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KERRY INVESTMENT COMPANY: IS TRACING TAXING?

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In June of 1972 the Tax Court of the United States applied section 482 of the Internal Revenue Code[1] and its implementing regulations[2] by allocating to the parent gross income earned by a wholly owned subsidiary through the use of interest-free loans made by its parent.[3] The tax court imposed a new tracing concept requiring the petitioner to show that interest-free loans did not produce gross income, and held that the Commissioner has the power under section 482 to allocate gross income to the parent where the proceeds of interest-free loans produced gross income or could not be traced into non-income producing assets.[4]

The Petitioner, Kerry Investment Company is a Washington corporation. It is a closely held personal holding company with assets consisting of stocks, bond, debentures, notes and contracts receivable. Kerry Timber Company[5] is a wholly owned subsidiary of Kerry Investment. Kerry Investment loaned funds, interest-free, to Timber over a period of years between 1948 and 1966. The loans totalled $505,617.50 at the end of the issue years 1966 and 1967, and were represented by a non-interest bearing contract with a deferred balance of $120,000;[6] non-interest demand notes totalling $326,617.50; and a non-interest bearing open account in the amount of $59,000. Timber used the proceeds of the loans to make various investments, meet current business obligations, and make advancements to tenants. Timber received gross income during the issue years and on its tax return claimed no deduction for interest on the loans made by Kerry Investment.[7] Kerry Investment

[1]INT. REV. CODE OF 1954, §482. Allocation of Income and Deductions Among Taxpayers. Taxpayers.

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 delegates 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.

[2]Treas. Reg. 1.482-1 (1961); Treas. Reg. 482-2 (1968).

[3]Kerry Investment Company, 58 T.C. 479 (1972) [hereinafter referred to as Kerry Investment].

[4]*Id.* at 490.

[5]Hereinafter referred to as Timber.

[6]The Medical Arts Building Company, a wholly owned subsidiary of Kerry Investment until its voluntary dissolution in 1948, sold certain real estate to Timber and the contract of sale was subsequently transferred to Kerry Investment when the Medical Arts Building Company was liquidated. The sale contract provided that the deferred balance was not to bear interest.

[7]Timber did claim deductions for interest paid on loans from the Washington Mutual Savings Bank.

did not receive or accrue any interest income from the loans, or make any contention that the loans were, in reality, a contribution to capital.[8]

The tax court agreed with the Commissioner's action under section 482 holding that where money is loaned on an interest-free basis between related entities,[9] and the borrower realizes gross income from the use of such loans, the Commissioner has the power, under section 482, to allocate a portion of the borrower's gross income to the lender to the extent that the lender cannot trace the proceeds of the loans into non-income producing properties.[10] It was determined that an amount equal to five per cent of the total loans which the petitioner could not trace into non-income producing properties was a reasonable allocation of Timber's gross income to "reflect an arm's length interest rate for the use of such loan or advance."[11] However, it was clearly pointed out that the Commissioner was without authority to make any adjustment under section 482 with respect to funds which did not produce gross income during the issue years.[12]

Section 482 is couched in broad and comprehensive terms giving the Commissioner remedial and discretionary authority to act in order to prevent evasion or clearly reflect income between controlled entities.

The earliest predecessor of section 482 was section 240(d) of the Revenue Act of 1921[13] which authorized the Commissioner to consolidate the accounts of related trades and businesses for the purpose of making an accurate distribution or apportionment of their income. The Revenue Act of 1928[14] expanded the Commissioner's right to "consolidate" accounts to a right to "distribute, apportion or allocate gross income or deductions." Since the Revenue Act of 1928 the language of the current section 482 and its other predecessors[15] has remained substantially the same. The legislative intent has remained basically the same since 1921.[16] The intent of Congress has been to allow the Commissioner to:

[8]A possible defense might have been that the loans were contributions to the capital of Timber and thus excluded from gross income. This defense was not used. 7 J. MERTENS, LAW OF FEDERAL INCOME TAXATION, §38.22 (1967).

[9]Common control is a prerequisite for a §482 allocation.

[10]The court held that placing the burden on the taxpayer was in accord with the general concept of the burden of proof in tax cases and would encourage good record-keeping. Kerry Investment, *supra* note 3 at 489, 490.

[11]*Id.* at 486. Although the five per cent allocation of gross income is technically indistinquishable from an allocation of interest income the reasonableness of five per cent was not challenged.

[12]*Id.* at 490.

