

1950

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Recommended Citation

Olen W. Burnett, *Reduction of Corporate Income Taxes by the Use of Separate Partnerships or Individual Proprietorships*, 15 Mo. L. REV. (1950)

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REDUCTION OF CORPORATE INCOME TAXES BY THE USE OF SEPARATE PARTNERSHIPS OR INDIVIDUAL PROPRIETORSHIPS

OLEN W. BURNETT*

In view of the income tax rates on corporations and the fact that corporate net income is, at least under some circumstances, taxed not only to the corporation but also to the shareholders when it is distributed as dividends, it seems clear that in many situations it is possible to achieve substantial tax savings by the careful use of other forms of business organization. Often it may be advantageous, for tax or other purposes, to conduct either all or some part of an enterprise either in the form of a partnership or an individual proprietorship. A discussion of the tax problems involved when a business is begun and continued in the form of a partnership or an individual proprietorship is not within the scope of this comment. What problems arise, however, when those in control of an operating corporation decide, for family, business or tax purposes, that a partnership should be formed and part or all of the corporation's business turned over to it? Or when the sole shareholder elects to take over part or all of the business and conduct it individually in his own name?

The problems in this connection which have had the attention of the Tax Court and to some extent that of other federal courts appear to fall generally into four groups: (1) Those in which the question is whether or not the separate existence of the partnership or individual proprietorship should be disregarded for tax purposes, and its income taxed to the corporation under the general provisions of Section 22 (a) of the Internal Revenue Code. (2) Those in which the question is whether or not the income of the partnership or individual proprietorship should be allocated to the corporation under Section 45 of the Internal Revenue Code. (3) Those involving claims for deductions under Section 23, Internal Revenue Code, for payments by the corporation to the partnership or individual proprietorship or its employees, or for expenses of the alleged partnership or proprietorship if it is disregarded. (4) Those involving the application of the personal holding company provisions of Sections 500 and following, Internal Revenue Code.

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I.

When the courts have sustained the Commissioner in disregarding partnerships or individual proprietorships for income-tax purposes and also when they have held that such organizations were entitled to separate recognition, decision has generally turned upon the answers to two questions, or what may amount to the same question in two forms. First, has the partnership or individual venture a valid business purpose? Second, is it genuine and, *bona fide*, a separate business?

Upon the first question, it has been held immaterial that a sole proprietorship served no business purpose of the corporation, part of the business of which was transferred.¹ This conclusion would seem inescapable; in fact, if the new venture should serve any business purpose of the corporation, whatever weight that factor might have should be on the side of disregarding the new venture as an agent or "adjunct" of the corporation. The purpose which is important is clearly that of the individual or of those who form the partnership.² It is also not determinative that one of several purposes is the avoidance of burdensome corporation taxes,³ though this factor may have some weight. If tax avoidance is the sole purpose, however, the partnership or individual proprietorship will most likely be disregarded.⁴

On the other hand, a substantial variety of purposes has been held to justify recognition of the partnership or individual venture. There are valid business purposes when members of a family (owners of all of the stock of a corporation) form a partnership to take over the business, in order to improve the cash position of the business (when that is bad) and to accomplish this while preserving the families of the family from loss of their investments and from putting more money into a hazardous

1. Miles-Conley Co. v. Commissioner, 10 T.C. 754 (1948), *aff'd* 173 F. 2d 958 (C. C. A. 4th 1949).

2. *Ibid.*

3. John Wachtel Corporation, P-H 1945 TC MEM. DEC. SERV. ¶ 45,250 (1945).

4. John Wachtel Corporation, *supra* note 3. Rasmusson v. Eddy's Steam Bakery, 57 F. 2d 27 (C. C. A. 9th 1932), *cert. denied* 287 U. S. 601 (1932); Twin Oaks Co., P-H 1949 TC MEM. DEC. SERV. ¶ 49,067 (1949). And, though the point is not made expressly, the following decisions appear to support the same conclusion: Advance Machinery Exchange, Inc. P-H 1949 TC MEM. DEC. SERV. ¶ 49,026 (1949); John L. Denning & Co., P-H 1948 TC MEM. DEC. SERV. ¶ 48,277 (1948), *reversed* 180 F.2d 288 (C. C. A. 10th 1950); R. O. Hill, Inc. v. Commissioner, 9 TC 153 (1947).

