Volume 20 | Issue 1 Article 11

1974

Federal Income Taxation - Section 482 Adjustment - Commissioner Has No Duty to Make Downward Correlative Adjustment to Parent Corporation's Interest Income from Corporate Group When Adjustment to Reflect Preferential Interest Charges to Some Subsidiaries Generates Income Due to Higher Payments by Other Subsidiaries

James Edward Maule

FEDERAL INCOME TAXATION — SECTION 482 ADJUSTMENT — COMMISSIONER HAS NO DUTY TO MAKE DOWNWARD CORRELATIVE ADJUSTMENT TO PARENT CORPORATION'S INTEREST INCOME FROM CORPORATE GROUP WHEN ADJUSTMENT TO REFLECT PREFERENTIAL INTEREST CHARGES TO SOME SUBSIDIARIES GENERATES INCOME DUE TO HIGHER PAYMENTS BY OTHER SUBSIDIARIES.

Liberty Loan Corp. v. United States (8th Cir. 1974)

Appellee-taxpayer, the parent corporation of a group of 400 consumer finance companies, borrowed approximately $110 million at an effective annual interest rate of 5.5 per cent. Subsequently, the taxpayer advanced the proceeds of the loan to each of its subsidiaries in varying amounts, charging 344 solvent subsidiaries interest at a rate of 5.75 per cent, 27 insolvent subsidiaries no interest, and 28 partially solvent subsidiaries interest at a rate of 5.75 per cent for 6 months and no interest for the other 6 months of the taxable year in question.[1] The Commissioner of Internal Revenue (Commissioner) acting pursuant to authority granted by section 482 of the Internal Revenue Code of 1954[2] (Code), and the regulations promulgated thereunder,[3] adjusted the taxpayer's income to reflect interest income at an effective annual rate of 5.0 per cent from the 55 insolvent subsidiaries. No adjustment was made to the income derived by the taxpayer from the 5.75 per cent interest charges made to the solvent subsidiaries. The interest expense deductions of the insolvent subsidiaries were correspondingly increased.[4] The taxpayer paid the resultant income tax assessment and sued for a refund.[5]

---

1. The parties stipulated that this method of borrowing was the most efficient, if not the only, means available to the subsidiaries for obtaining cash to carry on their business. As a group the subsidiaries and parent were much less a credit risk than they would have been on an individual basis. Liberty Loan Corp. v. United States, 498 F.2d 225, 226 n.2 (8th Cir.), *cert. denied,* 95 S. Ct. 680 (1974). The interest rates charged to the subsidiaries were determined by the taxpayer-parent after it made each semi-annual evaluation of the financial condition of the subsidiaries, and any subsidiary determined to be insolvent was not charged interest on its loan for that 6-month period. *Id.* at 227 n.4.

2. The section states:

> 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 such organizations, trades, or businesses.

INT. REV. CODE of 1954, § 482.

3. Treas. Reg. § 1.482–1, T.D. 6952, 1968–1 CUM. BULL. 218; Treas. Reg. § 1.482–2(a) (1968). Relevant text appears in notes 40 and 41 *infra.*

4. 498 F.2d at 227. The income tax liabilities of these subsidiaries were not affected; the deductions allowed by the IRS merely increased the net losses of the insolvent subsidiaries.

5. The amount of tax in dispute was in excess of $246,000. *Id.* at 226.

The trial court accepted the taxpayer's argument that since its total interest expense was equal to its interest income from the subsidiaries, no additional income should have been imputed by the Commissioner.[6] The trial court therefore found no distortion in the taxpayer's income and held that the Commissioner had abused his discretion by applying the provisions of section 482 and its regulations to the taxpayer's income rather than to the subsidiaries'.[7] The United States Court of Appeals for the Eighth Circuit reversed, *holding* that the Commissioner's adjustment of the taxpayer's income was not an abuse of his discretion[8] since it was made in accordance with the regulations promulgated under section 482.[9] *Liberty Loan Corp. v. United States,* 498 F.2d 225 (8th Cir.), *cert. denied,* 95 S. Ct. 680 (1974).

The principle underlying section 482 is that a taxpayer should not be able to obtain a tax advantage not generally available to other taxpayers solely on account of an ability to manipulate the accounts of another taxpayer over which the first has control. Since Congress found it difficult to particularize remedies for such situations, it gave the Commissioner, through section 482, the discretion to determine the necessity and nature of adjustments to be made to a taxpayer's income tax return.[10] The Treasury proclaimed the philosophy of its approach in its section 482 regulations:

> The purpose of section 482 is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer, by determining, according to the standard of an uncontrolled taxpayer, the true taxable income from the property and business of a controlled taxpayer.[11]

And yet, although section 482 and its predecessors[12] had existed since 1921 in form and with wording very similar to that of the current statute, litigation involving the proper application of this section of the Code had been very infrequent until recently.[13] In *Tennessee-Arkansas Gravel Co.*

---

6. Liberty Loan Corp. v. United States, 359 F. Supp. 158, 164 (E.D. Mo. 1973).

7. *Id.* at 164.

