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The Income Tax Aspects of Real Estate Developments by Multiple Corporations

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STUDENT NOTES

The Income Tax Aspects of Real Estate Developments by Multiple Corporations

For the purposes of this note the following factual situation may be assumed: a group of business men wish to develop Blackacre for residential purposes and they seek information as to the advisability of using multiple corporations to accomplish this purpose. This note will deal with the advantages and disadvantages of such incorporations with particular emphasis upon the possible tax consequences involved in light of two recent cases in the area.[1]

The term multiple corporations encompasses the carrying on of a business through several small corporations rather than one

[1] James Realty Co. v. United States, 176 F. Supp. 306 (D.C. Minn. 1959); Aldon Homes, 33 T.C. 582 (1959).

large corporation. Multiple corporations can be classified in two major groups, one known as the horizontal type and the other as the vertical type.[2] Where each corporation operates as a self-sufficient unit and does everything from the commencement to the completion of the project, it is classified as the horizontal type. On the other hand, where each corporation performs a separate function for the entire development and no single entity is self-sufficient, it is known as the vertical type.[3] An example would involve four corporations, all owned by the same parties, which are developing a four hundred acre plot. When each corporation owns one hundred acres, builds its own houses and sells them, it is of the horizontal variety. But when one corporation owns the land, another builds the houses, the third is responsible for finance and the fourth for selling the houses, the result is vertical multiple corporations. Another method of classifying multiple corporations is to divide them into parent-subsidiary groups, where the subsidiary corporations are owned by a parent corporation, and brother-sister groups, where the multiple corporations are owned directly by the same individual shareholders.[4]

The 1954 Code[5] contains several provisions which provide major tax advantages for multiple corporations. Section 11[6] provides for a tax upon corporations of 25% of taxable income for taxable years beginning after June 30, 1960 or a tax of 30% on taxable income for taxable years beginning before July 1, 1960 plus a surtax of 22% for the amount of taxable income over $25,000. As to taxable income exceeding $25,000 a tax of 47% results when the taxable year began after June 30, 1960 and a tax of 52% results when the taxable year began before July 1, 1960. If one corporation has $100,000 of taxable income a tax of $41,500 results if the taxable year began after June 30, 1960, or a tax of $46,500 if the taxable year began before July 1, 1960. Whereas by the use of four multiple corporations a tax of only $25,000 results when the taxable year began after June 30, 1960, or a tax

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[2] Balter, *Selected Tax Aspects of Residential Developments—From the Investor's Point of View*, 38 TAXES 683, 693 (1960).

[3] *Ibid.*

[4] Surrey, *Income Tax Problems of Corporations and Shareholders*, 14 TAX L. REV. 1, 37 (1958-59).

[5] All code sections will be to the 1954 Internal Revenue Code unless otherwise specified.

[6] INT. REV. CODE OF 1954, § 11. However, this "temporary" 30% rate has been extended each year on a year to year basis by Congress.

of $30,000 when the taxable year began before July 1, 1960. This amounts to a tax savings of $16,500 or $5,500 per additional corporation if each corporation earns at least $25,000 (22% of $25,000) regardless of when the taxable year began. Thus, a substantial tax savings can result from the use of many corporations.

Section 531[7] imposes a tax of 27½% on accumulated earnings not in excess of $100,000, plus 38½% of such earnings in excess of $100,000 for any given year. This section is to prevent a corporation from retaining large sums of money above its reasonable needs for any given year and thus avoid distributing the money to its stockholders, in the form of dividends, who in turn would have to include such dividends in their own personal earnings and pay a tax upon them as such. Section 535(c)[8] provides for a $100,000 exemption for each corporation in determining its accumulated earnings. Thus if one corporation attempted to accumulate $400,000 beyond its reasonable needs for that year, a tax of $143,000 would result; however, by the use of four multiple corporations, each with a $100,000 exemption, $400,000 could be accumulated without being subject to the tax under Section 531—a tax savings of $143,000 under these circumstances.