enterprise.⁵ Moreover, the validity of these purposes is not affected by an incidental hope of reducing burdensome corporation taxes.⁶ When a manufacturing and distributing corporation is losing accounts and business through inability to provide its outlets with advertising and promotion services called for in its contracts, valid business purposes exist for the stockholders' formation of a limited partnership to take over the promotion, advertising, distribution, and sale of the corporation's product; and it is immaterial that other methods of solving the problems were available, discussed, and rejected, and that tax savings were considered.⁷ Also, the stockholders of a corporation may form a partnership to improve operation of the business generally, to establish rental values on corporate real estate, and to save taxes, transferring conduct of the business to the partnership and relegating the corporation to the function of landlord.⁸ A partnership has a legitimate object when it is formed in order to increase the interest and responsibility which individuals take in the conduct of the business affairs while permitting the corporation to avoid the hazards of business by becoming a seller at a fixed price.⁹ When a manufacturing corporation has been formed mainly to secure and preserve a non-transferrable franchise, the two shareholders may properly form a partnership to take over distribution of the bulk of the product, the objects being to take over also the distribution of other lines, to adopt a brand of their own, and to permit the officers of the manufacturing corporation to devote more time to problems of production.¹⁰ A family partnership also has a legitimate purpose when it is formed so that sons of some of the corporation's stockholders may conveniently be admitted to a substantial share in the business upon their completion of college.¹¹ And there are sufficient business purposes for the formation of a joint venture by two officers of a corporation together with a third person to develop plans for special-purpose machines, the three of them owning the plans; the corporation is not a member of the joint venture, and the earnings which the officers receive from the venture are not dividends.¹²

5. John Wachtel Corporation, *supra* note 3.

6. *Ibid.*

7. *Seminole Flavor Co. v. Commissioner*, 4 T.C. 1215 (1945).

8. *Ames Theatre Co.*, P-H 1946 TC MEM. DEC. SERV. ¶ 46,016 (1946).

9. *Fair Price Stations, Inc.*, P-H 1946 TC MEM. DEC. SERV. ¶ 46,120 (1946).

10. *Barq's Bottling Co.*, P-H 1946 TC MEM. DEC. SERV. ¶ 46,150 (1946).

11. *Buffalo Meter Co. v. Commissioner*, 10 T.C. 83 (1948).

12. *Barney Machinery Co.*, P-H 1947 TC MEM. DEC. SERV. ¶ 47,199 (1947).

It would appear from the decisions just noted that almost any purpose not illegal, not a mere ruse for the avoidance of taxes, and not adopted for the carrying on of the corporate business as such is sufficient to justify recognition of a partnership or individual venture insofar as any business purpose may be necessary. Going even farther, however, the Tax Court has suggested that valid business purposes may be inferred from the fact that at the time of the dispute a partnership is still in existence and still doing business.¹³ This suggestion is, of course, weakened by the fact that there was at least one purpose clearly shown in the case and by the fact that the two firms involved were rather clearly separate. In at least two cases, however, no issue was made of business purposes or lack of them.¹⁴ It may be, then, that if an individual venture or a partnership is found to be separate from the corporation in question, the purpose for which it was organized is unimportant in itself. In other words, the real significance of a legitimate business purpose would appear to be evidentiary, a real purpose tending to indicate separateness of entity, and the absence of a real purpose tending to show that the new venture is not really separate enough in object or operation to justify separate treatment for tax purposes. It might also be suggested that if a venture is undertaken for sufficient business purposes, inquiry may still be made of whether or not it is kept sufficiently separate; while if such a venture is actually conducted as a separate and distinct enterprise, the question of its object should be unimportant.

We may proceed, then, to consider other factors bearing on the question of whether or not the businesses are genuinely distinct. As may be expected, they are numerous, and it is probably safe to say that no one of them will be conclusive in any given situation. Perhaps one of the most important is the maintenance of separate and complete books and records. This factor is considered in nearly every case,¹⁵ and is also important, as we shall see, in connection with questions arising under Section 45, Internal Revenue

13. Fair Price Stations, Inc., P-H 1946 TC MEM. DEC. SERV. ¶ 46,120 (1946).

14. Miles-Conley Co. v. Commissioner, 10 TC 754 (1948), *aff'd* 173 F.2d 958 (C. C. A. 4th 1949); Ross v. Commissioner, 129 F.2d 310 (C.C.A. 5th 1942).

15. John Wachtel Corporation, P-H 1945 TC MEM. DEC. SERV. ¶ 45,250 (1945); Seminole Flavor Co. v. Commissioner, 4 TC 1215 (1945); Ames Theatre Co., P-H 1946 TC MEM. DEC. SERV. ¶ 46,016 (1946); Barq's Bottling Co., P-H 1946 TC MEM. DEC. SERV. ¶ 46,150 (1946); Buffalo Meter Co. v. Commissioner, 10 TC 83 (1948); Fair Price Stations, Inc., P-H 1946 TC MEM. DEC. SERV. ¶ 46,120 (1946); Miles Conley Co. v. Commissioner, *supra* note 14; Ross v. Commissioner, *supra* note 14.

