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Corporations- Allocation of Subsidiary's Tax Benefit from Consolidated Return

Thomas B. Ridgley
University of Michigan Law School

CORPORATIONS—ALLOCATION OF SUBSIDIARY'S TAX BENEFIT FROM CONSOLIDATED RETURN—Defendant parent corporation received from its subsidiary 3,556,992 dollars in tax benefits which had accrued to the subsidiary from filing a consolidated income tax return.[1] By agreement between parent and subsidiary, the profit-making corporation was to pay the losing corporation the savings created by the consolidated return. The working relationship of the two assured the subsidiary profits and the parent losses.[2] Consequently, nearly all tax benefit inevitably flowed to the parent.[3] Plaintiffs, the subsidiary's minority stockholders, sought a refunding of benefits allocated to defendant, claiming that the agreement was unfair and alleging that the defendant, as the subsidiary's majority shareholder, had violated its fiduciary obligation to minority shareholders. The Supreme Court, finding no violation, dismissed the complaint. On appeal to the Appellate Division, *held*, reversed. The subsidiary's majority shareholder owes its minority shareholders a fiduciary duty not to part with all or nearly all the tax benefit resulting from a consolidated return; since the agreement between the parent (majority shareholder) and the subsidiary violates this obligation, the allocation agreement is unenforceable. *Case v. New York Cent. R.R.*, 19 App. Div. 2d 383, 243 N.Y.S.2d 620 (1963).

The consolidated return permits a group of corporations to be taxed on their consolidated taxable income, thereby representing only the results of the operations of the group after eliminating inter-company profits and losses.[4] A second important advantage is that a profit-making corporation's taxable income may be lessened by the amount of another corporation's losses, thereby reducing their combined tax liability. Section 1552 of the Internal Revenue Code of 1954[5] offers several possible systems of

1 See INT. REV. CODE OF 1954, §§ 1501-04. Section 1503(a) is the only section noted here which was altered by the 1964 Revenue Act. The special 2% tax on corporations filing a consolidated return was abolished. Revenue Act of 1964, § 234(a), 78 Stat. 19. Due to § 1503(a)(C), however, railroads were and have remained exempt from the 2% tax.

2 Parent was lessee of subsidiary's railroad. It paid all maintenance and operating expenses of the railroad and in addition paid to the subsidiary 40% of gross earnings. The court noted that subsidiary enjoyed a "practically guaranteed taxable income into the indefinite future." Parent, on the other hand, could avail itself of not only its operating losses, but also those of its other affiliates. The court gave no figures concerning parent's losses, but it concluded that parent was assured of operating at a loss.

3 In actuality, the subsidiary allocated $3,556,992.15 to the parent from the total savings of $3,825,717.43. The net saving remaining with the subsidiary was $268,725.28. Eighty percent of that went to parent as stockholder, so that only $53,751.05, or less than 1.5% of the total savings, accrued to the minority shareholders.

4 BITTKER, FEDERAL INCOME TAXATION 67 (1959).

5 INT. REV. CODE OF 1954, § 1552. This section suggests four possible systems of tax liability allocation among members of a group filing a consolidated return. The method chosen in the first consolidated return filed must be followed in subsequent years.

allocating tax liability among the members, but suggests no method of tax credit allocation.[6] Therefore, in the absence of agreement by the parties, the corporation whose tax liability is reduced retains the savings. A corporation with a wholly-owned subsidiary receives all the tax benefit either directly, if its liability is reduced, or indirectly, as the subsidiary's sole stockholder, if the subsidiary's liability is diminished. However, when the parent does not wholly own the subsidiary, and the subsidiary's tax liability is lessened, the parent will normally share the savings with the minority shareholders. The 1954 Code, by lowering the affiliation test for consolidated returns from ninety-five to eighty percent ownership by a common parent,[7] enlarged the number of minority interests affected by consolidated returns and increased benefit distribution problems.[8] In order to avoid sharing benefits with minority stockholders, parent corporations sometimes make allocation agreements with the subsidiaries which provide for payment of the tax benefit to the parent. Since the parent owns eighty percent or more of the voting stock of the subsidiary, minority stockholders generally have no voice in deciding whether to file a consolidated return or in drafting the allocation agreement. Apprehension that parents might violate their fiduciary duty while in such a dominant position has caused several courts to scrutinize these agreements, holding unenforceable those whose practical consequence channels all tax benefits to the dominant corporation.[9]

