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FIRST SECURITY BANK OF UTAH—ITS EFFECT UPON THE EXPANDED SCOPE OF SECTION 482

> And so it is. The result of today's decision may not be too important, for it affects only a few taxpayers. It seems to me, however, that it effectively dulls one edge of what has been a sharp two edged tool fashioned and bestowed by the Congress upon the Internal Revenue Service for the effective enforcement of our Federal tax laws.[1]

The "two edged tool" of Mr. Justice Blackmun's dissenting opinion in *Commissioner v. First Security Bank of Utah*[2] denotes the discretionary power of allocation given the Commissioner of Internal Revenue by Section 482 of the Internal Revenue Code of 1954. Its edge was not dulled in the international business scene where its use is most notorious, but in its use upon the monetary structure of a domestic bank holding corporation through the slightly tarnished theory of taxpayer disability.

The first decision of the United States Supreme Court on Section 482 of the Internal Revenue Code comes at a time when the Commissioner is relying more and more upon this simply-worded, but powerful, statutory weapon to attack commonly controlled taxpayers in an effort either to prevent tax evasion or to reflect the true taxable income of the entities.[3] Section 482 provides that:

> In any case of two or more organizations, trades, 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 Secretary or his delegate may 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.[4]

The controversy which has been engendered[5] is evidenced by the amalgam of principles and policies of tax law relied upon by the Tax

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[1] Comm'r v. First Security Bank, 405 U.S. 394, 426 (1972).

[2] *Id.*

[3] During the 1930's, Section 482 served more in the role of a "silent policeman." During the past ten years its application to foreign and domestic operations has increased significantly. A recent computer report stated that Section 482 was the most frequently cited section in deficiency notices in pending cases in the Mid-Atlantic Region. Seieroe & Gerber, *Section 482—Still Growing at the Age of 50,* 46 TAXES 893, 894 (1968) [hereinafter cited as Seieroe].

[4] 26 U.S.C. § 482 (1970).

[5] This case began as a Tax Court memorandum. 26 CCH Tax Ct. Mem. 1320 (1967).

Court, the Tenth Circuit Court of Appeals and the United States Supreme Court in the judicial evolution of the case. The rationales of the decisions have been based either directly or indirectly on such issues as taxpayer disability, generation of income, dominion or control over income, assignment of income, and illegality of receipt of income.

Mr. Justice Powell, in his first opinion for the Court, wrote that the Commissioner's exercise of Section 482 authority was unwarranted where a holding company did not utilize its control over two national banks to distort their true taxable income.[6] The implied prohibition by federal law of the receipt of insurance sales commissions by national banks was considered by the Court to be sufficient disability to inhibit the holding company's exercise of "complete power." The decision, in which two strong dissenting opinions were entered, came on a six to three vote of the Court.[7]

The relatively uncomplicated history of Section 482 had its legislative beginnings in the Revenue Act of 1918.[8] Section 240 of that Act provided for the filing of consolidated returns by affiliated corporations and in so doing recognized the existence of commonly controlled businesses.[9] In 1921 Congress, in adding a proviso to the Act of 1918,[10] established what has been called the "single enterprise approach" by giving the Commissioner the power to consolidate the accounts of related taxpayers. The purpose of Section 240(d) of the Revenue Act of 1921 was to "prevent the arbitrary shifting of profits among related businesses"[11] and to prevent corporations from "milking" their subsidiaries or "otherwise improperly manipulat[ing] the financial

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[6] 405 U.S. at 400-01.

[7] Justice Marshall's dissenting opinion can be found at 405 U.S. 407-18. The dissenting opinion of Justice Blackmun, with whom Justice White joined, can be found at 405 U.S. 418-26.

[8] The legislative history of Section 482 appears in the following articles: Murdoch, *The Scope of the Power of the Internal Revenue Service to Reallocate Under Section 482,* 6 B.C. IND. & COM. L. REV. 717 (1965) [hereinafter cited as Murdoch]; Spaeth, *Section 482—Past and Future,* 47 TAXES 45, 46-47 (1969) [hereinafter cited as Spaeth].

[9] Section 240 stated that two or more domestic corporations are affiliated (1) if one corporation owned directly or controlled "through closely affiliated interests . . . substantially all the stock of the other or others, or (2) if substantially all the stock of two or more corporations is owned or controlled by the same interests." Revenue Act of 1918, ch. 18, § 240(b), 40 Stat. 1082 (1919).

[10] Revenue Act of 1921, ch. 136, § 240(d), 42 Stat. 227.

> That in any case of two or more related trades or businesses (whether unincorporated or incorporated and whether organized in the United States or not) owned or controlled directly or indirectly by the same interests, the Commissioner may consolidate the accounts of such related trades and businesses, in any proper case, for the purpose of making an accurate distribution or apportionment of gains, profits, income, deductions, or capital between or among such related trades or businesses.