[13]REVENUE ACT OF 1921, ch. 136, §240(d), 42 Stat. 227.

[14]REVENUE ACT OF 1928, ch. 852, §45, 45 Stat. 791.

[15]REVENUE ACT OF 1934, ch. 277, §45, 48 Stat. 680; INT. REV. CODE OF 1939, §45, 54 Stat. 725.

[16]Spaeth, *Section 482—Past and Future*, 47 TAXES 45, 46 (1969).

> . . . distribute the income or deductions between or among (commonly controlled taxpayers) . . . , as may be necessary in order to prevent evasion (by the shifting of profits, the making of fictitious sales, and other methods frequently adopted for the purpose of 'milking'), and in order to clearly reflect their true tax liability.[17]

Although the code and its legislative history are uncluttered and relatively simple the case precedents have not allowed such a pattern.

In *Tennessee-Arkansas Gravel Co. v. Commissioner*[18] the petitioner rented river equipment to a wholly owned subsidiary, Mississippi Sand and Gravel Co. Pursuant to an oral agreement, a previously agreed rental of $1,000 a month was not charged during the issue year. Under the authority of section 45 of the Revenue Act of 1934[19] the Commissioner assessed $12,000 of *rental income*[20] to the petitioner. Although the Board of Tax Appeals[21] sustained the Commissioner's action the sixth circuit reversed, holding that the Commissioner made no attempt to allocate any portion of the subsidiary's gross income. The circuit court held that the Commissioner had simply charged the petitioner with rental income and that section 45 "did not authorize the Commissioner to set up income where none existed."[22] In *Smith-Bridgman & Co.*,[23] the petitioner, a wholly owned subsidiary, made non-interest bearing loans to its parent in order that the parent could retire certain outstanding debentures. The Commissioner used the authority of section 45 of the Internal Revenue Code of 1939[24] to increase the petitioner's net income by adding $5,865.50 in *interest income.* The tax court held that the Commissioner had created income out of a transaction where no income was realized:

> That the respondent did not 'allocate' gross income of Continental is apparent, since the record shows no adjustment to the income or deductions of Continental.[25]

The Commissioner initially acquiesced in the *Smith-Bridgman* holding.[26] However, this acquiescence was later explained on the basis of concurrence in the result only, a result which the Commissioner believed to be due to his procedural failure to make correlative adjustments in gross income of the parent.[27]

[17] H.R. REP. No. 2, 70th Cong., 1st Sess. 16-17 (1928).
[18] Tennessee-Arkansas Gravel Co. v. Commissioner, 112 F.2d 508 (6th Cir. 1940) [hereinafter referred to as Tennessee-Arkansas Gravel].
[19] REVENUE ACT OF 1934, ch. 277, §45, 48 Stat. 680.
[20] The statutory notice of deficiency purported to assess rental income instead of allocating a portion of the borrower's gross income.
[21] Tennessee-Arkansas Gravel, 7P-H BTA Mem. 416 (1938).
[22] Tennessee-Arkansas Gravel, *supra* note 18 at 510.
[23] Smith-Bridgman & Company, 16 T.C. 287 (1951) [hereinafter referred to as Smith-Bridgman & Co.].
[24] INT. REV. CODE OF 1939, §45, 53 Stat. 725.
[25] Smith-Bridgman & Co., *supra* note 23 at 294.
[26] 1951-1 CUM. BULL. 3.
[27] Rev. Rul. 67-79; 1967-1 CUM. BULL. 117.
At least some commentators were in agreement with the Commissioner's explanation. Plumb and Kapp, 41 TAXES 809, 815 (1963).
B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS (1971).

In 1968 the Treasury Department promulgated new regulations under section 482. The new regulations were intended to redefine and delineate the implementation and application of section 482 to certain specific transactions (e.g., interest-free loans) between controlled taxpayers.[28] The purpose of the new regulations was to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer, and the standard to be applied was that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer.[29] The first case involving interest-free loans decided under the new regulations was *PPG Industries, Inc.*[30] PPG made interest-free loans to its wholly owned Brazilian subsidiary (Pittsburco) in 1940. In 1960 the Commissioner attempted to allocate a portion of Pittsburco's gross income to PPG. The tax court, without deciding the validity of the regulation under section 482 or deciding whether the Commissioner was authorized to make an allocation of income which is "indistinguishable from the imputation of an interest charge," held that not even the "most tenuous connection" existed between the 1940 loans and the 1960 gross income of Pittsburco.[31] The tax court simply could not believe that the 1940 interest-free advances were the transaction out of which the 1960 gross income was realized and thus held that section 482 was inapplicable. It was indicated that the Commissioner's procedural failure to make correlative adjustments in *Smith-Bridgman* would not be a sufficiently controlling factor to distinguish *Smith-Bridgman.*[32]