The use of multiple corporations may also result in a third tax advantage. Such incorporation permits the shareholders to withdraw a portion of the profits they need at capital gains rates by liquidating one or more of the multiple corporations, instead of liquidating the whole company in the case of a single corporation, or attempting a partial liquidation which might result in taxation of the distribution as an ordinary dividend.[9]

There are also many non-tax advantages of multiple corporations, the importance of which will be developed later in the note; however, at this time it is important that they be mentioned. By dividing the business concern into several entities, as opposed to one, the possibility of a general claim against the entire project is reduced. The use of multiple corporations also results in limiting the amount of tort liability. Greater ease is obtained in the handling of mechanic's liens.[10] Due to the necessity of dealing with union and non-union labor, the use of such corporations may also be

[7] INT. REV. CODE OF 1954, § 531.
[8] INT. REV. CODE OF 1954, § 535(c).
[9] Huberman, *Income Tax Planning for a Residential Subdivision,* U. So. CAL. 1956 TAX INST. 649, 654.
[10] Aldon Homes, *supra* note 1, at 593.

important in the labor relations area by having separately identified employers for employees on the different phases of an operation.[11] The tax advantages already mentioned are also very important and useful in the attraction of investment capital, as such tax savings will naturally provide a greater return on that capital.

Yet, the use of multiple corporations has certain disadvantages, excluding the additional cost of incorporating and maintaining these separate units. By the use of this method of incorporation, the taxpayer loses the opportunity to offset his losses against income. For example, if only one corporation is involved and it suffers a loss, such loss will be offset against the income of that corporation. However, when multiple corporations are involved and one of the entities suffers a loss without any income to offset it, the loss cannot be offset against the income of the other corporations.[12] The use of consolidated returns partially overcomes this disadvantage, but such returns are not an unmixed blessing since the tax imposed under section 11 is increased by 2% of the consolidated taxable income.[13] Also, the use of consolidated returns may make it very difficult to show that the corporations are each a separate business entity, which is very important under other sections of the code. The biggest problem in this area, however, is whether the Commissioner will permit the taxpayer to receive the tax advantages of multiple corporations.

The Commissioner has various means of attacking multiple corporations. He can allege that the corporations are not viable business entities created for valid business purposes, but on the contrary are mere shams.[14] He also has several code provisions which give him authority to scrutinize closely such creations and acquisitions to determine whether they are merely devices to avoid taxes.

Section 61(a),[15] substantially the same as section 22(a) of the 1939 Code, defines gross income to mean all income from whatever source derived. Under this section if the entities are actually only tax shams, lacking substance and reality, and were not created

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[11] Convery, *Residential Developments: Multiple Corporations, Allocations, Administration,* N.Y.U. 14TH INST. ON FED. TAX 189, 190.

[12] Tritt and Spencer, *Current Tax Problems in Incorporation of a Going Business,* U. SO. CAL. 1958 TAX INST. 71, 111.

[13] INT. REV. CODE OF 1954, §§ 1501 to 1504.

[14] Higgins v. Smith, 308 U.S. 473 (1940).

[15] INT. REV. CODE OF 1954, § 61(a).

for any valid business purpose, the Commissioner may disregard the corporate fiction and determine who actually earned the income.[16] It is well settled that a taxpayer has the right "to decrease the amount of what would otherwise be his taxes, or to avoid them altogether, by means which the law permits."[17] However, the "tax liabilities are measured by the reality of the transaction, not the mere form employed in bringing it about."[18] Also, a taxpayer may choose the form by which he wishes to do business.[19] In the case of *National Investors Corp. v. Hoey*,[20] Judge Hand stated that to be a jural person for tax purposes, a corporation has to be engaged in some business and that escaping taxation is not a business in the ordinary meaning. Therefore, it is evident under this section, and also under sections to be discussed later, that the important question is always whether the corporation was created for valid business reasons or merely to escape taxation.

In this context the previously discussed non-tax advantages of multiple corporations become extremely important. If the Commissioner believes that the corporations were formed for these purposes instead of the tax advantages, he will not attack them. As a corollary it might be well to emphasize the importance of meticulously observing the independence of the separate activities by keeping separate books, minutes, and other records,[21] as well as separate contracts and agreements negotiated and executed by the different corporations, since this is very important in determining whether a corporation is created for valid business purposes.