Code. The keeping of the separate books and records, of course, must not be a mere formality; there must be substance in the transactions recorded.¹⁶ Absence of separate and complete records is a strong indication that the businesses are also not separate.¹⁷

Of similar importance and, in some instances, almost if not entirely controlling, is the question of whether the business transferred to the new organization is a logically separable segment of the whole. In other words, is the entire business susceptible of division into distinct parts, and has it been so divided?¹⁸ It appears to be accepted that relegation of the corporation to the holding and renting of realty and other fixed asset is such a rational division.¹⁹ Similarly, it is reasonable for the new venture to handle distribution while the corporation is left to engage in manufacturing.²⁰ This appears to be true even though the corporation continues to distribute from ten to fifteen percent of its product, at least so long as it distributes this part in territory not covered by the new venture.²¹ Likewise, the partnership or individual proprietorship may take over retail sales, leaving wholesale distribution and the functions of landlord to the corporation.²² The sole stockholder of a corporation engaged in the produce business may handle all dealing in vegetables in his own name, leaving to his corporation the business in fruits, it being common for produce companies to specialize in one or the other.²³ A corporation may conduct a commission-auction business in horses and mules at the same time as its stockholders and one other carry on as partners a business of buying horses and mules.²⁴ And there

16. *R. O. Hill, Inc. v. Commissioner*, 9 TC 153 (1947); *Twin Oaks Co., P-H 1949 TC MEM. DEC. SERV.* ¶ 49,067 (1949); *John L. Denning & Co., P-H 1948 TC MEM. DEC. SERV.* ¶ 48,277 (1948), *reversed on the facts* 180 F.2d 288 (C. C. A. 10th 1950).

17. *Rasmusson v. Eddy's Steam Bakery*, 57 F.2d 27 (C.C.A. 9th 1932); *Advance Machinery Exchange, Inc., P-H 1949 TC MEM. DEC. SERV.* ¶ 49,026 (1949). (The factor was especially strong in this case, many of the books and records having been thrown away while the suit was pending.) *Hinz & Landt, Inc. v. Commissioner*, 8 B.T.A. 375 (1927); *Broadway Strand Theatre Co. v. Commissioner*, 12 B.T.A. 1052 (1928); *W. G. Duncan, Transferee, P-H 1947 TC MEM. DEC. SERV.* ¶ 47,334 (1947).

18. It may be important that the new venture carries on business activities not formerly conducted by the corporation; see *Q. I. Roberts, P-H 1949 TC MEM. DEC. SERV.* ¶ 49,013 (1949).

19. *John Wachtel Corporation, P-H 1945 TC MEM. DEC. SERV.* ¶ 45,250 (1945); *Ames Theatre Co., P-H 1946 TC MEM. DEC. SERV.* ¶ 46,016 (1946).

20. *Seminole Flavor Co. v. Commissioner*, 4 T. C. 1215 (1945).

21. *Barg's Bottling Co., P-H 1946 TC MEM. DEC. SERV.* ¶ 46,150 (1946).

22. *Fair Price Stations, Inc., P-H 1946 T. C. MEM. DEC. SERV.* ¶ 46,120 (1946).

23. *Miles-Conley Co. v. Commissioner*, 10 T.C. 754 (1948), *aff'd* 173 F. 2d 958 (C. C. A. 4th 1949).

24. *Ross v. Commissioner*, 129 F.2d 310 (C. C. A. 5th 1942).

seems to be no objection to dividing a business so that a family partnership handles the manufacture of meters for measuring liquids while the corporation owned by the same persons continues to conduct a foundry business.²⁵ Nor does any difficult question of division arise when two officers of a machinery company, together with one other, join in a venture to develop plans for special-purpose machines.²⁶ In fact, considering modern methods of production and distribution and the degree to which specialization has been carried in our economic system, it is difficult to imagine a business which could not be divided into logically separable parts. The examples noted above show at least that many types of division are possible in many types of business, and the list is by no means exhaustive.