A few days after the decision in PPG Industries the tax court decided *Huber Homes, Inc.*[33] Huber Homes, the petitioner, transferred 52 homes to a subsidiary at cost. The homes were rented by the subsidiary, and although a loss was sustained on the rental, the Commissioner determined that income should be allocated to the petitioner to the extent of the excess of fair market value of the homes over the sales price to the subsidiary. The Commissioner's determination was held to be unauthorized under section 482:

> [T]he Commissioner does not here contend that any of Huber Investment's gross rental income was not earned by it or that any portion of its income should be allocated to Huber Homes. Rather the Commissioner is purporting to exercise his authority under section 482 to create income. . . .[34]

Without passing on the validity of the regulations at issue the Court held that the regulations were inapplicable in a situation where there

[28]Treas. Reg. 1.482-2(a) (1968) (Loans or advances); Treas. Reg. 1.482-2(b) (1968) (Performance of services for another); Treas. Reg. 1.482-2(c) (1968) (Use of tangible property); Treas. Reg. 1.482-2(d) (1968) (Transfer or use of intangible property); Treas. Reg. 1.482-2(e) (1968) (Sales of tangible property).

[29]Treas. Reg. 1.482-1(b)(1) (1961).

[30]PPG Industries, Inc., 55 T.C. 928 (1970).

[31]*Id.* at 1009.

[32]*Id.*

[33]Huber Homes, Inc., 55 T.C. 598 (1971).

[34]*Id.* at 607.

was no intention to resell,[35] where the houses were converted for rental purposes and where they did not appear to be productive of any net income whatever.

The trend of these cases was disappointing from the Commissioner's viewpoint until the decision of the second circuit in *B. Foreman Company v. Commissioner.*[36] The tax court had held that the requisite control necessary for an application of section 482 was not present and thus did not decide the question of whether the Commissioner was authorized to make an allocation of income.[37] The circuit court reversed the tax court on the issue of control and then went on to hold, as valid, both the regulations and the Commissioner's allocation of five per cent interest income to the petitioner as a result of interest-free loans made by the petitioner to a related entity. It is not entirely clear from the decision whether the borrower had gross income.[38] However, it is clear that an allocation indistinguishable from an imputation of interest charges was held to be authorized. *B. Foreman* thus became a definite departure from the position of the tax court in the precedent cases.

The previously discussed cases formed the underpinning of the *Kerry Investment* decision. *Smith-Bridgman* and *Tennessee-Arkansas Gravel* were distinguished on the ground that there was gross income and that it was evidenced by correlative adjustments in the borrower's income.[39] *PPG Industries* was distinguished on the basis that there was a definite tie between the interest-free loans and Timber's gross income in the year in question.[40] *Huber Homes* was distinguished:

> The court also stated at 610, [referring to Huber Homes decision] perhaps in anticipation of a case like the present one:
>
> "But if as a consequence of . . . use or consumption by the transferee (of goods or services transferred to it at less than arm's length prices), income is realized within the controlled group, an entirely different question would be presented. . . ."[41]

Although the Commissioner purported to allocate *interest income* in the statutory notice of deficiency the court held that the notice could have been more "artfully worded" but that the petitioner was sufficiently put on notice of the deficiency.[42] Accordingly, the Commissioner was not bound by the exact wording of the statutory notice of deficiency. The

[35]The validity of a distinction between the intention to resell a bargain-purchase and the intention to rent the proceeds of a bargain has been questioned. Broder, *Section 482 of the Internal Revenue Code, The Creation, Allocation and Imputation of Income: Vital Distinctions*, 45 TEMP. L.Q. 91, 96 (Fall 1971).

[36]B. Foreman Company v. Commissioner, 453 F.2d 1144 (2d Cir. 1972) [hereinafter referred to as B. Foreman Co.].

[37]54 T.C. 912, 923 (1970).

[38]The court in *Kerry Investment* noted that the borrower apparently did have gross income during the year in question. Kerry Investment, *supra* note 3 at 490.

[39]*Id.* at 491.