8. The court stated:

> The regulations under § 482 specifically require that the method of allocating and apportioning income "shall be determined with reference to the *substance* of the particular transactions . . . ."

498 F.2d at 227, *citing* Treas. Reg. § 1.482-1(d)(1), T.D. 6952, 1968-1 CUM. BULL. 218 (emphasis added by the court).

9. Treas. Reg. § 1.482-2(a) (1968).

10. *See* note 2 *supra.*

11. Treas. Reg. § 1.482-1(b)(1) (1968).

12. Int. Rev. Code of 1939, ch. 1, § 45, 53 Stat. 25; Act of Nov. 23, 1921, ch. 136, § 240(d), 42 Stat. 260.

13. Informative and extensive analyses of recent section 482 problems can be found in Berger, Gilman & Stapleton, *Section 482 and the Nonrecognition Provisions: An Analysis of the Boundary Lines,* 26 TAX LAW. 523 (1973); Eustice, *Tax Problems Arising from Transactions Between Affiliated or Controlled Corporations,* 23 TAX L. REV. 451 (1968); Hewitt, *Section 482 — Reallocation of Income and Deductions Between Related Persons — Up to Date,* N.Y.U. 22ND INST. ON FED. TAX. 381 (1964); Jenks, *The "Creation of Income" Doctrine: A Comment on the Proposed Section 482 Regulations,* 43 TAXES 486 (1965); Jenks, *Treasury Regulations Under*

v. Commissioner,[14] the Court of Appeals for the Sixth Circuit held that the Internal Revenue Service (IRS) could not create rental income for a corporation which had loaned equipment to another corporation formed by the same stockholders.[15] Eleven years later, the Tax Court in *Smith-Bridgman & Co.*[16] held that a subsidiary which had made an interest-free loan to its parent was not required to accrue interest income.[17] In response to these decisions, the Treasury issued a limited acquiescence and explanation in which it contended that its interpretation of section 482 had not been accepted by the courts because the Commissioner had not offered to make a correlative adjustment to the taxpayer's related corporation.[18] At about the same time, steps were taken which eventually resulted in the issuance of the current regulations.[19] The IRS received another setback in *Huber Homes, Inc.*,[20] in which the Tax Court held that the economic benefit accruing to the taxpayer's subsidiary upon the transfer to it of rental units at a less-than-arm's-length price was not income taxable to the parent as long as the subsidiary did not sell the units and thereby cause the income to be realized by the group; the existence or lack of a correlative adjustment was held irrelevant because the IRS had no authority to create income.[21] Subsequently, the Tax Court developed its tracing test: a section 482 adjustment to the income of a group member by the Commissioner could properly be made only if the transaction under review had resulted in any group member's realization of income from a source outside the group.[22] However, the Court of Appeals for the Second Circuit, in *B. Forman & Co. v. Commissioner,*[23] accepted the IRS' contention that the correlative adjustment was the determinative factor in reviewing the

---

Section 482, 23 TAX LAW. 279 (1970); Loening, *Section 482: Allocation Resulting in the Creation of Income or in Constructive Dividends to Shareholders,* N.Y.U. 30TH INST. ON FED. TAX. 1247 (1972); Nauheim, B. Forman & Co., Inc. — *A Crucial Test of the Future of Section 482,* 26 TAX LAW. 107 (1972); Nicholson, *Intercompany Accounting Among Related Companies: Maintaining Proper Records to Meet Section 482,* N.Y.U. 26TH INST. ON FED. TAX. 665 (1968); Seieroe & Gerber, *Section 482 — Still Growing at the Age of 50,* 46 TAXES 893 (1968); Spaeth, *Section 482 — Past and Future,* 47 TAXES 45 (1969); Waris, *What's New in Section 482? The Proposed Regulations — First Installment,* 43 TAXES 614 (1965).

14. 112 F.2d 508 (6th Cir. 1940).
15. *Id.* at 510.
16. 16 T.C. 287 (1951).
17. *Id.* at 294.
18. Rev. Rul. 67-79, 1967-1 CUM. BULL. 117. An adjustment to a taxpayer's income (or deductions) which is based upon a transactional relationship with another taxpayer should be reflected on that other taxpayer's books. *E.g.,* an increase in the purchase price paid by *A* to *B* for an item should not only increase *B*'s income, but also *A's* expense deduction. *Id.* at 118. *See* Treas. Reg. § 1.482-1(d)(2), T.D. 6952, 1968-1 CUM. BULL. 218, 219-20.
19. *See* note 3 *supra.*
20. 55 T.C. 598 (1971).
21. *Id.* at 607-08.
22. P.P.G. Indus., Inc., 55 T.C. 928, 1009-10 (1970).
23. 453 F.2d 1144 (2d Cir.), *cert. denied,* 407 U.S. 934 (1972).