Section 269,[22] substantially the same as section 129 of the 1939 Code, relates to the acquisition of control over other corporations. It was enacted to prevent one corporation from acquiring control over another corporation for the purpose of obtaining the benefits of tax credits or losses of those corporations. For purposes of this section, control is ownership of over 50% of the acquired corporation's stock. This section does not apply unless the principal purpose of an acquisition was to obtain such tax benefits. If that is found to be the principal purpose, then such deduction, credit,

[16] Higgins v. Smith, *supra* note 14.
[17] Gregory v. Helvering, 293 U.S. 465, 469 (1935).
[18] United States v. Isham, 84 U.S. (17 Wall.) 496 (1873).
[19] Helvering v. Clifford, 309 U.S. 331 (1940).
[20] National Investors Corp. v. Hoey, 144 F.2d 466 (2d Cir. 1944).
[21] Palm Beach Aero Corp., 17 T.C. 1169 (1952); Seminole Rock and Sand Co., 19 T.C. 259 (1952).
[22] INT. REV. CODE OF 1954, § 269(a).

or other allowance will not be permitted. It was generally thought that this section only disallowed such benefits to the acquiring corporation and not the acquired corporation;[23] however, in the recent cases of *Mill Ridge Coal Co. v. Patterson*[24] and *Coastal Oil Storage Co. v. Commissioner,*[25] the courts held that the deductions of the acquired corporation could also be properly disallowed. Prior to 1959, section 269 was not thought to be a deterrent to the original formation of multiple corporations, since the section spoke of acquiring corporations and not of creating or forming corporations. It was thought that it prohibited only the splitting up of one corporation into many smaller ones.[26] But the *James Realty Company* case[27] held that section 269 applied to the original formation as well as to the subsequent acquisitions of a corporation. The Tax Court has held that under section 269 the Commissioner cannot disallow the $25,000 exemption to a new multiple corporation, since in the formation of a new corporation there could not be an acquisition of control which is a necessary element within the meaning of that section.[28] So it seems that the Tax Court will not apply section 269 to the creation of new corporations, but at least one district court will.

Section 482,[29] substantially the same as section 45 of the 1939 Code, was enacted to prevent inter-company manipulations whereby profits and losses are arbitrarily shifted from one business entity to another. This section gives the Commissioner authority to reallocate the income among the parties who actually earned it. It generally is only invoked in situations where there are dealings between corporately related taxpayers and then only where such dealings are not

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[23] Chelsea Products, Inc., 16 T.C. 840 (1951), *aff'd,* 197 F.2d 620 (3d Cir. 1952).

[24] Mill Ridge Coal Co. v. Patterson, 264 F.2d 713 (5th Cir. 1959).

[25] Coastal Oil Storage Co. v. Commissioner, 242 F.2d 396 (4th Cir. 1957).

[26] *First Case Denies Surtax Exemption To Horizontally-Affiliated New Corporation,* 11 TAXATION 326 (December 1959).

[27] James Realty Co. v. United States, *supra* note 1, at 310.

[28] British Motor Car Distrib. Ltd., 31 T.C. 437 (1958).

[29] INT. REV. CODE OF 1954, § 482, "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."

at arm's length.[30] It should also be remembered that the taxpayer cannot invoke it for tax relief—only the Commissioner may employ it.[31]

Section 1551,[32] substantially the same as section 15(c) of the 1939 Code, gives the Commissioner authority to disallow the $25,-000 exemption from the surtax provided in section 11(c) and the accumulated earnings credit provided in section 535(c) to a subsidiary created by the transfer of property from a parent when the subsidiary is controlled by the parent after the transfer. This does not apply if the transferee corporation can prove by the clear preponderance of the evidence that the securing of the exemption or credit was not a major purpose of the transfer. "For purposes of this section, control means the ownership of stock possessing at least 80% of the total combined voting power of all classes of stock entitled to vote or at least 80% of the total value of shares of all classes of stock of the corporation."[33] The language of section 1551 also indicates that section 544,[34] is to be used in determining the ownership of the necessary 80% of the stock, except that under section 544(a) (2)[35] only the individual's spouse and minor children are to be considered. Under section 544 an individual is held to constructively own all stock owned by a corporation, partnership, estate, or trust in proportion to his interest in these various units. He is also considered to own all stock owned by his family, which includes his "brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants." Due to the limitation of section 544(a) (2), a father could own 79% of the stock in a corporation and his adult son or a third party could own 21% of the stock and section 1551 would not apply. The prohibitions of section 1551 apply only where there is a transfer of property other than money, so that one of the corporations could transfer cash to a new corporation for the purpose of developing additional land and such a transfer would not be within this section.[36] As a result of this section it is imperative that multiple corporations be

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[30] Mortenson, *The Multiple Attack On Multiple Corporations*, 35 TAXES 647, 653 (1957).