Two attacks can be made on such agreements; both ultimately are designed to test the equitability of the tax benefit allocation. First, payment of the subsidiary's tax benefits to its majority shareholder may constitute an illegal dividend. Second, the payment may violate the fiduciary duty which the majority owe the minority stockholders. The initial premise of the illegal dividend theory is the accepted principle that all stockholders of the same class are entitled to share equally in profit distribution according to the number of shares held by each.[10] Discriminatory dividends are

[6] Justice Jackson, dissenting from the granting of a rehearing in Western Pac. R.R. v. Western Pac. R.R., 345 U.S. 247, 277 (1953), asserted that the legislative intent was to provide salvage for the losing corporation and not profit for a corporation sustaining no loss.

[7] INT. REV. CODE OF 1954, § 1504. The previous requirement of 95% ownership is found in INT. REV. CODE OF 1939, § 141(d).

[8] See BITTKER, *op. cit. supra* note 4, at 69; CUDDIHY, *Consolidated Returns*, N.Y.U. 16TH INST. ON FED. TAX 351, 358 (1958); H.R. REP. No. 1337, 83d Cong., 2d Sess. 88 (1954). The importance of the consolidated return is evident from these figures from the fiscal year 1955-1956; although only 2,900 consolidated returns were filed, the tax liability of the taxpayers involved was $2.8 billion, almost 13% of the aggregate corporate tax liability that year. BITTKER, *op. cit. supra* note 4, at 68.

[9] See Alliegro v. Pan Am. Bank, 136 So. 2d 656 (Fla. App. 1962), *aff'd*, 149 So. 2d 45 (Fla. 1963); principal case at 387, 243 N.Y.S.2d at 623.

[10] *E.g.*, Southern Pac. Co. v. Bogart, 250 U.S. 483 (1918); Penfield v. Davis, 105 F. Supp. 292 (N.D. Ala. 1952), *aff'd*, 205 F.2d 798 (5th Cir. 1953); Louisville, H. & St. L. Ry. v. United States, 20 F. Supp. 483 (W.D. Ky. 1937), *appeal dismissed*, 97 F.2d 1017 (6th Cir. 1938).

illegal, rectifiable only by the unanimous consent of all shareholders.[11] Consequently, if tax benefit payments are dividends, and the allocation agreement transfers all tax savings to the majority stockholder parent, such preferential treatment among stockholders of the same class renders the distribution illegal.

The troublesome link in the argument is the contention that tax benefit distributions are dividends. A dividend need not be formally declared nor even called a dividend by those authorizing it.[12] By analogizing from other distributions held to be dividends by various courts, it is conceivable that tax benefit payments might also be identified as dividends. In corporate law cases, courts have classified as dividends certain wages and salaries,[13] loans to shareholders,[14] and a payment by a corporation of taxes on its stockholders' dividends.[15] In tax cases courts are seemingly even more involved with identifying spurious dividends. The Tax Court, deciding a case factually similar to the principal case, held that for income tax purposes an allocation to the parent of tax benefits received by subsidiary from a consolidated return is a dividend.[16] Analogically, support has been given this holding by other courts, which have asserted that the following are disguised dividends for tax purposes: profits accruing to a shareholder from a theatre lease by the corporation to the shareholder at a low rental,[17] the sale of property by a corporation to a shareholder at a price substantially below market value,[18] and payment by the corporation of premiums on a stockholder's life insurance policy.[19] The difficulty with analogizing from tax cases is that even if a tax credit payment is a dividend for tax purposes, it may not be a dividend for corporate law purposes.[20] However, because courts deciding corporate cases have been willing to disregard form and acknowledge various distributions as spurious dividends, it seems apparent that, where justice requires, most profit distributions classified as dividends for tax purposes could also be so identified for

11 Speier Co. v. United States, 9 F. Supp. 1020 (Ct. Cl. 1935); Alliegro v. Pan Am. Bank, 136 So. 2d 656 (Fla. App. 1962), *aff'd*, 149 So. 2d 45 (Fla. 1963); Scott v. P. Lorillard Co., 108 N.J. Eq. 153, 154 Atl. 515 (Ch. 1931); see 11 FLETCHER, PRIVATE CORPORATIONS § 5352 (perm ed. rev. repl. 1958).

12 See BALLANTINE, CORPORATIONS § 239 (1946); 11 FLETCHER, *op. cit. supra* note 11, § 5350.

13 De Martini v. Scavenger's Protective Ass'n, 3 Cal. App. 691, 40 P.2d 317 (1935); Prater v. Commonwealth, 216 Ky. 440, 288 S.W. 342 (1926); Shaw v. Ansaldi Co., 178 App. Div. 589, 165 N.Y. Supp. 872 (1917).