[11] S. REP. No. 275, 67th Cong., 1st Sess. 20 (1921).

accounts of the parent company."[12] Changes, considered purely technical, were made in Section 240(d) by the Revenue Act of 1924.[13] A further change—making reallocation of profits mandatory at the request of the taxpayer—was embodied in Section 240(f) of the Revenue Act of 1926.[14]

With the adoption of the 1926 Act, the stage was set for the most recognizable ancestor of Section 482—Section 45 of the Revenue Act of 1928.[15] Two significant changes were embodied in Section 45.[16] First, the taxpayer was not privileged to require a reallocation. The new provision became "solely a government sword" and was no longer available to reallocate gross income and deductions among related taxpayers whereas previously Section 240(f) had permitted a consolidation of accounts of the related businesses.[17] The language of the House Committee Report on Section 45 makes clear the congressional intention: "to prevent tax evasion (by the shifting of profits, the making of fictitious sales, and other methods frequently adopted for the purpose of 'milking')."[18] Two minor changes in the statutory language were made by the Revenue Acts of 1934[19] and 1943.[20] No legislative

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[12] H.R. REP. No. 350, 67th Cong., 1st Sess. 14 (1921).

[13] Spaeth, *supra* note 8, at 46.

[14] This Act provided that the Commissioner might "consolidate the accounts" of commonly controlled trades or businesses, if such was "necessary in order to make an accurate distribution or apportionment of gains, profits, income, deductions or capital" among the commonly controlled businesses. Revenue Act of 1926, ch. 136, § 240(f), 44 Stat. 46.

[15] The new language in Section 45 was:

> In any case of two or more trades or businesses (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 or deductions between or among such 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 trades or businesses. Revenue Act of 1928, ch. 852, § 45, 45 Stat. 806.

[16] Murdoch, *supra* note 8, at 718.

[17] The House Committee Report specifically noted this change and explained it as being aimed at forestalling any contention that nonaffiliated corporations can achieve the equivalent of a filing of a consolidated return. H.R. REP. No. 2, 70th Cong., 1st Sess. (1928).

[18] *Id.*

[19] Section 45 was slightly expanded to add the term "organization" to the terms "trades or businesses." These terms are used to explain and describe the entities among which reallocations could be made. According to the congressional committee reports the change was made to insure that the phrase would be interpreted to be applicable to all kinds of business activity. Revenue Act of 1934, ch. 277, § 45, 48 Stat. 680. H.R. REP. No. 704, 73d Cong., 2d Sess. (1934) and S. REP. No. 558, 73d Cong., 2d Sess. (1934).

[20] This statutory language change adds credits and allowances to the list of items subject to reallocation; previously gross income and deductions were the only items. Revenue Act of 1943, ch. 240, § 128(b), 58 Stat. 47.

changes have been made since 1943; Section 45 of the 1939 Code remains unaltered as Section 482 of the 1954 Code.

There is considerable administrative discretion in the application of Section 482, but three requirements must be met before Section 482 can be invoked: first, there must be two or more organizations, trades or businesses; second, there must be common control; and third, control must be exercised to understate "true taxable income" or to evade taxation.[21] Treasury Regulations have been promulgated to establish the guidelines for application of this section and to outline the extent of the Commissioner's powers. The first such Regulations, in 1934,[22] were promulgated to clarify the proposition that the section was not to be limited to sham transactions designed to reduce the taxpayer's liability for taxes,[23] nor to foreign trade corporations. The Regulations attempted to extend the Commissioner's power of allocation into the area of mere tax avoidance.[24] The Treasury introduced its "arm's length" and "true net income" concepts at this time. The Commissioner is given the power to scrutinize closely all transactions between mutually controlled corporations with the object of arriving at the true net income of each controlled taxpayer by using as a standard an uncontrolled taxpayer's dealing at "arm's length" with another uncontrolled taxpayer.[25]

JUDICIAL INTERPRETATION

Initially the courts were reluctant to go beyond the question of tax evasion in permitting the application of this discretionary section, except in extreme cases.[26] It has been held that the mere creation of a corporation to take advantage of the tax laws does not of itself constitute evasion of taxes under Section 482.[27] Taxpayers were generally free to structure their business affairs to their best interests, including tax savings. Judge Learned Hand expressed this sentiment:

> Over and over again courts have said that there is nothing sinister in so arranging one's affairs as to keep taxes as low as possible. Everybody does so, rich or poor; and all do right, for nobody owes

[21] Seieroe, *supra* note 3, at 894.
[22] Treas. Reg. § 29.45-1 (1948).
[23] Spaeth, *supra* note 8, at 45, 49.
[24] The courts were more reluctant to recognize the latter of Section 482's dual purposes—"to prevent evasion of taxes *or* clearly to reflect the income."
[25] *See* Oil Base, Inc. v. Comm'r, 362 F.2d 212 (9th Cir. 1966); Baldwin Bros. v. Comm'r, 361 F.2d 668 (3d Cir. 1966); Spicer Theatre, Inc. v. Comm'r, 346 F.2d 704 (6th Cir. 1965); Aiken Drive-In Theatre Corp. v. United States, 281 F.2d 7 (4th Cir. 1959); Comm'r v. Chelsea Products, 197 F.2d 620 (3d Cir. 1952).
[26] *See, e.g.*, Eli Lilly & Co. v. United States, 372 F.2d 990 (Ct. Cl. 1967).
[27] W. Braun Co. v. Comm'r, 396 F.2d 264 (2d Cir. 1968).