Commissioner's discretionary actions under section 482.[24] The conflict between the courts of appeals and the Tax Court sharpened when the Tax Court, in *Kerry Inv. Co.,*[25] and in *Kahler Corp.,*[26] reaffirmed its adherence to the tracing test, a standard which was ultimately rejected by the respective courts of appeals.[27] The instant case was significant because it presented for the first time a section 482 situation in which more than two group members were parties to the occurrence under review.[28]

Faced with this conflict a majority[29] of the *Liberty Loan* court first rejected the taxpayer's group loan argument which had been accepted by the district court.[30] The court determined that the taxpayer's loans to its subsidiaries were made on an individual basis.[31] Additionally, the court accepted the IRS' contention that the concept of a group loan was meaningless since the taxpayer's creditor would have access to the subsidiaries' assets whether the loan was on an individual or group basis.[32] Finally, the court rejected for three reasons the notion that the insolvent subsidiaries were actually indebted to the solvent ones for the interest differential paid. First, no adjustments had been made on the balance sheets of the subsidiaries to reflect such transactions.[33] Second, 27 of the insolvent subsidiaries had paid the taxpayer 5.75 per cent interest for 6 months.[34] Third, the stipulation of the taxpayer that the subsidiaries had been charged various rates *by the parent* was inconsistent with the group loan inter-subsidiary loan premise.[35]

24. *Id.* at 1156. Thus, since that adjustment is nonetheless a regulatory requirement (*see* note 18 *supra*), the only limitation upon the Commissioner's discretion is the nature of the correlative adjustment. *See* notes 64–71 and accompanying text *infra.*

25. 58 T.C. 479 (1973).

26. 58 T.C. 496 (1973).

27. Shortly before the instant case was decided, *Kahler* was reversed by the Court of Appeals for the Eighth Circuit. Kahler Corp. v. Commissioner, 486 F.2d 1 (8th Cir. 1973). Shortly after the decision of the instant case, *Kerry* was reversed by the Court of Appeals for the Ninth Circuit. Kerry Inv. Co. v. Commissioner, 500 F.2d 108 (9th Cir. 1974). Neither court of appeals was required to reach the question of the characterization of the correlative adjustment in a group setting. *See* notes 67–72 and accompanying text *infra.*

28. *See* notes 67–77 and accompanying text *infra.*

29. Senior Circuit Judge Van Oosterhout dissented.

30. *See* note 6 and accompanying text *supra.*

31. The evidence was that the taxpayer advanced the funds to each subsidiary in separate transactions independent of those with the other subsidiaries. The record also showed that each subsidiary issued a promissory note to the taxpayer for the amount of its loan, and there appeared on the balance sheet of each subsidiary a note payable to its parent. 498 F.2d at 227.

32. *Id.* at 228.

33. *Id.*

34. *Id.* The subsidiaries' obligations thus ran directly to the parent-taxpayer. If the taxpayer's premise were sound, the subsidiaries insolvent at the end of the first 6 months but solvent at the end of the second 6 months should have paid to the parent 5.5 per cent interest and the balance (.25 per cent) to the subsidiaries which had been solvent at the end of the first 6 months.

35. *Id.* This was more than a procedural argument. Had it been shown or stipulated that the rate charged was uniform, the IRS would have made an adjustment only if that rate were not within the limits specified in regulation section 1.482-2(a)(2).

Having disposed of the group loan theory, the court proceeded to find that the method of intragroup interest expense allocation used by the taxpayer was a distortion of the taxpayer's and its subsidiaries' taxable incomes. By incidentally shifting interest expense deductions to the subsidiaries with income — an apportionment device not available to entities dealing on an arm's length basis[36] — the members of the taxpayer's group were able to realize tax savings which would be otherwise unattainable.[37] The taxpayer's net worth was thereby increased. The court stated, however, that it did not face a creation of income question since the subsidiaries had loaned the funds to consumers at much higher interest rates.[38]

The court then brushed aside one of the taxpayer's objections by holding that the IRS could increase the interest income of the parent before increasing the interest expense deductions of the insolvent subsidiaries because the correlative adjustment required by regulation section 1.482–1(d)(2) had the effect of making the net result of the adjustments the same despite any reversal of the order of their timing.[39]

The adjustment made by the IRS on account of the distortion of the taxpayer's income was found by the court to be a proper exercise of the Commissioner's discretion. The court looked to regulation section 1.482–2(a)(2)[40] in order to determine the arm's length standard required by

---

Such a case would have been a pure creation of income situation; the court would have faced no greater a problem than that faced in *Kerry* and *Kahler*.