[31] Landman, *Multiplying Business Corporations and Acquiring Tax Losses*, 8 TAX L. REV. 81, 84 (1952-53).

[32] INT. REV. CODE OF 1954, § 1551.

[33] *Ibid.*

[34] INT. REV. CODE OF 1954, § 544.

[35] INT. REV. CODE OF 1954, § 544(a) (2).

[36] INT. REV. REG. OF 1954, § 1.1551-1. (d).

formed at the outset rather than by subsequent transfers and that no part of the land be transferred to any corporation other than one which is intended to be the ultimate owner of the parcel.[37]

It has been suggested that another possible means of attacking multiple corporations would be to consider the entire group of corporations as an "association" taxable as a single entity under section 7701(a) (3).[38,39]

Two recent court decisions in the area of real estate developments, which have been adverse to the taxpayer and have probably shifted the pendulum to the side of the Commissioner, re-emphasize the need for an underlying sound business purpose.[40] In *James Realty Co. v. United States,*[41] *X* had created a construction company in 1944 and in 1949 created a company to sell the homes the construction company built. Between 1950 and 1954, *X* formed nine development companies (one of which was the taxpayer involved in this case) to buy and hold land, to contract with the construction company to have houses constructed upon the land, and to contract with the realty company to have them handle the sale of the houses. All of the nine development companies occupied offices owned by the construction company and were supplied with bookkeeping services by its personnel. The court under the power of section 129 of the 1939 Code, which is substantially the same as section 269 of the 1954 Code, found that the creation of a new corporation came within the meaning of section 129 and also that the section could be used to deny the acquired corporation its surtax exemption. The court decided that the principal purpose for the acquisition of the realty company by *X* was tax avoidance by securing the additional surtax exemption and that the exemption was properly disallowed by the Commissioner under the authority of section 129 of the 1939 Code.

In the case of *Aldon Homes,*[42] a master corporation acquired the land and, in effect, did all of the preliminary work in setting up the residential tract subdivision. Before the actual start of construction, the land was conveyed to sixteen alphabetical corporations,

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[37] Tritt and Spencer, *op. cit. supra* note 12, at 113.
[38] INT. REV. CODE OF 1954, § 7701(a) (3).
[39] SURREY & WARREN, FEDERAL INCOME TAXATION 1666 (1960).
[40] *Supra* note 1.
[41] *Supra* note 1.
[42] *Supra* note 1.

each corporation owning fourteen or fifteen lots. The master corporation also controlled a construction corporation which contracted to build the houses for the alphabetical corporations for cost plus a $100 fee. A realty company handled the sale of the houses in the entire tract, and advertised the subdivision as the "Briarcliff Estates" with no mention of the alphabetical corporations. The facts of the case do not disclose whether the realty company was independent or controlled by the master corporation.

In an attempt to convince the court that these corporations were created for valid business purposes, the taxpayer listed the previously discussed non-tax advantages of multiple corporations. However, the court said, "The alleged business purposes impressed us simply as a lawyer's marshalling of possible business reasons that might conceivably have motivated the adoption of the forms here employed but which in fact played no part whatever in the utilization of the multiple corporate structure."[43] The Tax Court held that the entire net income from the whole development was taxable to the master corporation under the provisions of section 22(a) of the 1939 Code, now covered by section 61(a) of the 1954 Code, since the sixteen alphabetical corporations were not formed for any valid business purpose. In reaching its decision that the corporations were not engaged in any independent substantive business activity the court noted that the same office staff, occupying the same office space, kept the books for all the corporations and that the alphabetical corporations were all organized and dissolved in unison.

It is too early to state conclusively that these cases should cause a discontinuance in the use of multiple corporations; however, it should be evident after closely reading and studying these two recent cases that developers who at present are using multiple corporations and those who are planning to use them in the future should be extremely careful in determining whether they can prove a valid business purpose in the creation of such corporations. If such a business purpose cannot be proven, then multiple corporations should probably not be used. In light of the recent case trend and the careful judicial scrutiny contained therein, a failure to heed this caveat may and probably will result in serious financial and business consequences.

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[43] *Supra* note 1.