14 Metropolitan Trust Co. v. Becklenberg, 300 Ill. App. 453, 21 N.E.2d 152 (1939).

15 Redhead v. Iowa Nat'l Bank, 127 Iowa 572, 103 N.W. 796 (1905).

16 Beneficial Corp., 18 T.C. 396 (1952), *aff'd per curiam*, 202 F.2d 150 (3d Cir. 1953).

17 58th St. Plaza Theatre, Inc. v. Commissioner, 195 F.2d 724 (2d Cir. 1952), *cert. denied*, 344 U.S. 820 (1952).

18 Elizabeth Susan Strake Trust, 1 T.C. 1131 (1943).

19 Paramount-Richards Theatres v. Commissioner, 153 F.2d 602 (5th Cir. 1946).

20 See WARREN & SURREY, FEDERAL INCOME TAXATION 123 (1963), in which the authors declare that a distribution may be a dividend for tax purposes although not a formal dividend as far as state corporation law is concerned.

corporate law purposes.[21] To that extent, tax cases should have analogical value. Drawing support from the apparent willingness of the courts, evidenced in both corporate and tax law cases, to conceptualize profit distributions as dividends, a court may maintain that tax benefit payments are dividends when it believes the allocation agreement forced upon the minority is inequitable. Therefore, an agreement to pay all of a corporation's tax benefit to a majority stockholder, being a discriminatory dividend, would be unenforceable unless ratified by all shareholders. One state court recently invalidated a distributive agreement on this ground.[22]

The alternative attack on allocation agreements alleges a violation of the well-recognized fiduciary obligation which majority shareholders owe the minority.[23] Although majority stockholders rightfully control a corporation, they may not use that power for their individual advantage.[24] The fiduciary cannot escape his duties merely by contracting with the controlled corporation, for self-serving contracts imposed by a majority shareholder may be rescinded.[25] However, a parent (the majority shareholder of its subsidiary) may deal with its affiliate for profit as long as there is no overreaching or unfairness.[26] Essentially, therefore, the legality of an agreement between a parent and its subsidiary requiring the profit-making corporation to pay the losing corporation those savings created by the consolidated return, turns upon whether there is present the requisite overreaching or unfairness constituting a breach of fiduciary duties.

The lower court, reversed in the principal case, asserted that inasmuch as the subsidiary's directors need not act prophetically when formulating the allocation agreement, the bare fact that subsequent to the agreement the parent operated at a loss and the subsidiary at a profit is no reason to conclude unfairness.[27] As the Appellate Division pointed out, however,

21 See cases cited notes 13-15 *supra*; BALLANTINE, *op. cit. supra* note 12, § 239; 11 FLETCHER, *op. cit. supra* note 11, § 5350.

22 Alliegro v. Pan Am. Bank, 136 So. 2d 656 (Fla. App. 1962), *aff'd*, 149 So. 2d 45 (Fla. 1963). This case is not to be confused with the Tax Court case cited in note 16 *supra*, which held that for *tax* purposes an allocation to a parent of tax benefits received by a subsidiary from a consolidated return is a dividend. The Florida case held the allocation to be a dividend for corporate law purposes, requiring ratification by all shareholders before being legal because of its discriminatory distribution.

23 *E.g.*, Southern Pac. Co. v. Bogart, 250 U.S. 483 (1918); Perlman v. Feldman, 219 F.2d 173 (2d Cir. 1955), *cert. denied*, 349 U.S. 952 (1955); Seventeen Stones Corp. v. General Tel. Co., 204 F. Supp. 885 (S.D.N.Y. 1962); Kavanaugh v. Kavanaugh Knitting Co., 226 N.Y. 185, 123 N.E. 148 (1919); see BERLE, *Corporate Powers as Powers in Trust*, 44 HARV. L. REV. 1049 (1931).

24 Pepper v. Litton, 308 U.S. 295, 311 (1939); Seventeen Stones Corp. v. General Tel. Co., *supra* note 23; Rank Organization Ltd. v. Pathe Labs., 33 Misc. 2d 748, 227 N.Y.S.2d 562 (Sup. Ct. 1962); Kavanaugh v. Kavanaugh Knitting Co., *supra* note 23.