36. *See* note 11 and accompanying text *supra*.

37. The IRS would not have interfered with the members' returns had the accounting distortion resulted in a tax disadvantage to the group. *See* note 59 *infra*.

38. 498 F.2d at 227 n.3. This was not an affirmation of the tracing test although it may have appeared to be such. The court did find a distinction between the instant case and *Forman* and the Tax Court decisions based on a misconception of the "creation of income" concept; the court then decided that it was meaningless in this case. *See* notes 86–88 and accompanying text *infra*.

39. *Id.* at 228–29.

40. The regulation in pertinent part reads:

> For the purposes of this paragraph, the arm's length interest rate shall be the rate of interest which was charged, or would have been charged at the time the indebtedness arose, in independent transactions with or between unrelated parties under similar circumstances. . . . [T]he arm's length rate for purposes of this paragraph shall be—
>
> (i) The rate of interest actually charged if at least 4 but not in excess of 6 percent per annum simple interest,
>
> (ii) 5 percent per annum simple interest if no interest was charged or if the rate of interest charged was less than 4, or in excess of 6 percent per annum simple interest, unless the taxpayer establishes a more appropriate rate under the standards set forth in the first sentence of this subparagraph. For the purposes of the preceding sentence if the rate actually charged is greater than 6 percent per annum simple interest and less than the rate determined under the standards set forth in the first sentence of this subparagraph, or if the rate actually charged is less than 4 percent per annum simple interest and greater than the rate determined under the standards set forth in the first sentence of this subparagraph, then the rate actually charged shall be deemed to be a more appropriate rate under the standards set forth in the first sentence of this subparagraph.

Treas. Reg. § 1.482–2(a)(2) (1968).

regulation section 1.482-2(a)(1).[41] Applying the regulation literally, the court found that although the 5.75 per cent charge to the 344 subsidiaries was within the 4.0 per cent to 6.0 per cent safe haven range, the imposition of an adjustment based upon a 5.0 per cent charge[42] was nevertheless proper since the rates charged to the insolvent subsidiaries were below the 4.0 per cent rate and the prevailing rate. The taxpayer contended that the Commissioner should have been compelled to reduce concomitantly the amount paid by the 344 solvent subsidiaries to an amount based on a 5.0 per cent rate. In addition to the fact that the 5.75 per cent rate charged to those subsidiaries was within the safe haven range the court noted that such an adjustment would move the eventual rate paid by those subsidiaries even further away from the prevailing arm's length market rate.[43]

Finally, the court denied the taxpayer its offset claims. The court held that the regulations[44] limit offsets to transactions between the same two members which were involved in the transaction under scrutiny;[45] here, the benefits would have accrued to other group members.[46] Moreover, the court recognized that offsets are limited to vertical, parent-subsidiary, and not horizontal, subsidiary-subsidiary, transactions.[47] The taxpayer's failure to give the IRS timely notification of its decision to claim an offset[48] was held against it.[49] The inapplicability of the offset regulation[50] to situations involving the imposition of an adjustment based upon a deemed 5.0 per

---

41. The regulation states:

> Where one member of a group of controlled entities makes a loan or advance directly or indirectly to, or otherwise becomes a creditor of, another member of such group, and charges no interest, or charges interest at a rate which is not equal to an arm's length rate as defined in subparagraph (2) of this paragraph, the district director may make appropriate allocations to reflect an arm's length interest rate for the use of such loan or advance.

Treas. Reg. § 1.482-2(a)(1) (1968).

42. The interest paid by the 55 subsidiaries was, of course, allowed as a credit thereon.

43. 498 F.2d at 230. Such an adjustment would have placed the taxpayer in a tax position less advantageous than that which it had enjoyed prior to the IRS adjustment, but more advantageous than that imposed by the IRS.

44. Treas. Reg. § 1.482-1(d)(3), T.D. 6952, 1968-1 CUM. BULL. 218, 220-21.

45. In this case, then, the court would look only to parent-subsidiary transactions and not subsidiary-subsidiary transactions.

46. 498 F.2d at 230-31.

47. *Id.* at 231, *quoting* Jenks, *Treasury Regulations Under Section 482,* 23 TAX LAW. 279, 285-86 (1970).

48. *See* Treas. Reg. § 1.482-1(d)(3), T.D. 6952, 1968-1 CUM. BULL. 218, 220-21.

49. 498 F.2d at 231.

