's own statements. Since no evidence was presented in the nature of "direct evidence, such as a statement . . . of persons entertained or other witnesses setting forth detailed informa-

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remanded the case for "as close an approximation as [can be made], . . . [with the burden of justification] upon the taxpayer." 39 F.2d at 544. Subsequent to *Cohan*, hundreds of cases under which claims for deductions of business expenses on the basis of estimates were decided. Because of the latitude permitted by such a rule, tremendous conflicts arose. See e.g., *Standard Galvanizing Co. v. Commissioner*, 202 F.2d 736 (7th Cir. 1953); *Estate of Waterman v. Commissioner*, 195 F.2d 244 (2d Cir. 1952); *Durkee v. Commissioner*, 181 F.2d 189 (6th Cir. 1950). See also Rev. Rul. 54-195, 1954-1 CUM. BULL. 47; Emanuel and Lipoff, *Travel and Entertainment: The New World of Section 274*, 18 TAX L. REV. 487, 516 (1962).

<sup>24</sup> Treas. Reg. § 1.274-5(c)(3) (1962).

<sup>25</sup> 451 F.2d 975 (2d Cir. 1971).

<sup>26</sup> The only records offered by Hughes to substantiate his expenditures were checks and billing statements from an inn near his home, where he had bought drinks occasionally for his boss and a few stagehands. The checks and statements on their face did not differentiate those drinks bought for business guests from drinks and food bought for Hughes' own consumption or that of his social guests. Aside from the checks and statements, and Hughes' own written and oral estimates of his expenses for food and drink both at studios and in bars, the only evidence supportive of his claimed expenses was the oral testimony of two witnesses. One had seen Hughes buying drinks at bars and entertaining stagehands at studios; however, the witness also testified that it was customary, when stagehands were entertained, for social friends of studio personnel to be treated to the same food or beverages. A second witness, a stage manager like the taxpayer, testified that he had worked on many shows with Hughes and had seen him "entertaining." The second witness also testified that as a stage manager, he himself had spent seven or eight dollars a day on coffee, doughnuts, and sandwiches, and that non-crew persons were not excluded when entertaining was done at studios or bars. *Id.* at 977-78.

tion,"<sup>27</sup> the alternative proof allowed under section 274 was not met. To allow a deduction in the present case would be to "wholly disregard" the statute and regulations.<sup>28</sup> Hughes' contention that the testimony of the witnesses should be given conclusive weight as sufficient corroborative evidence was quickly dismissed.<sup>29</sup> Although it is true that a written statement may not be required for substantiation, "the corroborative evidence must nevertheless establish each statutory element — amount, time, place, and purpose — of the expenditure with precision and particularity."<sup>30</sup> As the taxpayer did not nearly approach the requisite specificity, the deductions must be disallowed.

*Hughes* will serve as another case delineating the disjunctive substantiation requirements provided by section 274 and the standards of proof required thereunder. While affirming the standards established in *Laforge v. Commissioner*,<sup>31</sup> it evinces the Circuit's resistance to unnecessary expansion of a sound doctrine.

### *Original Issue Discount*

Interest paid by the issue of a bond is deductible under Section 163 of the Internal Revenue Code of 1954.<sup>32</sup> However, in lieu of a stated interest rate, some issuers will release bonds to the public at a discount. This practice, known as "original issue discount," has been equated to payment of a stated interest rate over the life of the issue by the Supreme Court.<sup>33</sup>

<sup>27</sup> *Id.* at 978, citing Treas. Reg. § 1.274-5(c)(3) (1962).

<sup>28</sup> 451 F.2d at 978. The witness' statement that he had seen Hughes entertaining in bars and at studios was much too general and insufficiently detailed, *i.e.*, not specific as to time, place, purpose, or amount. "Were we to hold otherwise, with a little trading back and forth from day to day well-nigh every drink at every bar, every doughnut and every cup of coffee bought in the United States would wind up as a deduction on somebody's tax return." *Id.* Similarly, the second witness' statement that his own coffee, doughnut and sandwich expenses averaged seven or eight dollars a day was of no corroborative value as to Hughes' claims, "lest we establish a minimum snack expense deduction for all stage managers." *Id.*

<sup>29</sup> The taxpayer based this argument on the recent holding of the Second Circuit in *Laforge v. Commissioner*, 434 F.2d 370 (2d Cir. 1970). For an excellent discussion of the *Laforge* doctrine, see 46 ST. JOHN'S L. REV. 537, 545 (1972).

<sup>30</sup> 451 F.2d at 979.

<sup>31</sup> 434 F.2d 370 (2d Cir. 1970).

<sup>32</sup> INT. REV. CODE OF 1954, § 163(a) provides

#### GENERAL RULE

There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness.

For possible exceptions to this general rule, see INT. REV. CODE OF 1954, §§ 264-67.

<sup>33</sup> *United States v. Midland-Ross Corp.*, 381 U.S. 54 (1965). The Court held that the discount allowed by the issuer of a bond was a cost of borrowing money. For example, a corporation has a choice of issuing a 20 year debenture paying 9 percent interest over its life or issuing the instrument at 90 percent of its face value at maturity and paying only 7 percent interest over the 20 year period.

The Internal Revenue Code itself does not directly provide a deduction for an original issue discount, but the Treasury Regulations, cognizant of the use of the discounts as an alternative to stated interest, allow a tax deduction.<sup>34</sup> The term "original issue discount" is defined as "the difference between the issue price and the stated redemption price at maturity."<sup>35</sup>

In *Chock Full O'Nuts Corp. v. United States*,<sup>36</sup> petitioner attempted to deduct the original issue discount on a convertible debenture.<sup>37</sup> The facts are undisputed. On or about August 1, 1964, petitioner issued convertible subordinated debentures (69,389) having a par value of \$100, bearing 4½ percent interest, due in 20 years and with a conversion price of \$28.50 per share. The equivalent value of such an issue without the conversion feature would be \$89.625 for each \$100 of par value. Petitioner, in its tax return for 1962, claimed a \$35,995.58 deduction<sup>38</sup> for amortization of bond discount. The Commissioner denied

<sup>34</sup> Treas. Reg. § 1.163-3(a)(1) (1968) provides:

Deductions for bond discount—

(a) Discount upon issuance

- (1) If bonds are issued by a corporation at a discount the net amount of such discount is deductible and should be prorated or amortized over the life of the bonds. For purposes of this section, the amortizable bond discount equals the excess of the amount payable at maturity (or in the case of a callable bond, at the earlier call date) over the issue price of the bond.