> any public duty to pay more than the law demands; taxes are enforced exactions, not voluntary contributions. To demand more in the name of morals is mere cant.[28]

In addition to the general hesitancy to cross the boundary of tax avoidance, particular concepts unfavorable to the application of Section 482 and its predecessors emerged. The courts early held that Section 482 "did not authorize the Commissioner to set up income where none existed."[29] This "creation of income" concept was vague enough to provide an umbrella for numerous taxpayers. Furthermore, the Commissioner has not been justified in applying the section where the businesses in question are separate and distinct entities with "legitimate business purposes."[30] The taxpayer had merely to show that there was a business purpose—other than tax savings—for having separately controlled entities and that the assignment of income and deductions to these entities was likewise reasonable.

THE EXPANDED SCOPE

A few setbacks were not to dampen the Treasury's spirit for the use of this valuable "tool." After all, the mandate ". . . to prevent evasion of taxes or clearly to reflect the income of any such organization . . ."[31] provided the Commissioner with virtually unlimited discretion to allocate income. The courts ruled that the taxpayer had the burden of showing that the Commissioner had acted "arbitrarily" or "capriciously" in making the allocation.[32] In view of its potentialities, it is not surprising that the scope and use of Section 482 underwent a process of continuous growth.[33]

This growth was most apparent in the proposed Regulations of 1966.[34] Approved in 1968,[35] the characteristics of these Regulations are summarized as follows:

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[28] Comm'r v. Newman, 159 F.2d 848, 850 (2d Cir. 1947). *See also* Chirelstein, *Learned Hand's Contribution to the Law of Tax Avoidance*, 77 YALE L.J. 440 (1968).

[29] Simon J. Murphy Co. v. Comm'r, 231 F.2d 264 (6th Cir. 1956); Tennessee-Arkansas Gravel Co. v. Comm'r, 112 F.2d 508 (6th Cir. 1940); Epsen Lithographers v. O'Malley, 67 F. Supp. 181 (D. Neb. 1946). *See also* Lewis, *Tax Court in Huber Homes Holds That the I.R.S. May Not Use 482 to Create Income*, 34 J. TAX. 208 (1971).

[30] W. Braun Co. v. Comm'r, 396 F.2d 264 (2d Cir. 1968); U.H. Monette & Co. v. Comm'r, 45 T.C. 15 (1965); Virginia Metal Prod., Inc. v. Comm'r, 33 T.C. 788 (1960).

[31] 26 U.S.C. § 482 (1970).

[32] *See* Philipp Bros. Chem., Inc. v. Comm'r, 435 F.2d 53 (2d Cir. 1970); Charles Town, Inc. v. Comm'r, 372 F.2d 415 (4th Cir. 1967); Advance Mach. Exch. v. Comm'r, 196 F.2d 1006 (2d Cir. 1952).

[33] Seieroe, *supra* note 3, at 893.

[34] Proposed Treas. Reg. § 1.482, 31 Fed. Reg. 10294 (1966).

[35] Treas. Reg. § 1.482, 33 Fed. Reg. 5848 (1968).

(1) Parent and subsidiary must deal with each other in much, if not precisely, the same way as unrelated, conceivably competing companies.
(2) Transactions are to be measured by various objective tests set forth in the Regulations, which pay little, if any, attention to the business purposes being served by the transactions being examined.[36]

The Service also took the opportunity to state that Section 482 and the new Regulations were to be applicable to transactions between related domestic taxpayers. This presented a warning that Section 482 would be used against domestic taxpayers where there have been significant deviations from "arm's length" dealings or where there has been a significant shifting of income.[37]

FIRST SECURITY

It was in the spirit of this expanded scope that the Commissioner approached First Security Corporation in 1967. First Security Corporation [hereinafter referred to as the Holding Company] includes within its fully owned subsidiaries First Security Bank of Utah and First Security Bank of Idaho [the Banks]. Other pertinent non-bank subsidiaries include First Security Company [Management Company] and, since 1954, First Security Life Insurance Company of Texas [Security Life].

Beginning in 1948, the Banks encouraged their borrowers to purchase credit life insurance. Their obvious reasons included: (1) offering a service increasingly supplied by competing financial institutions, (2) obtaining the benefit of the additional collateral which credit insurance provides by repaying loans upon the death, injury, or illness of the borrower, and (3) providing an additional source of income—part of the premiums—to the Holding Company or its subsidiaries.[38] Prior to 1954, the insurance was placed with an independent insurance carrier. Commissions of 40 to 55 per cent were paid to an insurance agency subsidiary of the Holding Company and the income was included in the taxable income for the Management Company. Since the Management Company and the Banks paid essentially the same tax rate, the allocation was of little interest to the Commissioner.