50. Treas. Reg. § 1.482-1(d)(3), T.D. 6952, 1968-1 CUM. BULL. 218, 220-21.

cent interest rate was given by the court as a further reason to bar the taxpayer's offset claims.[51]

The pointed dissent, expressing its admiration for the district court opinion, and citing it extensively, concluded that the group loan theory was correct since the group acted as a whole and the taxpayer claimed as an interest expense deduction an amount equal to the interest income charged to the subsidiaries.[52] It made a point of distinguishing *Kahler* and *Forman* by noting that in those cases the parent taxpayer had made no interest charges to the subsidiaries.[53] Finally, the dissent postulated that the shifting of the interest burden to certain subsidiaries and the relieving of other subsidiaries of that expense had a legitimate business purpose and was not tax evasion within the meaning of section 482.[54]

The court's initial rejection of the taxpayer's group loan argument was strongly supported by the facts of the case.[55] The remote possibility that the results sought by the taxpayer *could* have occurred in an arm's length transaction was not the determinative factor in deciding what *would* have occurred in an arm's length transaction.[56] Nor was the dissent's opinion that the taxpayer in its group action was not attempting to evade income tax meaningful in light of the language of section 482.[57]

Section 482 was designed to prevent misallocation of income among members of a group of controlled taxpayers.[58] In the instant case, the effect of the interest-free loans was to distort the net worth, and thus the taxable income, of the taxpayer.[59] The court was not deterred by the

---

51. 498 F.2d at 231–32. The court's analysis was a proper reading of regulation section 1.482-1(d)(3), which provides that arm's length means actual market interest rates, and not the deemed rate imposed by regulation section 1.482-2(a)(2), the text of which appears at note 40 *supra*. *See* Treas. Reg. § 1.482-1(d)(3), T.D. 6952, 1968-1 CUM. BULL. 218, 220–21.

52. 498 F.2d at 232–33 (Van Oosterhout, J., dissenting).

53. *Id.* It is submitted that this distinctive fact, without more, is immaterial, as it is only when the analysis underlying its existence is undertaken that the distinction becomes meaningful. *See* note 87 *infra*.

54. *Id.* at 233.

55. *See* note 31 *supra*.

56. The dissent's argument that the group's activity as a whole barred initial IRS adjustment, 498 F.2d at 232–33, would have required that the group be given characteristics of a separate legal entity, which the group was not.

57. Certainly the dissent did not think that the IRS' adjustment was predicated upon the tax evasion basis of section 482; yet the dissent approached the issue as though the word "and" and not the word "or" preceded the section's alternative ground of failure clearly to reflect income. Section 482 has a purpose broader than that of merely eliminating tax evasion. *See* note 2 *supra*, and note 58 and accompanying text *infra*.

58. The actual exercise of power by the controlling corporation invites the use of section 482 as long as that exercise is in a less-than-arm's-length manner. *See* Eustice, *supra* note 13, at 484. *See also* 7 J. MERTENS, THE LAW OF FEDERAL INCOME TAXATION ¶¶ 38.61–.62 (J. Malone rev. ed. 1967).

59. The solvent subsidiaries were in a higher tax bracket than were the insolvent subsidiaries; the group as a whole paid less tax than it would have paid had the interest charges been uniformly allocated; the resultant tax savings thereby increased the parent-taxpayer's net worth.

inconsequential fact that this increase in the taxpayer's net worth was an accrual and not a cash transaction.[60] One corollary of this portion of the court's opinion is that the arm's length remedy of regulation section 1.482-2(a)(1) becomes the test to determine if section 482 should be applied. This is a proper result only if there are no other methods of determining clearly reflected income.[61] Moreover, the regulations define the result of the application of the arm's length standard to be the taxpayer's "true taxable income."[62] Unfortunately, the court failed to recognize affirmatively that its arm's length test had the effect of equating clearly reflected income with true taxable income.[63]

The court resolved the question of the scope of the correlative adjustment without sufficiently discussing its nature. Having determined that an adjustment was necessary because the taxpayer had distorted its income by improperly allocating interest expenses, the court should have discussed the propriety of eliminating the problem by removing the less-than-arm's-length charges and imposing, in their place, the charges as they would have been made at arm's length, which would have resulted in the taxpayer's and subsidiaries' incomes being more clearly reflected than they were as a consequence of the Commissioner's adjustment.[64] The result of this proposed adjustment would have been more consistent with the statutory intent than that achieved by the Commissioner's adjustment. Rather, in a manner which indicated that it did not think the meaning of correlative adjustment had any bearing on the case,[65] the court rejected the taxpayer's contention

60. The creation of taxable income from a situation involving accrual but not cash basis accounting income is consistent with the idea of clearly reflecting income. *See* Hewitt, *supra* note 13, at 398.

61. Some commentators have expressed the opinion that the distinction between the clearly reflected income section 482 test and the arm's length remedy is critical. *See, e.g.*, Berger, Gilman & Stapleton, *supra* note 13, at 531.