<sup>35</sup> INT. REV. CODE OF 1954, § 1232(b). This section first appeared in the 1954 Code to reverse the trend toward treating an original issue discount as a capital gain. Section 1232 accomplished this objective by stipulating that gains made on the sale of corporate debt held for more than six months, at least as to the amount attributable to the original issue discount, would be characterized as ordinary income.

The section also contains a *de minimus* rule which provides that the original issue discount will be considered to have a zero value if the discount is less than one-fourth of one percent of the redemption price of the security at maturity multiplied by the number of complete years to maturity. See generally Paine and Westheimer, *Original Issue Discount Regulations Revised But Remain Controversial*, 35 J. OF TAXATION 282 (November 1971).

"Stated redemption price at maturity" for purposes of § 1232 is defined as the amount set at the last modification of the purchase agreement including dividends payable. For an illustration, see Treas. Reg. § 1.1232-3(b)(1) (1968).

"Issue price" is defined in Treas. Reg. § 1.1232-3(b)(2) (1968) as the "initial offering price to the public [excluding bond houses and brokers] at which price a substantial amount of such bonds or other evidences of indebtedness were sold." In addition, where a convertible security is involved, the issue price will include any amount paid for the conversion feature.

<sup>36</sup> 453 F.2d 300 (2d Cir. 1971).

<sup>37</sup> A convertible debenture is a corporate debt instrument which allows the holder the option of waiting till maturity to collect the face value or converting the debenture into stock of the corporation. It allows the corporate organization to enlarge its capital while providing the holder with an option he can exercise as a hedge against inflation. For a discussion of convertible bonds and their tax consequences, see Fleischer and Cary, *The Taxation of Convertible Bonds and Stock*, 74 HARV. L. REV. 473 (1961).

<sup>38</sup> Petitioner calculated the discount as follows: Number of debentures sold (69,389) multiplied by the discount (\$100 par value minus \$89.625 price if issued without the conversion feature = \$10.375) equals \$719,911. This total is then amortized over the life of the bonds (20 years).

the deduction in part and assessed the petitioner \$20,741.66 for taxes and interest. Petitioner paid the sum and sued in district court for a refund. The district court ruled in favor of the Commissioner.<sup>39</sup> The Second Circuit affirmed, holding that the amount of issue price attributable to the conversion feature does not constitute original issue discount under Code section 1232.<sup>40</sup>

Petitioner contended that Internal Revenue Code section 1232 (b)(2)<sup>41</sup> did not include the amount attributable to the conversion feature in the "issue price." The Commissioner contended that this question was resolved by the enactment of Treasury Regulation section 1.1232-3(b)(2)(i) which clearly includes in the issue price any sum paid for the conversion feature.<sup>42</sup> However, petitioner contested the attempted retroactive effect of the regulation to an occurrence in 1961.<sup>43</sup>

<sup>39</sup> 322 F. Supp. 772 (S.D.N.Y. 1971). (judgment upon the stipulated facts, without testimony, by Judge Levett).

<sup>40</sup> 453 F.2d 300 (2d Cir. 1971). Filing briefs amicus curiae were Hunt Food & Industries, Inc., J.P. Stevens & Co. Inc. and the Olin Corporation.

In a more recent judicial proceeding, the Tax Court has followed the precedent established in *Chock Full O'Nuts*. See *Hunt Foods & Industries, Inc.*, 57 T.C. 693 (1972), (denying a tax deduction for original issue discount on a convertible debenture). Petitioner in *Hunt Foods* challenged Treas. Reg. § 1.1232-3(b)(2)(i) (1968), arguing that part of the proceeds received for a convertible debenture was attributable to the conversion feature and deductible as an additional cost of borrowing money. The Tax Court, citing *Chock Full O'Nuts*, decided against the petitioner, and held that the regulations provide that such cost of the conversion feature does not constitute an original issue discount. In addition, the court expressed the view that a convertible debenture is a "hybrid" type of security, being neither debt nor equity. The holder can either be paid fully at maturity or exercise the conversion feature with the issuer repaying no more than what was initially received. For a discussion of *Hunt Foods*, see 3 TAX ADVISOR 437 (1972).

<sup>41</sup> Treas. Reg. § 1.1232-3(b)(1) (1968) defines "original issue discount" as "the difference between the issue price and the stated redemption price at maturity." For purposes of this section, "issue price" is defined as "the initial offering price to the public" at which a substantial amount of the obligations are sold. Treas. Reg. § 1.1232-3(b)(2)(i) (1968).

<sup>42</sup> Treas. Reg. § 1.1232(b)(2)(i) (1968), when promulgated, was made retroactive to all obligations issued after December 31, 1954. The regulation provides that "any amount paid in respect of the conversion privilege" is to be considered as part of the issue price. Applying this provision to the petitioner's contention, it is clear that there would be no original issue discount since the issue price and the stated redemption price were identical.

<sup>43</sup> Under INT. REV. CODE OF 1954, § 7805(b) the Commissioner is allowed to establish the extent to which regulations will be treated retroactively.

The Secretary or his delegate may prescribe the extent, if any, to which any ruling or regulation, relating to the internal revenue laws, shall be applied without retroactive effect.

