*5 T.C. 851 (1945)*

When a company transitions from filing consolidated tax returns to filing separate returns, its opening inventory for the first separate return must be adjusted to prevent the avoidance of tax resulting from previously untaxed intercompany profits during the consolidated return period.

**Summary**

Singer Sewing Machine Co. disputed the Commissioner's determination of deficiencies in its income tax for 1934, 1935, 1937, and 1938. The central issue was the proper valuation of Singer's opening inventory for 1934 following the discontinuation of consolidated tax returns with its parent company. The Tax Court held that the opening inventory should be adjusted downward to reflect the amount of intercompany profit that had escaped taxation during the period of consolidated returns. Additionally, the court found that small donations to local charities were ordinary and necessary business expenses.

**Facts**

Singer Sewing Machine Co. (Singer) filed separate corporate income tax returns for the years in question. Its parent company, Singer Manufacturing Co. (Manufacturing), owned all of Singer's stock. Singer's primary business was selling sewing machines manufactured by Manufacturing. From 1918 through 1933, Singer and Manufacturing filed consolidated tax returns. Singer valued its inventories at cost or market, whichever was lower. During the period of consolidated returns, intercompany profits from Manufacturing's sales to Singer were not always fully taxed in the year of the sale, leading to an accumulation of untaxed profits in Singer's closing inventory.

**Procedural History**

The Commissioner of Internal Revenue determined deficiencies in Singer's income tax for the years 1934, 1935, 1937, and 1938. Singer challenged the Commissioner's assessment in the United States Tax Court.

**Issue(s)**

1. Whether the Commissioner properly adjusted Singer's opening inventory for 1934 to eliminate intercompany profits that had not been taxed during the period of consolidated returns.
2. Whether Singer's donations to local charities constituted ordinary and necessary business expenses.

**Holding**

1. No, the Commissioner's adjustment was too high. The correct adjustment to

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Singer's opening inventory for 1934 is the amount of intercompany profit that had escaped taxation up to the date of the opening inventory, because this prevents a windfall to the company due to the shift from consolidated to separate returns.
2. Yes, the donations to local charities were ordinary and necessary business expenses, because they were made with the reasonable expectation of maintaining or developing Singer's business in those localities.

**Court's Reasoning**

The Tax Court reasoned that the shift from consolidated to separate returns should not allow income to escape taxation. The court recognized that the consolidated return regulations authorized an adjustment to the opening inventory for the first separate return to prevent the avoidance of tax resulting from previously eliminated intercompany profits. However, the adjustment should only reflect the amount of profit that had not yet been taxed. The court emphasized that Congress authorized the Commissioner to promulgate regulations in regard to consolidated returns to cause income to be clearly reflected and to prevent the avoidance of tax. As to the charitable deductions, the court found that the donations bore a reasonable relationship to Singer's business and were made with a reasonable expectation of financial return, thus qualifying as ordinary and necessary business expenses.

The court stated, "The shift from consolidated to separate returns should be made so that the revenues will not suffer. However, no greater burden than necessary for this purpose should be imposed upon the petitioner."

**Practical Implications**

This case provides guidance on how to handle inventory adjustments when a company transitions from filing consolidated tax returns to separate returns. It highlights the importance of ensuring that intercompany profits that were previously untaxed are properly accounted for to prevent tax avoidance. The ruling clarifies that the opening inventory for the first separate return should be adjusted to reflect the amount of intercompany profit that had escaped taxation during the consolidated return period. It also illustrates that even seemingly small charitable donations can be deductible as ordinary and necessary business expenses if they are proximately related to the business and made with a reasonable expectation of financial return. This case remains relevant for tax practitioners dealing with consolidated returns and the determination of appropriate inventory values following deconsolidation. Later cases have cited this ruling to support the principle that tax regulations should be interpreted to prevent the avoidance of tax, especially in the context of consolidated returns.

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