However, in 1954, Security Life was organized by the Holding Company to reinsure all credit life placed by the Banks with an independent insurer, pursuant to a treaty by which Security Life received

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[36] Spaeth, *supra* note 8, at 50.
[37] Steiner, *How New 482 Regs Apply to Domestic Taxpayers: A Powerful I.R.S. Weapon*, 25 J. TAX. 258 (1966).
[38] 36 P-H Tax Ct. Mem. 1451 (1967).

85 per cent of the premiums for assuming the risks. For the remaining 15 per cent, the independent carrier assumed the major administrative functions. With an initial capital of $25,000[39] and an initial paid-in surplus of $12,500,[40] Security Life realized net profits in excess of one and a half million dollars during its first five years of operation. No sales commissions were paid. Security Life reported all the reinsurance premiums on its income tax returns for the period 1955 to 1959, at the preferential tax rate for insurance companies.[41] The Commissioner, pursuant to his power under Section 482, determined that 40 per cent, some $700,000, of Security Life's premium income was allocable to the Banks as commission income earned for "originating" and "processing" the credit life insurance.

The allocation met no resistance in its initial test before the Tax Court.[42] The court relied on a recent Seventh Circuit case nearly identical on its facts.[43] In *Local Finance v. Commissioner*,[44] a holding company controlled several finance companies and an insurance company which similarly reinsured the credit life funneled through the finance companies. The Seventh Circuit Court of Appeals held that the Commissioner properly allocated 50 per cent of the net premiums to the finance companies even though the companies did not receive any premiums and were forbidden by state law from doing so.[45] The court followed a simple generation of income concept.[46] The finance companies were responsible for generating the income and therefore should be taxed on it. The Seventh Circuit, citing *Lucas v. Earl*,[47] noted that the doctrine of anticipatory assignment of income negated

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[39] Security Life's capital was increased to $100,000 in 1956 through a $75,000 stock dividend.

[40] This was an unusually low capitalization with which to begin an insurance company. In 1954, Texas had low minimum capitalization requirements for incorporating insurance companies.

[41] Both the Life Insurance Company Act of 1955, 70 Stat. 36, and the Life Insurance Company Tax Act of 1959, 73 Stat. 112, accorded preferential tax treatment to life insurance companies.

[42] 36 P-H Tax Ct. Mem. 1451 (1967).

[43] Local Fin. Co. v. Comm'r, 407 F.2d 629 (7th Cir.), *cert. denied*, 396 U.S. 956 (1969).

[44] *Id.*

[45] The state law argument was based on Indiana's Small Loan Law, IND. ANN. STAT. § 18-3002 (1964).

[46] Under the generation of income doctrine a taxpayer who designates an entity to perform services and exercises control over that entity is taxable upon income produced by such services.

The "generation of income" doctrine has been described as a corollary of the "assignment of income" doctrine. The incidence of tax in both of these doctrines is based on the definition of who controls the income. The "assignment of income" doctrine focuses on the power to control the disposition of income, while the generation of income doctrine focuses on the power to control the creation of income.

[47] 281 U.S. 111 (1930).

the taxpayer's argument that it never had control over the premium income.

In reviewing *First Security* on appeal, the Tenth Circuit was in disagreement with this generation of income concept.[48] The court said that since the Banks in fact did not receive any commissions and were prohibited by law from doing so, the Commissioner's attribution of a portion of the premium income to them was unwarranted. The court found the position taken by the Commissioner that "whoever generates income must include the amount thereof in his gross income"[49] to be a "fallacy."

> Indeed, the acceptance of the generation of business theory would have alarming consequences on normal commercial practices such as all types of referral business and security commission giveups. . . . We believe that in principle it runs contrary to all court and Tax Court decisions except *Local Finance*.[50]

The Supreme Court subsequently granted the Commissioner's petition for certiorari to resolve the conflict between the two circuits.[51] Mr. Justice Powell (for himself, Chief Justice Burger, and Justices Douglas, Brennan, Stewart, and Rehnquist) affirmed the Tenth Circuit on the essential premise that the Bank "could never have received a share of these premiums."

The cornerstone of the majority's decision is the relationship of illegality of receipt of income with the inability to tax—a "taxpayer's disability" proposition. Courts have held that 12 United States Code § 92—which authorizes national banks to act as insurance agents when located in places having a population not to exceed 5,000—by implication prohibits banks in areas where the population exceeds 5,000 from acting as agents.[52] Relying on this statute, the Court reasoned that

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[48] 436 F.2d 1192 (10th Cir. 1971).

[49] *Id.*

[50] *Id.* at 1197.

[51] Comm'r v. First Security Bank, 405 U.S. 394 (1972).

[52] The Comptroller of the Currency considers 12 U.S.C.A. § 92 (1945) to be effective—although when the National Bank Act was revised in 1918, § 92 was omitted— 12 CFR § 2.1-2.5 (1971). The revisers of the United States Code have omitted it from recent editions of the Code. Courts, have held that this statute applies to banks of First Security of Utah's size by implication.