To date it has been the Commissioner's intention that every Revenue Ruling be given retroactive effect unless retroactivity has been specifically excluded. Rev. Proc. 68-37, 1968-2 CUM. BULL. 926. However, in promulgating retroactive rulings the Commissioner must avoid abusing his discretion. As expressed by the court in *International Business Machines Corp. v. United States*, 343 F.2d 914, 920 (Ct. Cl. 1965), cert. denied, 382 U.S. 1028 (1966), "[t]he Internal Revenue Service does not have carte blanche. Its choice must be a rational one, supported by relevant considerations." In the end it is up to the court to decide what statutes will be given retroactive effect. *May Seed & Nursery Co. v. Commissioner*, 242 F.2d 151,155 (8th Cir.), cert. denied, 355 U.S. 839 (1957); *Kay v. Commissioner*, 178 F.2d 772, 773 (3d Cir. 1950).

The court sidestepped the question of retroactivity by deciding that, under the regulations that had been promulgated at the date of issuance, the conversion feature was not an original issue discount.<sup>44</sup>

In addition, the court concluded that petitioner had not met the burden of establishing that the amount allocated to the conversion feature constituted a cost of borrowing money that must "without qualification be paid."<sup>45</sup>

In the alternative, petitioner attempted to equate the convertible debentures to a bond-warrant investment unit.<sup>46</sup> The court soundly rejected this contention on the ground that the convertible issue is an indivisible investment unit while the bond-warrant type of issue contains two independent obligations.<sup>47</sup>

The court indicated that an amount paid for a conversion feature is usually attributable to equity transactions and not debt as argued by petitioner.<sup>48</sup>

With the Second Circuit's *Chock Full O'Nuts* opinion and the Tax Court's *Hunt* decision,<sup>49</sup> it would appear that the use of convertible debentures will diminish, possibly to be replaced by the bond-warrant type of issue. But, considering the large number of convertible debentures already issued, it would also appear that there will be more litigation.

A possible compromise would be the allowance of the current de-

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<sup>44</sup> 453 F.2d at 303. The court concluded there was no evidence to support the petitioner's contention that "offering price" was intended to include only the investment element of a convertible bond. See Note, *The Tax Consequences of Convertible Bonds*, 49 B.U.L. REV. 96, 102-03 (1969).

In *Hunt Foods*, the Tax Court took the approach that the regulation would be given retroactive effect although it based its decision on other grounds.

<sup>45</sup> Convertible debentures may be satisfied in two ways. One alternative permits the holder to convert the issue into stock by surrendering it to the corporation. In this case, it will not be paid at maturity and the debenture is considered to be satisfied. To allow the deduction of a discount in this situation would be to ignore the concept of establishing the discount as a cost of borrowing money. The second alternative is for the holder to wait until maturity to collect, thus terminating the conversion feature and resulting in the issuer paying out no more than was received when the security was issued. 453 F.2d at 304. For a discussion of whether a convertible debenture is debt or equity, see Thrower, *Glomerates and Convertibles*, 1 TAX ADVISOR 4 (1970).

<sup>46</sup> Bond-warrant investment units consist of a bond obligation as well as warrants (options) for the purchase of stock, each of which may be taken separately. Bond-warrant units can be distinguished from convertible debentures. For example, with a convertible bond, the holder must choose either to exercise the conversion feature or hold the bond to maturity, whereas, with a bond-warrant unit, the holder can keep the bond till maturity and use the warrants to purchase stock. See generally Morreale, *Original Issue Discount: Guiding the Ventura Capital Company through the Maze*, 32 J. OF TAXATION 2 (1970).

<sup>47</sup> 453 F.2d at 305.

<sup>48</sup> 453 F.2d at 305, citing Note, *The Tax Consequences of Convertible Bonds*, 49 B.U.L. REV. 96, 112 (1969).

<sup>49</sup> See note 40 *supra*.

duction up to the time of conversion or recall. Then if the holder chose to convert the issue into shares the taxpayer's return could be adjusted to reflect the amounts already deducted.

### *Acquisitions of Loss Corporations*

The Internal Revenue Code of 1954 strictly prohibits the use by individuals or corporations of tax deductions, credits or other such allowances created through acquisitions where the purpose of the acquisition is the avoidance or evasion of tax liability.<sup>50</sup> The principal intent of the original statute<sup>51</sup> was to prevent reductions in tax liability created by the wholesale purchase of "loss corporations" and the application of their loss carryover<sup>52</sup> against current income. For many years,

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<sup>50</sup> INTERNAL REVENUE CODE OF 1954 § 269 provides:

(a) In General.—If—

(1) any person or persons acquire, or acquired on or after October 8, 1940, directly or indirectly, control of a corporation, or

(2) any corporation acquires, or acquired on or after October 8, 1940, directly or indirectly, property of another corporation, not controlled, directly or indirectly, immediately before such acquisition, by such acquiring corporation or its stockholders, the basis of which property, in the hands of the acquiring corporation, is determined by reference to the basis in the hands of the transferor corporation.

and the principal purpose for which such acquisition was made is evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit, or other allowance which such person or corporation would not otherwise enjoy, then the Secretary or his delegate may disallow such deduction, credit, or other allowance.

Thus not all acquisitions come under the control of § 269, but only those whose principal purpose is judged to be distortion of the taxpayer's tax liability. Treas. Reg. § 1.269-2(b) (1962).

Control, for purposes of this section, is defined by Treas. Reg. § 1.269-1(c) (1962) as ownership of at least 50 percent of the total combined voting power of all classes of stock entitled to vote of 50 percent of the total value of all shares of the corporation.

For an insight into direct and indirect control, see Feder, *The Application of Section 269 to Corporations Having Net Operating Loss Carryovers and Potential Losses*, N.Y.U. 21st INST. ON FED. TAX 1277, 1281 (1963).