62. Treas. Reg. § 1.482-1(a)(6) (1968).

63. This is not necessarily an undesirable result; it is submitted that the court merely did not face the collateral issue of whether this amending effect of the regulations on section 482 was within the congressional tax philosophy.

64. Such an adjustment would have resulted in the application of a uniform 5.5 percent interest charge (the presumed prevailing market rate) to all the subsidiaries. This is not the group loan theory resurfacing in another guise; the group loan theory was advanced by the taxpayer, and accepted by the dissent, in order to contend that *no* IRS adjustment would have been proper.

65. A correlative adjustment, as accepted by the court, would have the same result regardless of the order in which it was made since it is an entry determined by one and not two concepts. A correlative adjustment as proposed in the text accompanying note 64 *supra* would not have the same result as the correlative adjustment made by the IRS. The proposed adjustment would result in a tax liability greater than that on the taxpayer's subsidiaries' returns as initially filed; it would not, however, produce a tax liability as great as that assessed by the IRS. Since the taxpayer's effective tax rate was approximately 52 percent, the proposed adjustment would not alter the parent's tax liability, but would shift the deductions from the taxpaying subsidiaries to the loss subsidiaries. The 344 subsidiaries, as a group, had an effective tax rate less than the taxpayer's and thus the group would pay less additional tax on the interest expense denied them as a useful deduction than it would according

that the IRS should adjust the subsidiaries' tax returns prior to adjusting the taxpayer's return.[66]

In fact, the court, early in its opinion, phrased the issue as one of "whether the Commissioner of Internal Revenue properly exercised his discretion under 26 U.S.C. § 482 and the regulations promulgated thereunder . . . ."[67] Neither the majority, the dissent, the district court, nor even the parties focused on whether the requisite correlative adjustment in a controlled group setting should have been made in light of a complete analysis of the occurrence which was the foundation of the transactions under review.[68] Since the regulations had been drafted in reaction to litigation which had involved transactions between two taxpayers of a controlled group, the court should have examined them to determine whether or not the Commissioner had properly exercised his discretion in using the literal definition of correlative adjustment in this case. The taxpayer's claim for offset relief[69] was in substance, though not in form, a plea for a reshaping of the issue in the terms delineated above.[70] The characterization of correlative adjustment advanced by the IRS and ac-

to the IRS assessment which taxed that interest expense as income to the taxpayer. This may be observed from the table below:

	AS FILED			IRS ADJ.			PROPOSED ADJ.		
	55 subs.	*344 subs.*	*tax-payer*	*55 subs.*	*344 subs.*	*tax-payer*	*55 subs.*	*344 subs.*	*tax-payer*
Income	500	1000	2000	500	1000	2100	500	1000	2000
Expenses	600	600	1500	700	600	1500	700	500	1500
Tax. Inc.	(100)	400	500	(200)	400	600	(200)	500	500
Effective tax rate (%)	—	40	50	—	40	50	—	40	50
Tax	—	160	250	—	160	300	—	200	250
Net income (loss)	(100)	240	250	(200)	240	300	(200)	300	250
Total tax paid by group		410			460			450	
Net worth of group		390			340			350	

(Note: the dollar amounts above are expressed in thousands)

66. The taxpayer was attempting to trap the IRS in a technicality since the IRS had not yet adjusted the subsidiaries' returns; however, the taxpayer was technically incorrect. *See* Treas. Reg. § 1.482-1(d)(2), T.D. 6952, 1968-1 CUM. BULL. 218, 219-20.

67. 498 F.2d at 226 (footnote omitted).

68. The 344 subsidiaries met the interest burden of the 55 subsidiaries in order to maintain the group's favorable credit position. As the 55 subsidiaries which found it inconvenient to pay interest were forced to do so, the amount the 344 subsidiaries were economically willing to pay on a utility theory decreased. This decrease was as much an economic loss worthy of section 482 adjustment as was the economic income of the taxpayer caused by the group's tax savings which was the object of the IRS adjustment.

69. *See* Treas. Reg. § 1.482-1(d)(3), T.D. 6952, 1968-1 CUM. BULL. 218, 220-21.

70. The court claimed that the district court's viewing the taxpayer's group as an entity had the effect of requiring the Commissioner to grant offset relief; since the present situation was not one which properly required the application of offsets, the court arguably would invalidate *any* theory whose application would produce the same results. 498 F.2d at 230. The validity of such reasoning is suspect.

cepted by the court was fictitious.[71] The meaning of "correlative" is intrinsically related to the words, "apportion," "allocate," and "distribute" which appear in section 482.[72] The court, commenting that "no creation of income problem is involved,"[73] took the first step toward analyzing the reconstruction of the subsidiaries' interest expense deductions but did not follow through on this approach.[74] Ironically, no creation of income problem existed in this case; it was the court's support of the adjustment made by the Commissioner which caused the eventual creation of nonexistent income.[75] The correlative adjustment serves no purpose unless it puts *all* the members of a controlled group in parity with uncontrolled taxpayers in the same situation.[76] The court analyzed the propriety of the Commissioner's adjustment by rigidly applying the regulations[77] to the situation which was before it, but overlooked the faults of the underlying principles of the Commissioner's case.[78]