The problem rather appears to be one of finding and making one of the divisions which is almost certainly possible.²⁷ The division, of course, must be made. If the two organizations compete, do not perform distinct operations, and are controlled by the same persons, who allot business to the partnership or corporation as they choose, the partnership is likely to be disregarded.²⁸ The same is true if the business organizations deal in the same kinds of merchandise, have customers in common, arbitrarily allot property purchased, and divide the proceeds of particular sales.²⁹ There is also lack of proper division when a sole shareholder conducts a business as would an individual, while having all expenses paid by the corporation which he retains to avoid personal risk and because it holds non-assignable

25. Buffalo Meter Co. v. Commissioner, 10 T. C. 83 (1948).

26. Barney Machinery Co., P-H 1947 TC MEM. DEC. SERV. ¶ 47,199 (1947).

27. But compare the following statement by the court in Twin Oaks Co., P-H 1949 TC MEM. DEC. SERV. ¶ 49,067 (1949), involving a corporation engaged in the sale of builders' materials, "Petitioner's business, it should be noted further, was unitary in character and in this respect differed from the businesses considered in Miles-Conley Co., Inc. . . . Buffalo Meter Company . . . and Seminole Flavor Co. . . . In those cases recognition for tax purposes was accorded the individual proprietorship or the partnership formed by the taxpayer's shareholders for operating a severable branch of the corporation's activities. But petitioner's building supply business was not susceptible of any logical division." The statement, however, is *dictum* and takes no account of the possibility of leaving a corporation to function as a landlord only (see the cases cited in note 19, *supra*). And *quaere*, what would have been the Tax Court's reaction if the partnership had taken over, for example, business in bricks, stone and cement, leaving the corporation to handle lumber, paints, etc?

28. See John L. Denning & Co., *supra* notes 4 and 16.

29. Advance Machinery Exchange, Inc., P-H 1949 TC MEM. DEC. SERV. ¶ 49,026 (1949). In this case, petitioner was taxed upon the income of two other corporations and of a business operated by its principal stockholder individually, largely for the reasons mentioned in the text.

leases essential to continuation of the business.³⁰ It should be noted, of course, that observing the formalities of dividing the business is not enough; the two organizations must perform their separate functions. So, if a partnership does not render real business services, it will not be recognized.³¹

Other factors bearing on the question of whether or not the partnership or individual proprietorship is sufficiently separate may be briefly summarized. That a new venture pays reasonable consideration and rental to the corporation, carries workmen's compensation insurance, has separate employees and payroll, pays unemployment compensation taxes, files partnership income tax returns, produces income, tax on which is paid by the partners, is publicly registered in accordance with state law or licensed by the United States to carry on business in interstate commerce, and acquires its own credit rating all tend to indicate that it is a separate entity.³² But again such factors are not conclusive.³³ Their absence, as might be expected, is suggestive of lack of separation.³⁴ Some weight may also be given to the fact that the corporation pays property taxes on real estate and equipment leased to the partnership while the latter carries insurance and pays taxes on

30. *Broadway Strand Theatre Co. v. Commissioner*, 12 B.T.A. 1052 (1928). See also *W. G. Duncan, Transferee*, P-H 1947 TC MEM. DEC. SERV. ¶ 47,334 (1947), reaching a similar result when the corporation involved was formed later than the partnership and at least in part as an effort to place assets beyond the reach of creditors.

31. *R. O. Hill, Inc. v. Commissioner*, 9 T. C. 153 (1947). Note that the problem of division does not arise when the plan is to transfer all of the corporation's business to a partnership or individual venture. What is then required is an actual transfer in good faith; that is, of course, a question of fact. Important in this connection are the name under which business is done, title to property and business, dates of transfer of title, dates of opening new books, and, perhaps one of the most important of the factors, consideration given to the corporation for the transfer of business or property or both. See *Hinz or Landt, Inc. v. Commissioner*, 8 B.T.A. 375 (1927), and *Rasmusson v. Eddy's Steam Bakery*, 57 F.2d 27 (C. C. A. 9th 1932), *cert. denied* 287 U. S. 601 (1932).

32. *John Wachtel Corporation*, P-H 1945 TC MEM. DEC. SERV. ¶ 45,250 (1945); *Ames Theatre Co.*, P-H 1946 TC MEM. DEC. SERV. ¶ 46,016 (1946); *Barq's Bottling Co.*, P-H 1946 TC MEM. DEC. SERV. ¶ 46,150 (1946); *Miles-Conley Co. v. Commissioner*, 10 T. C. 754 (1948), *aff'd* 173 F.2d 958 (C. C. A. 4th 1949); *Q. I. Roberts*, P-H 1949 TC MEM. DEC. SERV. ¶ 49,013 (1949).

33. *John L. Denning & Co.*, P-H 1948 TC MEM. DEC. SERV. ¶ 48,277 (1948); *Twin Oaks Co.*, P-H 1949 TC MEM. DEC. SERV. ¶ 49,067 (1949). *But see* *John L. Denning & Co. U. Commissioner*, 180 F.2d 288, (C. C. A. 10th 1950).