<sup>51</sup> INTERNAL REVENUE CODE OF 1939 § 129 was enacted in 1943 to combat the evasion of the World War II excess profit tax through the acquisition of corporate control. H.R. REP. NO. 871, 78th Cong., 1st Sess. 23, 49 (1943); 1944 CUM. BULL. 901, 919-20, 928-39; S. REP. NO. 627, 78th Cong., 1st Sess. (1943); 1944 CUM. BULL. 973, 993-4, 1016-18. Indeed, it seems that a "market" for defunct corporate shells was in existence. An advertisement in the New York Times in 1943 read: "For Sale. Stock of corporation having 1943 tax loss deduction \$120,000. Sale assets are \$80,000 in cash and equivalent." BITTKER and EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS, ¶ 16-21 n.43 (3d ed. 1971). For a brief but concise development of the statute, see McDonald, *Acquisition Made to Evade or Avoid Income Tax*, 14 U. SO. CALIF. TAX INST. 435, 436-38 (1962). See also Barnard, *Acquisitions for Tax Benefit*, 34 CAL. L. REV. 36 (1946); Leake, *Dividing Corporations and Section 129*, 30 TAXES 603 (August, 1952); Rudick, *Acquisitions to Avoid Income or Excess Profits Tax: Section 129 of the Internal Revenue Code*, 58 HARV. L. REV. 196 (1944); Wales, *The Phipps Case, Section 129 and the Availability of Tax Advantage of an Acquired Corporation*, N.Y.U. 8TH INST. ON FED. TAX 920 (1949).

<sup>52</sup> Under Internal Revenue Code of 1954 § 172, a net operating loss deduction permits the carryback and carryover of operating losses to the taxpayer. Treas. Reg. § 1.172-2(a) (1972) provides that

(a) net operating loss is sustained by a corporation in any taxable year beginning

this section of the Code proved ineffective and was used infrequently by the government. However, section 269 has now become one of the Commissioner's most potent weapons.<sup>53</sup>

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after December 31, 1953, if and to the extent that, for such year, there is an excess of deductions allowed by chapter 1 of the Internal Revenue Code of 1954 over gross income computed thereunder.

However, carryover benefits are limited by section 382 of the Code. See Lanahan, *Net Operating Loss Deduction*, 9th TUL. TAX INSTR. 87, 117 (1960).

The development of section 382 was controversial. The House bill provided for an automatic decrease in the loss deduction once 50 percent or more of the stock changed hands, H.R. REP. NO. 1337, 83rd Cong., 2d Sess. 42 (1954). The Senate bill required the continuation of the business to obtain the benefit and, in addition, provided for the complete loss of the benefit as a penalty. S. REP. NO. 1622, 83d Cong., 2d Sess. 53 (1954).

Under section 382(a), if the acquisition is accomplished by purchase and 50 percent of the loss company's shares are purchased and the business of the loss corporation ceases or is changed within a two-year period, the entire loss carryover benefit is lost. However, if the acquisition is made as a result of a reorganization a partial disallowance of the carryover will result based upon the percentage points below 20 percent of the outstanding stock of the acquiring corporation received by the shareholders of the loss corporation. INT. REV. CODE OF 1954, § 382(b). For example, when the former stockholders of a loss corporation, after reorganization, own only 10 percent of the fair market value of the acquiring corporation, the amount of the loss carryover is computed as follows: 20 percent ownership (minimum) - 10 percent held = 10 percent. This figure is multiplied by 5 (disallowance penalty), resulting in 50 percent, which is the amount of the loss carryover allowed. For a fuller explanation, see Treas. Reg. § 1.382(b)-1(a) (1964).

When section 382(b) was enacted, there was some doubt as to whether section 269 might be inapplicable if section 382(b) was involved because of the wording in the Senate Report. S. REP. NO. 1622, 83rd Cong., 2d Sess. 284 (1954). However, the Regulations have clearly stated that section 269 may be applied whether or not reliance upon section 382(b) is invalidated by the Commissioner. Treas. Reg. § 1.269-6, example (3). This closed an apparent loophole which would have allowed a taxpayer to avoid § 269 by having the stockholders of the loss corporation hold only 18 or 19 percent interest in the acquiring corporation and subject the loss carryover to only the 5 percent penalty under § 382(b). See generally Note, *Net Operating Loss Carryovers and Corporate Adjustments: Retaining an Advantageous Tax History under Libson Shops and § 269, 381 and 382*, 70 YALE L.J. 1201 (1960).

<sup>53</sup> The law in the area is based upon the requirement established in *Gregory v. Helvering*, 293 U.S. 465 (1935), that the business purpose of a transaction must be established by a taxpayer who wishes to take advantage of an appendant tax benefit. See also *Griffiths v. Commissioner*, 308 U.S. 355 (1939); *Moline Properties v. Commissioner*, 319 U.S. 436 (1943); *J.D. & A.B. Sprechels Co. v. Commissioner*, 41 B.T.A. 370 (1940).

Since INT. REV. CODE OF 1939, § 129 was general in scope, it proved extremely difficult to predict accurately what actions were controlled by it. See Rudick, *Acquisitions to Avoid Income or Excess Profits Tax: Section 129 of the Internal Revenue Code*, 58 HARV. L. REV. 196 (1944); Cohen, *Exemptions and Credits of Multiple Corporations: Section 15(c) and 129*, 1953 SO. CALIF. TAX INSTR. 1. For many years after its passage, there was uncertainty in the Tax Court as to whether a corporation could be deprived of its own tax benefit because of the dictum expressed in *Alprosa Watch Corp.*, 11 T.C. 240 (1948), which stated that the statute only prohibited the use of the deduction, credit or allowance to an acquiring corporation but not to the acquired corporation.

Some recent cases have erased this erroneous dictum and made § 269 one of the Commissioner's most effective weapons. Adopting the "benefit theory" in *Thomas E. Snyder Sons Co.*, 34 T.C. 400 (1960), *aff'd*, 288 F.2d 36 (7th Cir. 1961), the Tax Court gave the statute a much broader sweep by including both acquiring and acquired corporations, and thus aligning its views with those of the circuit courts. See *Commissioner v. British Motor Car Distributors, Ltd.*, 278 F.2d 392 (9th Cir. 1960); *James Realty Co. v. United States*, 280 F.2d 394 (8th Cir. 1960).

In *Pepi, Inc. v. Commissioner*,<sup>54</sup> petitioner attempted to reduce its tax liability by application of a loss carryover sustained by a predecessor corporation. *Pepi* was a member of a conglomerate known as American Philips. Prior to World War II, the American assets of Dutch Philips were placed in a trust fund located in a U.S. bank. Following the war, the American Philips group, interested in expansion, formed a committee to investigate possible alternatives.