Section 92 provides:

> If the directors of any national banking association shall knowingly violate, or knowingly permit any of the officers, agents, or servants of the association to violate any of the provisions of this chapter, all the rights, privileges, and franchises of the association shall be thereby forfeited. . . . And in cases of such violation, every director who participated in or assented to the same shall be held liable in his personal and individual capacity for all damages which the association, its shareholders, or any other persons, shall have sustained in consequence of such violation.

since the Banks were legally barred from ever receiving the money they could not be taxed.

In weaving a taxpayer's disability argument, Justice Powell turned to the Section 61 principle of "complete dominion." To support his conclusion "that in order to be taxed for income, a taxpayer must have complete dominion over it," he relied upon dictum expressed in two previous Supreme Court cases—*Corliss v. Bowers*[53] and *Harrison v. Schaffner*.[54] To apply the "complete dominion" restraint on Section 482 the Court used a sentence of the Commissioner's Regulations:

> The interests controlling a group of controlled taxpayers are assumed to have complete power to cause each controlled taxpayer so to conduct its affairs that its transactions and accounting records truly reflect the taxable income from the property and business of each of the controlled taxpayers.[55]

The Court stated that "[t]he regulation, as applied to the facts in this case, contemplates that Holding Company—the controlling interest—must have 'complete power' to shift income among its subsidiaries."[56] The Court reasoned that since the Holding Company did not have the power to force the Banks to violate the law by accepting the premiums, it did not have "complete power."[57] Since the Commissioner is only authorized to reallocate under Section 482 where "complete power" exists and has been used in such a way as to understate the "true taxable income of the subsidiary," the reallocation was unwarranted.[58] If the "complete power" concept were interpreted broadly, it could be said that the Court has added another condition that must be satisfied before Section 482 can be applied.

The present statutory language defining the term "control" is extremely vague. The Treasury Regulations state that:

> Control includes any kind of control, direct or indirect, whether legally enforceable, and however exercisable or exercised. It is reality of the control which is decisive, not its form or the mode of its exercise. A presumption of control arises if income or deductions have been arbitrarily shifted.[59]

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[53] 281 U.S. 376 (1930).
[54] 312 U.S. 579 (1941).
[55] Treas. Reg. § 1.482-1(b)(1) (1971).
[56] 405 U.S. at 404.
[57] Justice Blackmun noted that the quotation used by the Court to uphold the "complete dominion" theory "consists of language used to *support* the taxation of income; it is not language, as the Court would make it out to be, that supported the nontaxation of income." 405 U.S. at 424 (Blackmun, J., dissenting).
[58] 405 U.S. at 405.
[59] Treas. Reg. § 1.482-1(a)(3) (1971).

For Section 482 to be applicable the Commissioner must determine whether the two or more organizations in question are "owned or controlled directly or indirectly by the same interests."[60] Unlike other Code provisions defining control, this statutory language is simple, plastic and not tied by cross reference or otherwise to additional sections of the Code.[61] The Regulations give the statutory language the broadest possible application.

A 1952 Tax Court decision was offered as token case support for this concept of disability through illegality. In *L. E. Skunk Latex Products, Inc. v. Commissioner*,[62] the same interest controlled both a manufacturer and a distributor of rubber prophylactics. By a quirk of OPA Price Regulation during World War II, the distributor was allowed to raise prices while the manufacturer was not. In an attempt to allocate a portion of the distributor's income to the manufacturer, the Tax Court held that the Commissioner had "no authority to attribute to Petitioners [manufacturers], income which they could not have received." In 1952, the Tax Court may well have been influenced by the Supreme Court's prior holding in *Commissioner v. Wilcox*.[63]

The Court did not rely upon Section 482's much used "arm's-length" standard in its analysis of the case. No banks (controlled or non-controlled) could receive commissions so there were no arm's-length transactions with which to compare the fact situation in *First Security*. Apparently no thought was given to contrasting the tax consequences before 1954—when the Banks were dealing at arm's-length with an independent insurance carrier—with the controlled insurance period after 1954. *Local Finance* was doomed; the *coup de maitre* had been administered quickly if somewhat unsatisfactorily.[64]

Justice Marshall, in his dissenting opinion, closely examined the language of Section 92 and the historical context in which it evolved.[65] He found that Congress was not only concerned with the receipt of insurance commissions, but also with restricting the activities—soliciting and selling—that generated the money. It appears that the majority semantically sidestepped the "soliciting and selling" issue by describ-

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[60] 26 U.S.C. § 482 (1971).

[61] Murdoch, *supra* note 8, at 719.

[62] 18 T.C. 940 (1952).

[63] 327 U.S. 404 (1946).

[64] Teschner, *First Security Bank of Utah Taxpayer Disability and the Supreme Court*, 50 TAXES 260, 265 (1972). [hereinafter cited as Teschner].