34. *R. O. Hill, Inc. v. Commissioner*, 9 TC 153 (1947); *W. G. Duncan, Transferee*, P-H 1947 TC MEM. DEC. SERV. ¶ 47,334 (1947); *Broadway Strand Theatre Co.*, 12 B.T.A. 1052 (1928); *Hinz & Landt, Inc. v. Commissioner*, 8 B.T.A. 375 (1927), *Rasmusson v. Eddy's Steam Bakery*, 57 F.2d 27 (C. C. A. 9th, 1932), *cert. denied* 287 U. S. 601 (1932). But use of the corporation's capital assets by a proprietorship without consideration is unimportant when it is not a material element in producing the proprietorship's income; *Miles-Conley Co. v. Commissioner*, 10 TC 754 (1948), *aff'd* 173 F.2d 958 (C. C. A. 4th 1949).

inventory.³⁵ When the owners treat the businesses as separate even when combining them would save taxes, there would seem little doubt of their good faith, which also has some weight in indicating separateness.³⁶ It is also significant that partnership interests are held in proportions different from those in which the corporate stock is owned, or that there are some partners who have no stock holdings.³⁷ But holding by the same persons and in the same proportions is not controlling.³⁸ The same may be said of the fact that business is carried on by the same personnel, whose duties remain the same when the plan is to transfer the whole business to a new organization.³⁹ Control of both organizations by the same persons is sometimes an important factor, but the primary emphasis in this connection is not upon the existence of control but rather upon the abuse of it.⁴⁰

If on the basis of all these and other factors, the partnership or proprietorship is disregarded, the result is simply that its income is taxed to the corporation under the provisions of Section 22(a), Internal Revenue Code, the broad policy of "tax the income to those who earn it" applying in this as in other situations. If, on the other hand, the separate existence of the new venture is recognized, still further problems arise.

II.

Part or all of the partnership or individual proprietorship income may be allocated to the corporation under Section 45, Internal Revenue Code.⁴¹

35. Fair Price Stations, Inc., P-H 1946 TC MEM. DEC. SERV. ¶ 46,120 (1946).

36. Ross v. Commissioner, 129 F.2d 310 (C. C. A. 5th 1942). And in Fair Price Stations, Inc., *supra* note 35, some weight was given to the fact that petitioner retained the benefit of certain commercial discounts and of state tax allowances for gasoline evaporation, on the ground that these items would have been shifted if the new venture were an attempt to evade corporate taxes.

37. Fair Price Stations, Inc., *supra* note 35; Ross v. Commissioner, *supra* note 36; Barney Machinery Co., P-H 1947 TC MEM. DEC. SERV. ¶ 47,199 (1947).

38. Ames Theatre Co., P-H 1946 TC MEM. DEC. SERV. ¶ 46,016 (1946); Barq's Bottling Co., P-H 1946 TC MEM. DEC. SERV. ¶ 46,150 (1946); Miles-Conley Co. v. Commissioner, 10 T. C. 754 (1948), *aff'd* 173 F.2d 958 (C. C. A. 4th 1949), involving a sole stockholder's taking over a division of the business as an individual proprietor. Buffalo Meter Co., 10 T. C. 83 (1948); Seminole Flavor Co. v. Commissioner, 4 TC 1215 (1945).

39. John Wachtel Corporation, P-H 1945 TC MEM. DEC. SERV. ¶ 45,250 (1945). But compare Twin Oaks Co., P-H 1949 TC MEM. DEC. SERV. ¶ 49,067 (1949), to the effect that the factors mentioned show "lack of substance in these forms."

40. John Wachtel Corporation, *supra* note 39; Ross v. Commissioner, 129 F.2d 310 (C. C. A. 5th 1942); Miles-Conley Co. v. Commissioner, *supra* note 38; Buffalo Meter Co. v. Commissioners, *supra* note 38; Advance Machinery Exchange, Inc., P-H 1949 TC MEM. DEC. SERV. ¶ 49,026 (1949).

41. INT. REV. CODE § 45: "In any case of two or more organizations, trades

If the entire income of a partnership results from work performed by a corporation, the fact that it is paid to the partnership pursuant to a contract does not prevent its being taxed to the corporation. That the partnership did not earn the income may be indicated by lack of separate place of doing business, lack of employees and equipment, the fact that partnership books were kept by corporate employees, that the corporation paid salaries to the partners while the partnership did not, and the fact that the partnership tax return reported no expenses incurred in the production of the income.⁴² Assuming the existence of a partnership controlled by the corporation's controlling shareholders, the inference from these and similar factors is that those in control are merely shifting income in order to avoid taxes. Similar results may also be reached when an individual proprietor forms a corporation to assist in the business. For example, when one engaged in bottling soft drinks forms a corporation to perpetuate the control of non-assignable contract rights and then contracts to purchase materials from the corporation at a rate higher than that which the holder of the franchise charges the corporation, the difference is income to the corporation, despite the fact that there are no corporate offices or employees and that the corporation does not handle the merchandise. The corporate income, however, is limited to this price differential.⁴³ This result is placed on the grounds that contracts entitled the corporation to that income and that one who takes advantage of the corporate form must also accept its disadvantages.