Simultaneously, A. Hollander & Sons, Inc., which had suffered losses in the fur business from 1953 through the first half of 1956, proceeded, upon the advice of a member of the Philips expansion committee, to retain Wallace A. Collins,<sup>55</sup> an attorney, to assist in its revitalization.<sup>56</sup>

Shedding its unprofitable fur business upon the advice of Collins, Hollander proceeded to negotiate a merger with the Brook Chemical Co.<sup>57</sup> However, since it lacked the necessary capital to procure a loan for the merger, Hollander enlisted the cooperation of the Philips expansion committee.

The necessary funds were obtained when the Schuyler Corporation,<sup>58</sup> an affiliate of Philips, offered Hollander the use of a \$1.6 million debenture to be used as collateral. As compensation for the loan, Schuyler Corporation received \$32,000 and an agreement by which they could force the merger of Hollander with a third party meeting certain qualifications.

Upon the recommendation of the American Philips expansion committee, Schuyler assigned its agreement with Hollander to Philips Industries. In turn, a merger was executed with the surviving corporation, Hollander, changing its name to Philips Electronics, Inc., predecessor corporation to *Pepi, Inc.* Since Hollander had suffered prior losses in the fur business, its successor attempted to utilize these losses in the reduction of its tax liability for 1958 and 1959. The Commissioner disallowed the deduction, contending the principal purpose of the acquisition was the evasion or avoidance of tax liability. The Tax

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<sup>54</sup> 448 F.2d 141 (2d Cir. 1971).

<sup>55</sup> Collins had been counsel for the Philips group in a prior merger acquisition in which Philips acquired a spring manufacturing concern that had a \$750,000 loss carryover. The successor corporation attempted to make use of the loss as a tax benefit but it was partially disallowed under INT. REV. CODE of 1954, § 382. 448 F.2d at 143 n.1.

<sup>56</sup> In addition to retaining Collins, Hollander dismissed its old accountants and hired the same public accounting firm engaged by the American Philips group.

<sup>57</sup> Brook Chemical Company was a profitable operation which had a cash purchase value of \$2.8 million dollars.

<sup>58</sup> Schuyler Corporation was controlled by a foundation which had been established as a welfare fund for the employees of Dutch Philips. It was to serve as an investment service on behalf of the welfare fund in the United States.



Court affirmed the Commissioner<sup>59</sup> and the court of appeals also affirmed<sup>60</sup> concluding that petitioner had not shown sufficient evidence to disprove the Commissioner's contention of tax avoidance or evasion.<sup>61</sup> The court indicated that the entire chain of events beginning with retention of the same accounting firm and counsel as employed by Philips and culminating in the actual merger according to the Hollander-Schuyler agreement was more than coincidental.

Pepi unsuccessfully attempted to inject some valid "business purposes"<sup>62</sup> by showing the importance of the indirect acquisition of

<sup>59</sup> *Pepi Corp. v. Commissioner*, 52 T.C. 854 (1969).

<sup>60</sup> 448 F.2d 141 (2d Cir. 1971).

<sup>61</sup> INT. REV. CODE of 1954, § 269 (c), an addition to the law that existed under section 129 of the 1939 Code, provides that

The fact the consideration paid upon an acquisition by any person or corporation described in subsection (a) is substantially disproportionate to the aggregate—

- (1) of the adjusted basis of the property of the corporation . . . and
- (2) of the tax benefits (to the extent not reflected in the adjusted basis of the property) not available to such persons or corporation otherwise than as a result of such acquisition,

shall be prima facie evidence of the principal purpose of evasion or avoidance of Federal income tax.

Treas. Reg. § 1.269-5(b) (1962) states that the Commissioner's determination of whether an acquisition is made for the principal purpose of evasion or avoidance of income tax is *presumptively* correct. Thus the burden of overcoming this presumption by a preponderance of evidence falls upon the taxpayer. See *Thomas E. Snyder Sons Co. v. Commissioner*, 288 F.2d 36 (7th Cir. 1961); *American Pipe and Steel Corp. v. Commissioner*, 243 F.2d 125 (9th Cir. 1957). See also RABKIN AND JOHNSON, *FEDERAL INCOME, GIFT AND ESTATE TAXATION* §§ 72.03, 72.04. However, there is some basis for the evaporation of the presumption once the taxpayer has introduced his evidence. *American Pipe and Steel v. Commissioner*, 243 F.2d 125, 126 (9th Cir. 1957). For a discussion of section 29(c) see Peterson, *Corporate Acquisitions for Tax Avoidance Purposes: The Ever-Tightening "Loophole,"* 19 J. OF TAXATION 1963 322, 323-24 (1963).

<sup>62</sup> Treas. Reg. § 1.269-3(a)(2) (1962) states:

If the purpose to evade or avoid Federal income tax exceeds in importance any other purpose, it is the principal purpose.

However:

The determination of the purpose for which an acquisition was made requires a security of the entire circumstances in which the transaction or course of conduct occurred, in connection with the tax result claimed to arise therefrom.

It is interesting to note that other sections of the Internal Revenue Code dealing with avoidance of tax liability require that such a motivation constitute either "a major purpose" as in § 1551 or "one of the principal purposes", (INT. REV. CODE of 1954, §§ 302 (c)(2)(b), 306(b)(4), 367, 532(a) and 552(b)(2)) of the transaction. See *Malat v. Riddell*, 383 U.S. 569 (1966). Compare *Baton Rouge Supply Co.*, 36 T.C. 1 (1961) (the taxpayer, in need of an adjoining parcel of land, attempted to purchase it directly. He was informed that the only way possession would be given to him was through a stock purchase of the loss corporation. The deal was consummated and it was only after the purchase that the taxpayer learned of that tax advantage. The court held the principal purpose of the acquisition was business need) with *Goodwyn Crockery Co.*, 37 T.C. 355 (1961), *aff'd*, 315 F.2d 110 (6th Cir. 1963) (the stock of a loss corporation, engaged in the manufacture of household goods, was acquired by Goodwyn which, also purchased the assets of another company engaged in a similar business. The court found that the principal purpose of the acquisition was the expansion of the business, thus allowing the tax benefit even though its existence was known prior to the acquisition).