[65] Justice Marshall based his congressional intent argument on a letter written by John Skelton Williams, who was then Comptroller of the Currency, to Congress. 12 U.S.C.A. § 92 was added to the federal banking laws in 1916 at his suggestion. Letter of June 8, 1916, to Senate, 52 CONG. REC. 11001 (July 17, 1916).

ing it as "originating" or "referring."[66] Regardless of the words used, the fact remains that the Banks were the responsible force behind the income. The loan officers explained the policy to the borrower, filled out the application form, collected the premiums and forwarded them to Management Company. Justice Marshall concluded:

> The substance is either that the respondents violated federal law, earned illegal income, attempted to avoid taxation on the income by channeling it elsewhere, and were caught by the Commissioner; or, that they did not violate federal law by soliciting sales of insurance and that there is no legal bar to their receiving the proceeds from their sales. In either case, the result is the same, and respondents cannot prevail.[67]

The Court's linking of illegality and taxability in order to construct a taxpayer's disability argument is not unique. In *Wilcox*[68] the Court developed the short-lived "claim of right" doctrine, based on the proposition that illegally obtained income was not taxable.[69] In *First Security* the Court discussed whether the taxpayers actually received or had a "right" to receive the insurance premiums. As in *Wilcox*, Justice Powell focused on the "imaginary barrier of illegality."[70] It should be noted, however, that the Court limited the import of *Wilcox* in its opinion in *Rutkin v. United States*[71] and finally hurdled the barrier of illegality of income when it overruled *Wilcox* in *James v. United States.*[72]

The fact that the Banks did not actually receive the premiums is of no importance. Taxability without formal receipt is found in a variety of contexts in our tax law.[73] This proposition is especially

[66] Neither the statute nor the regulations used the words "originating and referring" insurance. Justice Marshall suggests that the Court is attempting to distinguish *sub silentio* between "originating and referring" and "soliciting" and only the latter is illegal. 405 U.S. at 414.

[67] 405 U.S. at 416.

[68] Comm'r v. Wilcox, 327 U.S. 404 (1946).

[69] The Court in *Wilcox* concluded that embezzled income was not taxable to the embezzler.

[70] 405 U.S. at 405.

[71] 343 U.S. 130 (1952). The Court in effect overruled the *Wilcox* case when it limited the import of the decision to its facts. The Court held that income obtained by extortion was taxable income to the extortioner. In *James v. United States*, the Court concluded that an "examination of the reasoning used in *Rutkin* leads us inescapably to the conclusion that *Wilcox* was thoroughly devitalized." 366 U.S. 213, 215 (1960).

[72] 366 U.S. 213, 222 (1960).

[73] Harrison v. Schaffner, 312 U.S. 579 (1941), and Lucas v. Earl, 281 U.S. 111 (1930) (for income or earnings assigned to another and never received); Helvering v. Horst, 311 U.S. 112 (1940) (for the income from bond coupons assigned to another and never received); Helvering v. Clifford, 309 U.S. 331 (1940) (for another's income from a short-term trust); Burnet v. Wells, 289 U.S. 670 (1933) (for irrevocable trust income used to pay insurance premiums on the settlor's life).

evident in the context of the application of Section 482. Careful scrutiny of the legislative, judicial and regulatory histories of Section 482 reveals a concern for the proper reflection of income among commonly controlled companies. It is the purpose of the statute to allow the Commissioner to go beyond the *form* in which a transaction is structured to its *substance*.[74] The essence of Section 482 is the reallocation of income regardless of the formal receipt.

Mr. Justice Blackmun, with whom Mr. Justice White joined in dissenting, chose to grant Section 482 the wider interpretation called for by the Regulations and refused to link illegality with inability to tax. He submitted that

> Section 482 has a double purpose and a double target. It authorizes the Secretary or his delegate . . . to allocate whenever he determines it necessary so to do in order (a) "to prevent evasion of taxes" or (b) "clearly to reflect the income of any of the controlled entities."[75]

Justice Blackmun treated the case with a great deal of deliberation, dividing his dissent into fifteen parts. His most persuasive argument centered upon the "generation of income" concept used in *Local Finance*, a concept refuted by the Tenth Circuit, and avoided by the majority. He asserted that the "[b]anks were the responsible force behind the premium income. No one else was."[76] It had been the Banks who gave out and examined the applications, prepared the certificates of insurance, collected the premiums, and sent the forms and premiums to the Management Company. "Clearly, services were rendered by that bank on behalf of its commonly controlled affiliate. Just as clearly, those services would have been compensated had the corporations been dealing with each other at arm's length."[77] The majority of the Court failed to grasp this most critical argument.

CONCLUSION

One writer has stated that the decision in *First Security* "[h]as infused tax law with a basic humanism—has, in short, treated taxpayers compassionately and as people."[78] The taxpayers here treated "compassionately" were not individuals, nor were they even small businesses. The taxpayers who will benefit from this decision are large corporations and business associations whose size already gives them a com-

[74] The substance rather than the form of a transaction has been the rationale for many decisions to tax by the Internal Revenue Service.
[75] 405 U.S. at 419.
[76] *Id.* at 421.
[77] *Id.* at 422.
[78] Teschner, *supra* note 64, at 260.

mercial advantage over their smaller competitors. The decision simply prevents the Commissioner from denying additional tax avoidance.

