Air Reduction Co. v. Commissioner, 6 T.C. 138 (1946)

In exceptional circumstances, the separate identity of a corporation may be disregarded for tax purposes when the subsidiary is merely an agent or integral part of the parent company's business, subject to the parent's complete domination and control.

Summary

Air Reduction Co. (Airco) argued that the income from its subsidiaries should be taxed to Airco, as the subsidiaries were mere departments or agencies. The Tax Court held that the subsidiaries' income was taxable to Airco because the subsidiaries were operated as integral parts of Airco's business with Airco exercising complete domination and control over them. This conclusion was based on factors such as centralized management, shared resources, and the subsidiaries acting under contract for a nominal fee, remitting all profits to Airco.

Facts

Airco, a parent corporation, wholly owned several subsidiary companies. The subsidiaries operated under contracts with Airco, agreeing to conduct a branch of Airco's business for a nominal fee. The board of directors of each subsidiary was substantially composed of Airco's senior executive officers. One main office in New York City served both Airco and its subsidiaries. Airco furnished all assets and working capital to its subsidiaries. The business was operated as one unit with six branches directed by Airco officers. All expenditures over $500 required Airco board approval. Advertising represented the subsidiaries as divisions of Airco. Purchases were made through Airco's purchasing agent. Products and materials were transferred between subsidiaries at cost. All bank accounts were treated as Airco's and drawn upon indiscriminately. Credits and collections were managed by Airco's credit manager. Accounting was done by Airco's general accounting office.

Procedural History

The Commissioner determined that the income from the subsidiaries belonged to the subsidiaries and was taxable to them. Airco challenged this determination in the Tax Court, arguing the income should be taxed to the parent company. The Tax Court ruled in favor of Airco, holding that the subsidiaries' income was taxable to Airco.

Issue(s)

Whether the income from the operations of the subsidiaries belonged to and was taxable to the subsidiaries, or whether the income from the operations of the subsidiaries belonged to and was taxable to Airco, the parent company, because the subsidiaries were in fact incorporated departments, divisions, or branches of Airco's business and because the subsidiaries operated pursuant to express contract with Airco.

Holding

No, the income from the subsidiaries is not taxable to them; Yes, because the subsidiaries were operated as branches or divisions of Airco and each under a contract which clearly disclosed the relationship, the net income of these subsidiaries was taxable to Airco.

Court's Reasoning

The court reasoned that corporations are normally treated as separate entities for tax purposes, but this rule does not apply when a subsidiary is so integrated into the parent's operations that it acts as a mere department or agency. The court relied on *Southern Pacific Co. v. Lowe*, where the Supreme Court found a practical identity between two companies due to complete ownership and control. The Tax Court found that the facts of this case aligned more closely with *Southern Pacific Co. v. Lowe* than with cases cited by the Commissioner, such as *Interstate Transit Lines v. Commissioner*. The court emphasized the extensive control Airco exercised over its subsidiaries, the shared resources, and the contractual arrangement where subsidiaries remitted all profits (above a nominal fee) to Airco. The court stated, "While the two companies were separate legal entities, yet in fact, and for all practical purposes they were merged, the former being but a part of the latter, acting merely as its agent and subject in all things to its proper direction and control."

Practical Implications

This case provides guidance on when the separate corporate existence of a subsidiary may be disregarded for tax purposes. It emphasizes the importance of examining the actual operational relationship between a parent and subsidiary. Factors such as centralized management, shared resources, and the extent of the parent's control are critical. The decision illustrates that even in the absence of consolidated returns (generally disallowed after the Revenue Act of 1934), the IRS may treat a subsidiary as a mere division of the parent company if the facts demonstrate sufficient integration and control. Later cases have distinguished *Air Reduction Co.* by focusing on the degree of independence maintained by the subsidiary and the business purpose served by its separate existence.