Many decisions have rejected claims of a valid business purpose. See, e.g., *J.T. Slocomb*, 38 T.C. 752 (1962), *aff'd*, 334 F.2d 269 (2d Cir. 1964) (the court decided there was no

Brook. But the very fact that Brook was acquired *indirectly* rendered this contention unsatisfactory. A weaker argument was Pepi's contention that Hollander's listing on the New York Stock Exchange was of significant value to Pepi. But, as the court pointed out, had an adequate investigation been made, it would have revealed that the listing would be unavailable after the merger.<sup>63</sup>

Finally, petitioner contended that the consideration given exceeded the tax benefit that could have been received. However, in reality the assets acquired equalled Hollander's expenditure without consideration of the \$815,000 tax benefit that would be received.<sup>64</sup> Thus the court maintained that Pepi had failed to produce adequate documentary evidence (such as corporate minutes, records, letters, memos, and resolutions)<sup>65</sup> proving the valid business purpose of the acquisition. Once the burden of proof has shifted to the taxpayer, the above evidence is essential.

If Hollander had acquired Brook without the assistance of the Philips affiliate, by using normal commercial channels, combined with an adequate showing of corporate records indicating the importance and value<sup>66</sup> of the acquisition, the court might have looked more favor-

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principal business purpose for the acquisition. Taxpayer there had acquired a firm producing micrometers but did nothing to expand the business. The court rejected the argument that the principal purpose was business diversification); Zanesville Investment Co., 38 T.C. 406 (1962); Thomas E. Snyder Sons Co., 34 T.C. 400 (1960), *aff'd*, 288 F.2d 36 (7th Cir. 1961); R.P. Collins & Co. v. United States, 193 F. Supp. 602 (D.C. Mass. 1961), *aff'd*, 303 F.2d 142 (1st Cir. 1962) (taxpayer made initial attempt to revitalize the loss corporation but abandoned the effort after two months and changed the nature of the business. The court denied the taxpayer the benefit of the carryover losses as well as the post acquisition operating losses. The attempt to revitalize the loss corporation was given no effect).

For a more complete look at postacquisition losses and how they are affected by the denial of preacquisition losses, see Note, *The Influence of Disallowed Preacquisition Losses on the Recognition of Postacquisition Losses Under Section 269*, 10 WM. AND M. L. REV. 169 (1968); Maher, *Sales and Acquisition of Loss Corporations*, N.Y.U. 28TH INST. ON FED. TAX 165, 178-79 (1970).

<sup>63</sup> 448 F.2d at 145-46.

<sup>64</sup> *Id.* at 146.

<sup>65</sup> In searching for motives in acquisition cases, the courts have looked to minutes of director and shareholder meetings. See, e.g., F.C. Publication Liquidating Corp., 36 T.C. 836 (1961), *aff'd*, 304 F.2d 779 (2d Cir. 1962); Alcorn Wholesale Co., 16 T.C. 75 (1951). In addition, courts have also reviewed proxy statements and letters to the shareholders (American Pipe and Steel Corp., 25 T.C. 351 (1955), *aff'd*, 243 F.2d 125 (9th Cir.), *cert. denied*, 355 U.S. 906 (1957)); inter-office correspondence (James Realty Co. v. United States, 176 F. Supp. 306 (D.C. Minn. 1959), *aff'd*, 280 F.2d 394 (8th Cir. 1960)); offers of acquisition (Spingolo Warehouse Co., 37 T.C. 1 (1961)); and correspondence between the parties (Hawaiian Trust Co. Ltd. v. United States, 291 F.2d 761 (9th Cir. 1961)).

<sup>66</sup> Petitioner should have shown the worth of the acquisition of Brook Chemical Co. and its listing on the New York Stock Exchange at between \$2.7 to \$4.0 million dollars. The court would then have been forced to look at petitioner's claim from a business view point.

For a brief summary of criteria to be met in avoiding section 269 complications, see

ably upon the petitioner's contention of a valid business purpose. Absent these countervailing circumstances, the court considered the acquisition primarily a means of tax avoidance.

### *Installment Method of Reporting Income*

Section 453 of the Internal Revenue Code of 1954 gives the taxpayer the option of reporting sales income in installments over the period during which he will receive payment.<sup>67</sup> The section is limited in application to either "dealers in personal property"<sup>68</sup> or "sales of realty and casual sales of personalty."<sup>69</sup> To take advantage of this option

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Feder, *The Application of Section 269 to Corporations Having Net Operating Loss Carryovers and Potential Losses*, N.Y.U. 21ST. INST. ON FED. TAX 1277, 1293 (1963).

<sup>67</sup> Under INT. REV. CODE of 1954, § 453, the seller can spread the gain received over the period of receipt and also allocate part of each receipt to the recovery of his basis. It should be recognized that the installment method is applicable only to gains and not losses. When a taxpayer sustains a loss on what normally would qualify as an installment sale, it is deductible only in the taxable year in which the sale is made not when payments are collected. Rev. Rul. 70-430 1970, INT. REV. BULL. No. 34, at 8. For an all inclusive discussion of section 453 see Emory, *The Installment Method of Reporting Income: Its Election, Use, and Effect*, 53 CORNELL L. REV. 181 (1968).

<sup>68</sup> INT. REV. CODE of 1954, § 453(a)(1) provides:

Under regulations prescribed by the Secretary or his delegate, a person who regularly sells or otherwise disposes of personal property on the installment plan may return as income therefrom in any taxable year that proportion of the installment payments actually received in that year which the gross profit, realized or to be realized when payment is complete, bears to the total contract price.

*Id.* (emphasis added).

"Total contract price" includes carrying charges and interest in addition to the fair market value of any trade-in or other consideration received by the dealer. INT. REV. CODE of 1954, § 453(a)(2).

