5 T.C. 558 (1945)

Section 45 of the Internal Revenue Code does not authorize the Commissioner to allocate income between entities unless they are owned or controlled directly or indirectly by the same interests, and mere common control by separate groups of stockholders is insufficient.

Summary

Lake Erie & Pittsburgh Railway Co. sought a redetermination of income tax deficiencies for 1937-1939. The Commissioner allocated income from the New York Central and Pennsylvania Railroads (lessees) to Lake Erie, arguing they were commonly controlled and the allocation was necessary to reflect true income. The Tax Court held that the Commissioner lacked authority because the railroads, while controlling Lake Erie through stock ownership, were not controlled by the same interests as each other. The amendment to the lease agreement was deemed effective only from the date of its formal approval.

Facts

Lake Erie & Pittsburgh Railway Co. (petitioner) leased its railway to New York Central and Pennsylvania Railroads. The original 1908 agreement stipulated rental payments based partly on a 5% dividend on Lake Erie's capital stock. In 1937, rental payments based on stock ownership ceased. A formal amendment to the lease, eliminating the dividend-based rental, was approved September 27, 1939, but declared it was effective retroactive to January 1, 1937. The Commissioner sought to allocate income from the lessee railroads to Lake Erie to ensure it received income equivalent to the 5% dividend.

Procedural History

The Commissioner determined deficiencies in the petitioner's income tax for the years 1937, 1938, and 1939, based on the allocation of income. Lake Erie & Pittsburgh Railway Co. petitioned the Tax Court for a redetermination of these deficiencies.

Issue(s)

1. Whether the Commissioner acted within the scope of his authority under Section 45 of the Internal Revenue Code in allocating gross income from the New York Central and Pennsylvania Railroads to Lake Erie & Pittsburgh Railway Co.?

2. Whether the modification of the original agreement of January 10, 1908, dates from January 1, 1937, or from September 27, 1939?

Holding

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1. No, because the New York Central and Pennsylvania Railroads, while both controlling Lake Erie through stock ownership, are not controlled by the same interests as each other.

2. The modification dates from September 27, 1939, because that is when it was formally approved, and the petitioner was on the accrual basis.

Court’s Reasoning

The court focused on the interpretation of

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