The court never considered the fact that "between or among" rather than merely "between" was used by the drafters of regulation section 1.482-1(b)(1). That wording should negate any supposition, such as the one inherent in the Commissioner's argument, that the correlative adjustment must be made on an individual, member-to-member basis.[79]

---

71. One commentator expressed the IRS' attachment to fiction very well:

> The basic inconsistency of the Treasury is that in invoking Section 482 in the first instance it utilizes the concept of the controlled corporations or entities involved as an integrated or unitary person and yet, in making the Section 482 adjustment, it fragments the unit and creates income with respect to one part of the whole although when the whole is examined as an entity it realizes no income.

Waris, *supra* note 13, at 632.

72. Nowhere in the legislative history of section 482 is the word "attribution" found. *See* Lewis, *Tax Court in* Huber Homes *Holds that the IRS May Not Use 482 to Create Income,* 34 J. TAX. 208 (1971).

73. 498 F.2d at 227 n.3.

74. This court is not the first to omit a determination of whether the basic principle of tax law underlying its decision is tax avoidance, assignment of income, general deduction theory, or clear reflection of income. *See* Eustice, *supra* note 13, at 483. *See also* Seieroe & Gerber, *supra* note 13, at 899-902.

75. The legislative history of section 482 indicates that it was designed to be a revenue maintenance and not a revenue producing measure. *See* Waris, *supra* note 13, at 628.

76. This was what the courts in the early section 482 cases meant by correlative adjustment. In each case the court focused upon a taxpayer and its related entity, and quite properly required compensatory adjustments. Thus, by looking at both entities, the court was also looking at the group. The 1954 version of the Code did not change the wording of the 1939 version upon which the court decisions unfavorable to the IRS had been based. *See* Hilinski, *New 482 Regs Decrease Latitude of Agents but Still Place Heavy Burden on Business,* 23 J. TAX. 102, 105 (1965).

77. Treas. Reg. § 1.482-2(a)(2) (1968).

78. Although the court had previously equated the meaning of true taxable income with that of clearly reflected income and had made arm's length dealing the test of section 482 applicability, it had not consciously recognized the impact of its reasoning. *See* notes 61-63 and accompanying text *supra.*

79. The adjustment made by the IRS was the sum of many taxpayer-subsidiary adjustments. The adjustment proposed in the text accompanying note 64 *supra* cannot be broken down into conceptually meaningful one-to-one adjustments, other than that adjustment required to eliminate the taxpayer's charges and to impose others.

The court also, in strictly applying the regulations, never reached and thus never answered the question of why a taxpayer which, because of the circumstances of its particular situation, might have charged a *few* subsidiaries interest at a rate far in excess of the prevailing arm's length rate and most of its subsidiaries no interest in order to meet its interest obligations, would have had the interest expense deductions of all the subsidiaries readjusted by the IRS to become interest expense deductions reflecting interest at a 5.0 per cent rate,[80] when such a result would have more favorable tax consequences than those faced by the taxpayer in the instant case, and when the situation would have been distinguishable from the instant case only by the number of financially troubled subsidiaries.[81] Had the court reached this question of the discriminatory nature of the regulations as applied to a group, rather than to a single transaction situation, it would have recognized the necessity of interpreting the meaning of correlative adjustment.[82]

Finally, in refusing to adjust the interest expense deductions of the 344 subsidiaries, the court created an artificial distinction, in terms of clearly reflected income, between the taxpayer's desired 5.75 per cent to 5.5 per cent adjustment and the IRS's 0 per cent to 5.0 per cent and 2.875 per cent to 5.0 per cent adjustments.[83] There are no objective criteria to determine interest rates in the bracket below the prevailing arm's length rate and each correlative adjustment based upon interest rate variations in this bracket is as meaningful or as meaningless as another. None should have been given judicial support to the exclusion of others solely on account of unexamined and arguably defective regulations.[84] The court's failure to achieve an acceptable result is the consequence of its failure to decide whether the regulations were applicable to the instant case[85] and to determine that perhaps they are not the most desirable aids

The adjustment and the correlative adjustment are intertwined in order to conform to the arm's length test in a realistic manner.

80. Application of regulation section 1.482-2(a)(2) to the hypothetical subsidiaries not charged interest would produce the same result as reached in the instant case; however, since the rate charged to the other hypothetical subsidiaries is above 6.0 percent and above the prevailing market rate, regulation section 1.482-2(a)(2) would require adjustment of that rate to 5.0 percent, a result not reached in the instant case since the rate charged to the solvent subsidiaries did not exceed 6.0 percent or the prevailing market rate. Treas. Reg. § 1.482-2(a)(2) (1968).