The courts have yet to shed light upon the difficult task of interpreting *First Security's* effect upon the future application of Section 482. If construed in the most narrow sense, the case would have importance only where receipt of income would be prohibited by statute or otherwise unlawful. While bank holding and finance companies are widespread,[79] there would be some credibility to Justice Blackmun's statement that *First Security* "affects only a few taxpayers."

The significance of the case might lie in the fact that Justice Powell avoided the application of the "generation of income" concept in the context of Section 482.[80] This issue was the backbone not only of the Tenth Circuit's decision in *First Security* but also that of *Local Finance*, although the respective conclusions of the courts differed. Justice Breitenstein, writing for the Tenth Circuit, found that the "[g]eneration of business is not enough to impose federal income tax liability."[81] He held that the Banks did not earn the premium payments and that, although they physically received them, they acted only as a conduit to pass the payments on to those legally entitled to receive them.[82] The Tenth Circuit hypothesized that the application of the business generation theory in this context would be overly broad.[83] *Teschner v. Commissioner of Internal Revenue*[84] explained the ramifications:

> If this were the law agents, conduits, fiduciaries, and others in a similar capacity would be personally taxable on the proceeds of their efforts. The charity fund-raiser would be taxable on the sums contributed as the result of his efforts. The employee would be

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[79] In 1965, there were 550 one-bank holding companies with commercial deposits of $15.1 billion. By the end of 1969, this number had grown to more than 890 with commercial deposits exceeding $181 billion—a figure representing 43 per cent of all deposits in insured commercial banks in the United States. Note, *The Bank Holding Company Act Amendments of 1970*, 39 GEO. WASH. L. REV. 1200 (1971).

[80] Justice Powell in footnote 11 of his opinion stated:

> The court below held that the mere generation of business does not necessarily result in taxable income. As we decide this case on a different ground, we need not consider the circumstances in which the origination or referral of business may or may not result in taxable income to the originating party. We do agree that origination of business does not necessarily result in such income. 405 U.S. at 401.

[81] 436 F.2d at 1198.

[82] *Id.*

[83] The court concluded that:

> [T]he acceptance of the generation of business theory would have alarming consequences on normal commercial practices such as all types of referral business and security commission giveups. We believe that in principle it runs contrary to all court and Tax Court decisions except *Local Finance*. *Id.* at 1197.

[84] 38 T.C. 103 (1962).

taxable on income generated for his employer by his efforts. Such results are completely at variance with every accepted concept of Federal income taxation.[85]

The context in which the generation of income doctrine is applied must be considered. *Teschner* and *Blair v. Commissioner of Internal Revenue*[86] involved unrelated, independent companies and unrelated individuals. However, *First Security* involves a complicated, interrelated economic structure where a relatively specific section is being applied. In this case, the premiums stayed within a corporate structure dominated by the Holding Company, and "did not pass elsewhere with consequent tax impact elsewhere."[87] The situation was quite different in *Teschner* and *Blair.*

The refusal by the Court to rely upon an interpretation of the generation of income argument to decide the case further dampens the limited success the Commissioner had when the court in *Local Finance* first adopted that proposition.[88] Although the court avoided the quagmire of the generation of income doctrine, it entered another by applying the "complete dominion" theory of Section 61 to create a "complete power" requirement in the Section 482 context. The Court substantially adopted a "panoramic view" for a very precise and specific authority.[89]

Broadly interpreted, the application of the "complete dominion" theory could mean the Commissioner's power to create income under Section 482 would be limited to the power now existing under Section 61. This conclusion would be contrary to Congressional intent,

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[85] *Id.* at 1007.

[86] 300 U.S. 5 (1937).

[87] 405 U.S. at 422 (Blackmun, J., dissenting).

[88] Historically, the use of the generation of income doctrine by the Commissioner has met with little success. The Supreme Court rejected this doctrine in a Section 61 case involving a multicorporate business structure, Nat'l Carbide Corp. v. Comm'r, 336 U.S. 422 (1949). However, in Marc's Big Boy v. Prospect, Inc. 52 T.C. 1073 (1969), the Commissioner relied on the doctrine to support a reallocation of income under Section 482. Although the Tax Court upheld the argument, it has been criticized because its application in the tax law would "result in unjustifiable absurdities and inconsistencies." Lee, *Section 482 and the Integrated Business Enterprise,* 57 VA. L. REV. 1376, 1414 (1971) [hereinafter cited as Lee].

The generation of income doctrine has been described as a "blunt tool" that forces the Court to disregard corporate entities that are not shams. *Id.* at 1411. It has also been called an "all or nothing" approach that would contradict the Section 482 concept of partial allocation of income between related, but separate, taxable entities. Moreover, applying the generation of income doctrine in Section 482 cases deprives the law of the predictability that would have attended Section 482 cases had the specific guidelines prescribed in the Regulations prevailed. For a thorough discussion of the adoption of the generation of income doctrine in the Section 482 context, see Lee, 1409-21.