In general, the real purpose of Section 45 appears quite clearly to be to give the Commissioner of Internal Revenue a convenient discretionary authority to prevent evasion of taxes by correcting erroneous or improper bookkeeping and eliminating the effects of misused inter-company trans-

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

42. *Forcum-James Co. v. Commissioner*, 7 T. C. 1195 (1946). In this case, the partnership was formed some seven years before the year in dispute, did not consist of all the corporation's shareholders, had interests in other firms, and was, therefore, quite clearly in existence. If these factors were not present, those referred to in the text would probably lead to the complete disregard of the partnership for tax purposes.

43. *Hugh Smith, Inc. v. Commissioner*, 8 T. C. 660 (1947).

actions among companies controlled by the same interests. Thus, when the Tax Court has refused to sustain the Commissioner's allocations under Section 45, reversal has usually been based on express findings that there has been no attempt to evade taxes, that the partnership or proprietorship has actually earned its income, and that the businesses involved have kept separate and accurate books which clearly show their respective incomes.⁴⁴ Conversely, the language of the court usually suggests that in the absence of such findings an allocation of income to the corporation would be sustained. And a partial allocation might be made if, for example, the corporation sells goods to the partnership at prices lower than those charged other customers,⁴⁵ or if an individual engages in the same line of business as his corporation and uses its assets and employees.⁴⁶

As should be clear from the wording of Section 45, the provision has no application unless there are two or more businesses controlled by the same interests. So when a corporation is owned by two members of a family, and a partnership is formed in good faith by five members of the same family, allocation of income under Section 45 is improper since the two businesses are not controlled by the *same* interests.⁴⁷ Also, when two persons each own half the stock of a corporation and one of them owns a one-third interest in a partnership, the other members of which have no interest in the corporation, there is not enough control by the same interests to justify application of Section 45.⁴⁸

Even when there are two or more businesses controlled by the same interests, what now appears to be the accepted interpretation of Section 45 does not authorize the arbitrary allocation of income so as to produce the

44. *Epsen Lithographers, Inc. v. O'Malley*, 67 F. Supp. 181 (D. C. Neb. 1946); *Briggs-Killian Co. v. Commissioner*, 40 B. T. A. 895 (1939); *John Wachtel Corporation, P-H 1945 TC MEM. DEC. SERV. ¶ 45,250 (1945)*; *Miles-Conley Co. v. Commissioner*, 10 TC 754 (1949); *Buffalo Meter Co.*, 10 TC 83 (1948); *Seminole Flavor Co. v. Commissioner*, 4 T. C. 1215 (1945).

45. *Barq's Bottling Co.*, P-H 1946 TC MEM. DEC. SERV. ¶ 46,150 (1946), in which the Tax Court suggested this possibility though the argument was not made by the Commissioner.

46. *Briggs-Killian Co. v. Commissioner*, *supra* note 44.

47. *Epsen Lithographers, Inc. v. O'Malley*, *supra* note 44.

48. *Q. I. Roberts*, P-H 1949 TC MEM. DEC. SERV. ¶ 49,013 (1949); see also *Briggs-Killian Co. v. Commissioner*, *supra* note 44, involving a single venture by the holder of 45% of the corporation's stock, backed financially by the holder of the other 55%. No issue was made of control, but it would seem that, the financial backing consisting of loans, the businesses were not controlled by the same interests.

equivalent of a consolidated net income.⁴⁹ Rather, as indicated above, the object of the section is primarily to correct improper bookkeeping and the shifting of profits and expenses among businesses subject to common control. More broadly put, as stated in Regulations 111, Section 29.45-1, the section aims to achieve the same results with reference to companies subject to common control as would naturally obtain if the companies were not so controlled but dealt independently "at arms length." It would seem, then, that any allocation under this section ought to be based on specific improper transactions or erroneous bookkeeping entries and limited to their correction. Any broader application would appear to go beyond the Treasury Department's own interpretation of the purposes of the section.