[40]*Id.*

[41]*Id.*

[42]*Id.* at 493.

overall decision was grounded on reasoning that drew an analogy between a bargain sale at less than arm's length and a non-interest loan at less than arm's length. The court reasoned that if one related party sells to another related party at a bargain and then the bargain buyer resells, a portion of the gross income earned by the sale was really made by the original bargain seller.

> Similarly, when a related party makes an interest-free loan, it has done all that is necessary to realize interest income, except charge interest: and some of the gross income which the borrower realizes from the use of the proceeds of the loan has, in reality, been earned by funds of the lender.[43]

Judge Irwin and Judge Forrester were careful to point out, in a concurring opinion, that the tax court was reaffirming its position in disallowing the Commissioner to make section 482 allocations where his only allegation is that interest-free advances were made between related parties, however, the income generatd by the *use and consumption* (court's emphasis) of interest-free loans could be allocated.[44]

The analogy treating an interest-free loan similarly to a bargain sale, and court reasoning based on this analogy (ultimately imposing a tracing concept), suffers from a dramatic analogical point of difference. Money is fungible, money has inherent usable worth, and all money looks alike. Consequently, when interest-free loans are advanced and gross income is realized by the borrower the very nature of money indicates that some portion of the borrower's gross income has been earned through the *use and consumption* of the interest-free funds. In a bargain sale situation the goods must be resold for there to be any income generated by the use of the bargain sale. But in the interest-free loan situation the proceeds of such loans could be traced directly into non-income producing properties and yet the borrower's gross income would inevitably reflect the *use or consumption* of the interest-free loans through the use of other funds which were freed for use by virtue of the interest-free advances. *B. Foreman* made this recognition in conjunction with a plain reading of Treas. Reg. 1.482-2(a) (1).[45] The *Kerry Investment* court, although not bound by the decision in *B. Foreman,* failed to sufficiently distinguish the *B. Foreman* decision and the application of the regulations in that case.[46] *Kerry Investment* affirmed the approval of the regulations in *B. Foreman,* but went on to impose a tracing con-

[43] *Id.* at 485.
[44] *Id.* at 494.
[45] Treas. Reg. 1.482-2(a)(1) (1968) (Loans or advances)
(1) In general. 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 that 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.
[46] In a companion case, *The Kahler Corporation,* 58 T.C. 496 (1972), the court stated that it was of the opinion that the Second Circuit incorrectly delineated both the purpose of section 482 and the circumstances required before the statute could operate in the *B. Foreman* decision.

cept not required by Treas. Reg. 1.482-2(a). The failure to satisfactorily distinguish *B. Foreman* along with the adoption of a tracing concept "inconsistent with the language of section 482 and its implementing regulations. . ." led Judge Featherston to dissent, calling the tracing concept a "mischievous rule" that places a "premium on accounting sophistication and 'lays a trap for the unwary'."[47]

CONCLUSION

The tracing concept is new although hints of its forthcoming could be found between the lines of *PPG Industries* and *Huber Homes*.[48] However, no prior decisions have specifically placed the burden on the petitioner to trace interest-free loans into non-income producing assets in order to escape a section 482 allocation. Despite a certain equitable appeal, the decision cannot easily be reconciled with *B. Foreman* or the plain meaning of Treas. Reg. 1.482-2(a). However, *B. Foreman* appears to be a major departure from any precedent and is not declaratory of the tax court's affirmed position on the "creation of income."[49] There are now three different positions with respect to the treatment of interest-free loans between related entities under section 482. It is too early to ascertain the impact of the *Kerry Investment* decision, although if the case is appealed and the ninth circuit sustains the position of the tax court, a declaration of the application of section 482 to interest-free loans by the Supreme Court of the United States may be in order. Until such time, any corporation contemplating interest-free loans to a subsidiary that is subject to a different tax rate may want to consider interest-free loans that are specifically invested in non-income producing properties.

[47] Kerry Investment, *supra* note 3 at 495.

[48] The *PPG Industries* court found that not even the "most tenuous tie" existed between the 1940 loans and the 1960 gross income and the Huber Homes, Inc. court thought that a different situation would exist if the proceeds of the bargain sale were used or consumed thereby producing gross income within the controlled group. PPG Industries, Inc. *supra* note 30 at 1009; Huber Homes, Inc., *supra* note 33 at 610.

[49] Kerry Investment, *supra* note 3 at 490; The Kahler Corp., *supra* note 46 at 508.