25 Consol. Rock Co. v. Dubois, 312 U.S. 510 (1941); Ripley v. International Rys. of Central America, 8 N.Y.2d 430, 171 N.E.2d 443, 209 N.Y.S.2d 289 (1962); see HENN, CORPORATIONS § 241 (1961).

26 Western Pac. R.R. v. Western Pac. R.R., 197 F.2d 994, 1000 (9th Cir. 1952), *rehearing denied*, 206 F.2d 495 (9th Cir. 1953), *cert. denied*, 346 U.S. 910 (1953).

27 Case v. New York Cent. R.R., 232 N.Y.S.2d 702, 705 (Sup. Ct. 1962), *rev'd*, principal case.

no element of prophecy was required to foresee that profits and losses were going to fall as they did. Where it is legitimately questionable who will benefit from the agreement, the lower court's argument appears sound.[28] Nevertheless, because of a parent's dominance over its subsidiary, courts probably will require clear evidence of the initial unpredictability as to which party would benefit from the agreement if in fact the agreement proves to be overwhelmingly in favor of the dominant party.

The dissent in the principal case reasoned that because minority shareholders were no worse off than before the consolidated return and allocation agreement—the money flowing to parent would have gone to the Internal Revenue had the parent-subsidiary agreement not been concluded—there was no violation of the fiduciary duty owed them. In fact, the minority received a small percentage of the tax savings. This argument, however, seems fallacious, for there need not be an absolute dollar loss to minority shareholders before the majority will be deemed to have breached its duty. Tax savings constitute an increase in the subsidiary's net profits, and by placing itself in a disproportionately advantageous position with respect to allocation of the profits, the majority violated its fiduciary duty.[29] Taking into consideration the percentage of total distributable income allocated to minority stockholders, the loss was real and substantial. If the creation of the tax benefit were totally attributable to the parent, such savings would rightfully belong to it. As both majority and dissenting opinions in the principal case attested, however, the parent and subsidiary were both essential parties, each having something of value to contribute to the realization of the tax credit. It would seem basically unfair in such a situation to permit the accrual of all or nearly all the tax benefit to only one party.

The court in the principal case did not suggest a proper distribution of tax benefits. Finding the allocation agreement unenforceable, it returned the savings to the initial beneficiary, the subsidiary. This solution did not deprive the parent of a substantial share of the benefit, since eighty percent would accrue to the parent as a stockholder of the subsidiary. Nevertheless, according to such a distributive system, the parent is rewarded only as a stockholder and not as an essential participant in the consolidated return. It might be argued that the following is a more reasonable method of tax benefit distribution. Since both parties are essential to create the tax credit, it might be argued theoretically that since both the parent (losing party) and the subsidiary (profit-making party) are equally valuable in creating the tax benefit, each should receive fifty percent of the savings

28 See Blaustein v. Pan Am. Petroleum & Transport Co., 293 N.Y. 281, 304, 56 N.E.2d 705, 715 (1944); Everett v. Phillips, 288 N.Y. 227, 232, 43 N.E.2d 19, 20 (1942); Costello v. Costello, 209 N.Y. 252, 262, 103 N.E. 148, 152 (1913).

29 See Pepper v. Litton, 308 U.S. 295, 311 (1939); Western Pac. R.R. Corp. v. Western Pac. R.R. Co., 197 F.2d 994, 1004 (9th Cir. 1952), *rehearing denied*, 206 F.2d 495 (9th Cir. 1953), *cert. denied*, 346 U.S. 910 (1953); Gaines v. Long Mfg. Co., 234 N.C. 340, 67 S.E.2d 350 (1951).

for its participation in achieving the saving. Even with this allocation based on the indispensability of the two corporations' participation in the consolidated return, the parent would still have an eighty-percent stockholder's interest in the benefits accruing to its subsidiary.[30] The result is that the parent would have a ninety-percent interest in the savings and the subsidiary's minority shareholders a ten-percent interest. A scheme which deprives the subsidiary's minority stockholders of any right to the consolidated return benefits is obviously inequitable because the subsidiary corporation is thus deprived of sharing in the tax savings it played an essential role in creating. This was in essence the effect of the allocation agreement in the principal case, which the court correctly held unenforceable. Courts may rely on the illegal dividend theory or find a violation of a fiduciary obligation; but regardless of approach, they are not likely to enforce allocation agreements which require all or nearly all tax savings of subsidiaries to accrue to losing parent corporations.

Thomas B. Ridgley

30 See INT. REV. CODE OF 1954, § 1504.