From what has been said and from the language of Section 45, it ought also to be clear that when the section is applied, talk of disregarding the partnership or sole proprietorship is unnecessary and out of place; while, if the decision is to disregard the separate venture, there is no need to invoke Section 45. And, in general, this seems to be the view of the better-considered cases; the two problems are properly to be kept separate.⁵⁰ A good deal

49. *Barq's Bottling Co.*, P-H 1946 TC MEM. DEC. SERV. ¶ 46,150 (1946); *Seminole Flavor Co. v. Commissioner*, 4 T. C. 1215 (1945). Regulations 111, Section 29.45-1, reads in part as follows: "It is not intended (except in the case of the computation of consolidated net income under a consolidated return) to effect in any case such a distribution, apportionment, or allocation of gross income, deductions, or any item of either, as would produce a result equivalent to a computation of consolidated net income under section 141." Further, Section 45 does not authorize the Commissioner to go beyond allocation and to assume the distribution of a dividend. In *Seminole Flavor Co. v. Commissioner*, *supra*, the court pointed out that an analysis of the facts showed that increased taxes would result only if the partnership income was not only allocated to the corporation but distributed as dividends, since the corporation very likely had a good defense to the application of Section 102 (Surtax on corporations improperly accumulating surplus). Assuming such a defense, recognizing the partnership resulted in over \$50,000 more tax than would disregard it or allocating its income to the corporation. It is not surprising that the partnership was recognized.

50. *Miles-Conley Co. v. Commissioner*, 10 T.C. 754, 763 (1948), the court noting that Section 45 cannot apply unless there are two or more trades or businesses, etc. and indicating the inconsistency of a different view: "Even his [the Commissioner's] disregard of the individual is provisional and paradoxical. His position appears to be that the sole proprietorship is recognized for the purpose of invoking section 45 and that the reason section 45 is applicable is that, in reality, the sole proprietorship does not exist. . . ." *Ames Theatre Co.*, P-H 1946 TC MEM. DEC. SERV. ¶ 46,016 (1946), in which the Commissioner abandoned the argument based on Section 45 and relied on the contention that the separate organization should be disregarded. *Ross v. Commissioner*, 129 F.2d 310, 313 (C. C. A. 5th 1942): "So far from justifying the consolidation of such businesses, this section recognizes and preserves their separateness, and seeks only to adjust and correct what may have been improperly done in the bookkeeping between them."

of confusion on this point, however, appears in some of the cases, caused apparently by the fact that some of the same factors are considered both in connection with Section 45 and in connection with disregarding the new venture. Chief among these, perhaps, is the question of complete and separate books and records, which necessarily is at the heart of any application of Section 45 and which, as has been observed, is relied on heavily in deciding whether or not to disregard separate business organizations. Similarly, questions of attempts to evade taxes or to shift income and expenses may be involved in either problem.⁵¹ In at least one case, the business purposes of a partnership have also been emphasized in refusing to sustain the application of Section 45;⁵² the same factor, as we have seen, is often emphasized in determining whether or not the ventures are separate. In *Q. I. Roberts*,⁵³ the two problems are intermingled, and in *Barq's Bottling Company*,⁵⁴ the court went so far as to suggest that on the basis of Regulations 111, Section 29.45-1, allocation of partnership income to a corporation when the partnership is held to be genuine would not be authorized. It is suggested that the confusion might conveniently be avoided by keeping Section 45 clearly separated from the problem of disregarding the new organization. Doing so would be entirely consistent with the wording of the section and with the Treasury Department's interpretation of it.

It might even be argued further that Section 45, though perhaps convenient, is unnecessary. If a proprietorship or partnership earns income, that income, under accepted doctrine, is taxable to the partnership or proprietorship which earned it and is not properly to be allocated to any other organization. If on the other hand, income is actually earned by a corporation, it may be taxed to the corporation under the accepted application of Section 22 (a) without regard to whether or not there is another separate organization involved in the situation and without regard to the authority apparently conferred by Section 45. That section, however, may serve a useful purpose as a clarification of the Commissioner's authority by direct grant.

51. See, for example, *Epsen Lithographers, Inc. v. O'Malley*, 67 F. Supp. 181 (D. C. Neb. 1946).

52. *John Wachtel Corporation*, P-H 1945 TC MEM. DEC. SERV. ¶ 45,250 (1945).

53. P-H 1949 TC MEM. DEC. SERV. ¶ 49,013 (1949).

54. P-H 1946 TC MEM. DEC. SERV. ¶ 46,150 (1946).

III.