The Code permits the reporting of revolving credit sales using the installment methods but requires the sampling of accounts to determine what percentage of the total qualifies for such treatment. For a complete discussion see Treas. Reg. § 1.453-2(d) (1958) and Rev. Proc. 65-5, 1965-1 CUM. BULL. 720; Rev. Proc. 64-4, 1964-1 CUM. BULL. 644.

Election of the installment method by a dealer in personal property must be indicated on an income tax return for the taxable year of the election. Treas. Reg. § 1.453-3(a)(1958) and Rev. Rul. 67-147, 1967-1 CUM. BULL. 105.

<sup>69</sup> INT. REV. CODE of 1954, § 453(b)(1) provides:

GENERAL RULE—Income from—

(A) a sale or other disposition of real property, or

(B) a casual sale or other casual disposition of personal property (other than property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year) for a price exceeding \$1,000

may (under regulations prescribed by the Secretary or his delegate) be returned on the basis and in the manner prescribed in subsection (a) [Installment Method].

*Id.*

The above section is limited by section 453(a)(2) which restricts its application to a situation where annual payments do not exceed 30 percent of the selling price. This subdivision of section 453 creates a pitfall to its proper use. The "selling price" is composed of the gross sale price, including cash, notes and other property received by the seller, plus any liabilities assumed or paid by the buyer. Rev. Rul. 60-52, 1960-1 CUM. BULL. 186. There is the danger that imputed interest will not be deducted from the selling price and total contract price. Thus, the selling price will be incorrectly inflated and the

the taxpayer must indicate his election on his tax return.<sup>70</sup>

Petitioner in *Billy Rose's Diamond Horseshoe, Inc. v. United States*<sup>71</sup> sought to elect the use of Section 453(b)(1) in reporting payments received from a lessee in lieu of an obligation to restore the leased premises.

During 1955 petitioner leased a theatre building including furniture and fixtures to the National Broadcasting Company, Inc. (NBC). The lease contained a covenant whereby NBC was to restore the premises to the same condition that existed when initially leased. Prior to the expiration of the lease NBC and the petitioner entered into an agreement which provided that the petitioner was to receive \$300,000 in full satisfaction for NBC's obligation to restore the building. Payment was to be accomplished through three promissory notes beginning September 4, 1962. Taxpayer, seeking to elect the installment method for the restoration payments, gave notice of his income tax return for the fiscal year ending August 31, 1962.

The Commissioner determined the three notes received as restoration payments were reportable in the fiscal year ending August 31, 1962 and not entitled to be treated as an installment because they did

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amount received during a period may exceed the 30% limitation. Treas. Reg. § 1.453-1 (b)(2)(1958); See also Levy, *Installment Sales of Real Estate*, N.Y.U. 25TH INST. ON FED. TAX 29, 36 (1967).

If there are any payments during the year of sale (initial payments), they will include the buyer's downpayment, installment payments and accrued liabilities of the seller discharged by the buyer. In safeguarding the use of this section, by remaining within the 30 percent limitation, the time of the completed sale becomes important, since advance payments in a prior year may be included in the initial payment. *Newaygo Portland Cement Co.*, 27 B.T.A. 1097 (1933), *aff'd*, 77 F.2d 536 (D.C. Cir. 1935); *Daniel Rosenthal*, 32 T.C. 225 (1959). See generally Emory, *The Installment Method of Reporting Income: Its Election, Use, and Effect*, 53 CORNELL L. REV. 181, 193 (1968).

Some difficulties have also arisen with the use of debentures in corporate acquisitions. *Installment Reporting of Gain on Receipt of Bonds in Corporate Acquisitions*, 30 J. TAXATION 198 (1969).

<sup>70</sup> Election of the installment method must be made in the taxpayer's return for the year of sale. In addition, the election must specify the type or types of sales transacted. Treas. Reg. § 1.453-8(a)(2) (1958). Originally the election had to be made on the original return and not on an amended return. *W.A. & Lorene B. Ireland*, 32 T.C. 994 (1959). But now the taxpayer may make the election on a timely amended return, provided that no inconsistent election was made on the original return. Rev. Rul. 65-297, 1965-2 CUM. BULL. 152. For a discussion of election of the installment method see Lane, *Timely Election of the Installment Method of Reporting Section 453(b) Sales: Murky Waters*, 18 ABA TAXATION SECTION 47 (April 1965); Horn, *Taxation of Installment and Deferred Payment Sales*, 9TH TULANE TAX INST. 628 (1960).

Section 453(c) was amended by the Tax Reform Act of 1969 to allow the taxpayer to retroactively revoke his election of the installment sales method by filing a notice of revocation. The revocation would apply to the year installment reporting was elected in addition to all subsequent years. However, once the taxpayer has revoked his election he cannot reelect the method for a period of five years. See Mulvey, *New Law Permits Taxpayer to take a Second Look at Installment Elections*, 32 J. OF TAXATION 149 (March 1970).

<sup>71</sup> 448 F.2d 549 (2d Cir. 1971).

not constitute income from a "sale." The district court affirmed the Commissioner's contention.<sup>72</sup>

In affirming the lower court, the court of appeals held that the restoration transaction was not entitled to application of the installment method since it was not a "sale or other disposition" as required by section 453.<sup>73</sup> The Second Circuit has, for many years, held that such releases of contract rights and cancellations are not "sales."<sup>74</sup>

However, the taxpayer contended that section 1241 of the Code<sup>75</sup> and the decision in *Commissioner v. Ferrer*<sup>76</sup> had diminished the validity of the above cases. The court rejected this argument and pointed out that section 1241 applies only to the two stated situations: cancellation of a lease by lessee or cancellation of a distributor's agreement.<sup>77</sup> Furthermore, the court held that the decision in *Ferrer* has not overruled the Second Circuit previous decisions on the issue, but is distinguished on the ground that the rights sold could have been sold to any third party.<sup>78</sup>

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<sup>72</sup> 322 F. Supp. 76 (S.D.N.Y. 1971).