81. The use of rigid formulae may produce unrealistic results in certain cases. The instant case is one of them. *See* Mansfield, *The 482 Proposed Regs: The Problems with which Practitioners Will Have to Contend,* 28 J. TAX. 66, 71 (1968).

82. *See* notes 64-78 and accompanying text *supra.*

83. Of course, rigid application of regulation § 1.482-2(a)(2) in conjunction with the concept of a group correlative adjustment would result in a 5.75 percent to 5.0 percent — and not 5.5 percent — interest adjustment. The artificiality of the regulations would thereby be more noticeable.

84. "Arm's length" and "clearly reflected income" are concepts which are not helpful in resolving intragroup transactions because substantial agreement on their practical application does not exist. *See* Jenks, *Treasury Regulations under Section 482,* 23 TAX LAW. 279, 312 (1970).

85. At the time the regulations were issued, the cases had been decided contrary to the concepts therein. *See* Jenks, *The Creation of Income Doctrine: A Comment*

(theoretically or pragmatically) towards establishing true taxable income or clearly reflected income in such situations.

The court's tendency to ignore the logical conclusions of its reasoning was illustrated once more by the manner in which it decided that this case did not present a creation of income problem.[86] The reason that no such problem existed was that the court faced, rather, a situation wherein it had to allocate extant income. Instead of recognizing this fact, the court used the tracing test to support its proper, but abandoned, conclusion.[87] The court thereby unnecessarily added to the confusion and debate concerning the tracing test. Since the tracing test had its genesis in assignment of income cases, it has never been a concept which could be adapted to section 482 allocation problems.[88]

The court's decision, then, had the effect of denying the taxpayer the defense that the Commissioner's adjustment is not an allocation within the meaning of section 482. The defense of creation of non-cash and non-accounting income is likewise eliminated since that is precisely what the court permitted the IRS to do. So long as the IRS can show that uncontrolled taxpayers would have transacted differently, it can, by separating occurrences into individual transactions, make only those adjustments which it feels are beneficial to the government, while ignoring the remaining components of the occurrence.[89]

For all multi-entity operations, any tax benefit which influenced the decision to so conduct business is in constant jeopardy of being eliminated. Consequently, other factors which were also conducive to such operations[90] will lose impact in the face of the possible adverse tax consequences.[91] The resulting uncertainty concerning the unpredictability of the Com-

---

on the Proposed Section 482 Regulations, 43 TAXES 486, 490 (1965). Moreover, the retroactive effect of the regulations as applied to the taxpayer's 1961 tax return may be in itself an abuse of discretion, if not a constitutional question. *See* Jenks, *supra* note 84, at 294.

86. *See* notes 73–75 and accompanying text *supra.*

87. The dissent came very close to carrying its argument concerning the distinguishability of *Kahler* and *Forman* to its full conclusion, and had it done so, it would have recognized that the issue should have been expressed in terms of a correlative adjustment in a group, and not in a single transaction situation. Such a distinction existed because the regulations' procedures for adjusting transactions in a single transaction situation do not function satisfactorily in a group context in which the distortion results not from a failure of the taxpayer to recognize income, but from a failure properly to allocate it.

88. This, along with the practical problems of applying the tracing test, had been espoused in the dissent in *Kerry* at the district court level. Upon appeal by the IRS, the Court of Appeals for the Ninth Circuit adopted the dissent's opinion and, one week after the instant case was decided, dealt a severe setback to the tracing test. Kerry Inv. Co. v. Commissioner, 500 F.2d 108 (9th Cir. 1974). For illustrations of the practical problems encountered in applying the tracing test to allocation situations, *see* Nicholson, *supra* note 13, at 671.

89. *See* notes 71 & 75 *supra.*

90. For a list of nontax factors favorably affecting the decision to operate in a multi-entity form, *see* Eustice, *supra* note 13, at 451.

91. *See generally* Spaeth, *supra* note 13.

missioner's decision to exercise his discretion in adjusting income under secton 482 is, understandably, likely to produce anxiety in any business entity.[92]

It is submitted that the Court of Appeals for the Eighth Circuit failed to recognize the critical issue of whether correlative adjustment has a meaning in a group context different from that in a single transaction context. The Commissioner of Internal Revenue has thereby been given a formidable tax-creating weapon: judicial support of rather inflexible and unrealistic regulations which purport to clarify an abstract section of the Internal Revenue Code.

James Edward Maule

92. For an excellent discussion of the indirect problems of a section 482 allocation, *see* O'Connor, *Side Effects of Section 482 Can Be More Serious than Original Allocation*, 28 J. TAX. 322 (1968).