Next to be considered is the question of deductions. So far there do not appear to be any particularly difficult or unusual problems of deductions in connection with disregarding the separate organization or in connection with the application of Section 45. If, for example, the decision is that a partnership is to be disregarded, its expenses are expenses of the corporation and are to be allowed or not according to the usual practice under Section 23. Thus, payments of additional compensation by the partnership to employees for exceptional services must be regarded as deductions allowed the corporation.⁵⁵ Payments of counsel fees for services in the formation of the disregarded partnership, however, and payments to accountants for services to the partnership are not deductible by the corporation because they are not ordinary and necessary expenses.⁵⁶ Withdrawals by the alleged partners (stockholders) are not expenses but dividends and are thus not deductible but a part of the income of the corporation, though if special services are performed by the partners, reasonable compensation for such special services may be deducted.⁵⁷ If a sole shareholder divides the business and conducts part of it as an individual enterprise, dividing his time between the two organizations, the deduction allowed his corporation for his salary may properly be reduced on the theory that his total services probably continue unchanged but are now divided between the two organizations.⁵⁸ Finally, if a separate organization is recognized, payments to it by the corporation are deductible or not simply depending on whether or not they are ordinary and necessary business expenses or come within some other provision for deductions.⁵⁹

IV.

Last of all, some attention must be given to provisions concerning personal holding company income.⁶⁰ Presumably the usual rules apply in the situations under discussion; little authority on them has been found in connection with these situations, and most of them are beyond the scope

55. *R. O. Hill, Inc. v. Commissioner*, 9 T.C. 153 (1947); *Heymann Mercantile Co.*, P-H 1948 TC MEM. DEC. SERV. ¶ 48,246 (1948).

56. *R. O. Hill, Inc. v. Commissioner*, *supra* note 55.

57. *Ibid.*

58. *Miles-Conley Co. v. Commissioner*, 10 T.C. 754 (1948), *aff'd*. 173 F.2d 958 (C. C. A. 4th 1949).

59. *Heymann Mercantile Co.*, P-H 1948 TC MEM. DEC. SERV. ¶ 48,246 (1948).

60. See INT. REV. CODE § § 500-511.

of this article. Two doctrines, however, deserve particular mention. First, each partner is considered as owning the stock which is owned by his partners.⁶¹ Second, a partnership is not regarded as a separate entity from the partners with reference to stock ownership and use of corporate property, and therefore, when a partnership rents property from the corporation, the payments may fall within Section 502 (f), Internal Revenue Code, declaring that personal holding company income includes compensation for the use of corporate property when twenty-five percent or more of the value of the corporation's stock is owned by an individual entitled to use the property.⁶² Thus it would seem possible that, on formation of a partnership to take over part or all of the corporate business, the corporation may come to be a personal holding company when it previously was not, and that income which was not previously personal holding company income may become such upon organization of the partnership. Only careful consideration of the relevant provisions of the Internal Revenue Code can assure avoidance of these results.⁶³

In conclusion, it may be repeated that, while substantial tax savings appear possible by the careful use of separate ventures, individual or partnership in form, considerable care must be used: (1) to establish the new organization in a way and for such purposes as to make it clearly separate and distinct from the old, (2) to keep relations between the businesses clear and "at arms length" in order that the books of each may clearly show its income and in order that the application of Section 45 may be avoided, (3) to arrange stockholdings, payments to the corporation for any use of its property, and membership in the partnership so that the

61. *Furniture Finance Corp. v. Commissioner*, 46 B.T.A. 240 (1942); INT. REV. CODE § 503(a)(2), "An individual shall be considered as owning the stock owned, directly or indirectly, by or for his family or by or for his partner."

62. *Walnut Street Co. v. Glenn*, 83 F. Supp. 945 (W. D. Ky. 1948).

63. Note also the provisions in INT. REV. CODE § 291, for penalties for failure to file returns. The penalty is not imposed if the failure is in good faith and due to reasonable cause. The opinion of a revenue agent in his report after examining taxpayer's books is such reasonable cause; *Hugh Smith, Inc. v. Commissioner*, 8 T.C. 660 (1947). The same is true of the advice given by a reputable tax accountant of long experience; *Walnut Street Co. v. Glenn*, *supra* note 62. In *Furniture Finance Corp. v. Commissioner*, *supra* note 61, the Board of Tax Appeals accepted the argument that the penalty should be exacted, however, when the facts clearly indicate a corporation to be a personal holding company. This view was rejected in *Haywood Lumber & Milling Co. v. Commissioner*, 178 F. 2d 769 (C.C.A. 2d 1950), the court saying that the standard of care imposed by section 291 "is personal to the taxpayer," and that the mistakes of his consultants are not to be imputed to him.

heavy taxes on personal holding company income are not applied. Accomplishment of the desired results would not appear difficult if the problems are sought and planned for in advance.