<sup>73</sup> "The term sale has inherent in it a transaction which, when finally completed, will dispose of title to property." Horn, *Taxation of Installment and Deferred Payment Sales*, 9TH TULANE TAX INST. 622 (1960).

<sup>74</sup> *Pittston Co. v. Commissioner*, 252 F.2d 344 (2d Cir.), cert. denied, 357 U.S. 919 (1958) (cancellation of an exclusive contract to purchase a coal company's entire output did not constitute a sale); *General Artists Corp. v. Commissioner*, 205 F.2d 360 (2d Cir.), cert. denied, 346 U.S. 866 (1953) (payments received by a taxpayer for transfer of its contract were not a sale). See also *Commissioner v. Starr Bros., Inc.*, 204 F.2d 673 (2d Cir. 1953).

The term "sale" has often been the subject of judicial review. In *Commissioner v. Brown*, 380 U.S. 563, 570-71 (1965), the Court stated that since a "sale" is a common event in the non-tax world and not limited by the Code, it should be given its common and ordinary meaning. Yet passage of title is not the keystone of a sale or disposition under section 453. *Charles J. Derbes*, 24 B.T.A. 276, 283 (1931). Title eventually must pass, but is not essential that it do so with the initial payment in an installment contract. *Treas. Reg. § 1.453-2(a)*(1958).

<sup>75</sup> INT. REV. CODE OF 1954, § 1241. Cancellation of Lease or Distributor's Agreement:

Amounts received by a lessee for the cancellation of lease, or by a distributor of goods for the cancellation of a distributor's agreement (if the distributor has a substantial capital investment in the distributorship), shall be considered as amounts received in exchange for such lease or agreement.

<sup>76</sup> 304 F.2d 125 (2d Cir. 1962). In *Ferrer*, a taxpayer who held a lease to produce a play and prevent filming until after production received a gain from a sale in surrendering such rights.

<sup>77</sup> The court cited the Senate Report which makes clear the legislative intent in limiting the scope of the statute: "The section is limited in scope and it does not constitute a re-examination of present law relating to contracts to which the section does not specifically apply." 448 F.2d at 552, citing S. REP. 1622, 83rd Cong., 2d Sess., at 115 (1954).

<sup>78</sup> 448 F. 2d at 552. It appears other circuits have taken a somewhat different approach to defining what is a "sale." For example the Ninth Circuit in *Dorman v. United States*, 296 F.2d 27 (1961), held the abandonment of an option to acquire a partnership interest constituted a sale or exchange of capital. In *Commissioner v. Golonsky*, 200 F.2d 72 (3d Cir. 1952), cert. denied, 345 U.S. 939 (1953), the court held a lessee's surrender of his lease to the lessor was a sale or exchange of capital. See also *Commissioner v. Ray*, 210 F.2d 390 (5th Cir.), cert. denied., 348 U.S. 829 (1954); *Metropolitan Bldg. Co. v. Commissioner*, 282 F.2d 592 (9th Cir. 1960).

Petitioner might have avoided his tax problem by allowing NBC to make \$300,000 worth of lease-hold improvements which are not taxable as rent.<sup>79</sup>

In the alternative, petitioner could have waived his right to restoration and entered into a new lease for 1 or 2 years. Shortly thereafter NBC could have given the petitioner three notes for \$300,000 for the cancellation of the new lease thus coming within section 1241 of the Code and also entitling the petitioner to elect the installment method of reporting income under section 453.

It is apparent from this case that the decision in *Ferrer* will not change the long-standing rule that taxpayers will only be allowed the use of section 453 when the sale includes the release of rights which can be sold.

#### ESTATE TAXATION

##### *Valuation of Mutual Funds for Estate Tax Purposes*

Most mutual funds (Funds) have both "bid" and "asked" prices.<sup>80</sup> The "bid" price is the net asset value of the Fund.<sup>81</sup> The Fund is required by law<sup>82</sup> to redeem its shares at this "bid" price. Except for a negligible few, Fund shareholders liquidate their investments by the redemption method.<sup>83</sup> The "asked" price is the amount at which the Fund's marketing agency will sell a share to the public and consists of the "bid" price plus a commission of approximately eight percent for the marketeers.<sup>84</sup>

Treasury regulations require a Fund to be valued at its "asked"

<sup>79</sup> INT. REV. CODE of 1954, § 109. But the improvements may not be a sham in an attempt to conceal the payment of rent. Treas. Reg. § 1.109-1 (1972).

<sup>80</sup> See *Wells v. Commissioner*, 50 T.C. 871 (1968), *aff'd sub nom.*, *Ruehlmann v. Commissioner*, 418 F.2d 1302 (6th Cir. 1969), *cert. denied*, 398 U.S. 950 (1970), citing the *Scudder, Stevens and Clark Common Stock Fund, Inc.*, as an example of a mutual fund having the same "bid" and "asked" price.

<sup>81</sup> *Cartwright v. United States*, 457 F.2d 567 (2d Cir. 1972), *cert. pending*, defines the net asset value as follows:

The "net asset value" is computed daily as of the close of trading on the New York Stock Exchange. The total assets are valued and the total outstanding liabilities, including all reserves and accrued expenses, are subtracted. The resulting net worth is divided by the number of shares outstanding to determine the "net asset value" per share of capital stock. This is generally described as the "bid" price in the financial pages.

*Id.* at 568 n.1.

<sup>82</sup> Investment Company Act of 1940, 15 U.S.C. § 80a-22 (1970).

<sup>83</sup> See *Wells v. Commissioner*, 50 T.C. 871, 873 (1968). See also *Howell v. United States*, 414 F.2d 45, 47 (7th Cir. 1969).

<sup>84</sup> The commission covers the marketing agencies' expenses and profit but does not provide for the Fund's management. *Cartwright v. United States*, 323 F. Supp. 769, 771 (W.D.N.Y. 1971). The management expenses are paid from the Fund's dividends. Brief for Petitioner at 33, *Cartwright v. United States*, 457 F.2d 567 (2d Cir. 1972).