[89] Seieroe, *supra* note 3, at 899.

the relatively explicit Regulations defining its application and its judicial history.

This decision may also have an impact on certain procedural principles which attach to a Section 482 case. Besides the usual presumption of correctness for the Commissioner in tax cases, in the recent past the taxpayer has had to show additionally that the Section 482 allocation was arbitrary, unreasonable and capricious.[90] This formidable advantage in favor of the Commissioner may have been reduced by *First Security*. Judicial decisions in this area have had limited value as precedent because of the highly factual character of typical Section 482 cases.[91] This limitation may be the only solace the Commissioner will find in this case in future years.

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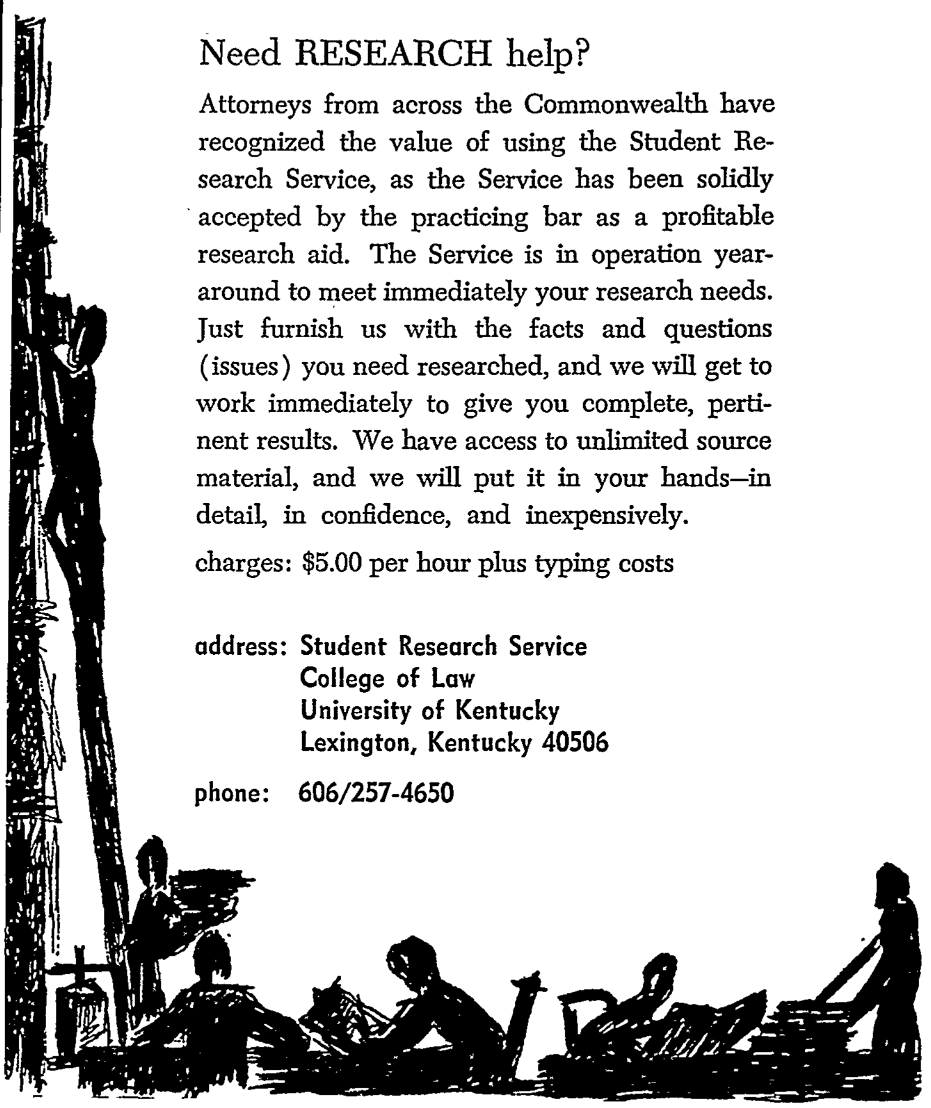
[90] *See, e.g.*, Grenada Ind., Inc. v. Comm'r, 17 T.C. 231, 255 (1951), *aff'd*, 202 F.2d 873 (5th Cir.), *cert. denied*, 346 U.S. 819 (1953); Nat'l Sec. Corp. v. Comm'r, 46 B.T.A. 562, 565 (1947), *aff'd*, 137 F.2d 600, 602 (3d Cir.), *cert. denied*, 320 U.S. 794 (1943); G.U.R. Co. v. Comm'r, 41 B.T.A. 223, 228 (1940), *aff'd*, 117 F.2d 187, 189 (7th Cir. 1941).

[91] For a thorough discussion of the applicable standards and procedures in Section 482 cases, see Eustice, *Tax Problems Arising From Transactions Between Affiliated or Controlled Corporations*, 23 TAX L. REV. 451, 492-96 (1968).



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