T.C. Memo. 1946-233

Section 45 of the Internal Revenue Code does not authorize the Commissioner to create income where no actual income was realized by related businesses; it only allows for the allocation of existing gross income and deductions to clearly reflect income.

Summary

Jaguar Stores, Inc., a subsidiary of Continental Department Stores, Inc., challenged the Commissioner's allocation of interest income to it under Section 45 of the Internal Revenue Code. The Commissioner argued that Jaguar Stores should have charged Continental interest on non-interest-bearing loans, thereby generating taxable income. The Tax Court held that the Commissioner's action was unwarranted because Section 45 does not allow the creation of income where none existed but only the allocation of existing income. The court also addressed deductions for management services and Chamber of Commerce payments, finding them to be legitimate business expenses.

Facts

Continental Department Stores, Inc. had outstanding debenture bonds. In 1942, Continental borrowed $104,500 from its wholly-owned subsidiary, Jaguar Stores, Inc., giving a non-interest-bearing demand note and then redeemed $100,000 of its debentures. In 1944, Continental borrowed an additional $143,274.50 from Jaguar Stores on a similar basis and used it to retire the remaining $138,000 in outstanding debentures. The debentures were redeemable at 102% of par value plus accrued interest. The Commissioner allocated $5,865.50 to Jaguar Stores' income, representing a 4% imputed interest charge on the loans to Continental. Jaguar Stores also deducted $3,000 paid to Continental for management services and payments to Chambers of Commerce.

Procedural History

The Commissioner determined a deficiency in Jaguar Stores' income tax. Jaguar Stores petitioned the Tax Court for a redetermination of the deficiency, contesting the allocation of interest income and the disallowance of certain deductions.

Issue(s)

1. Whether the Commissioner can allocate income to a subsidiary under Section 45 of the Internal Revenue Code by imputing interest on a non-interest-bearing loan to its parent corporation.
2. Whether payments made by the subsidiary to its parent corporation for management services are deductible as ordinary and necessary business expenses.
3. Whether payments made by the subsidiary to the Chamber of Commerce are

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deductible as ordinary and necessary business expenses.

Holding

1. No, because Section 45 does not authorize the creation of income where none existed, but only allows for the allocation of existing gross income.
2. Yes, because the management services were actually rendered, directly related to the subsidiary's business, and the amount charged was reasonable.
3. Yes, because the payments were motivated by a reasonable expectation that the subsidiary's business would be advanced.

Court's Reasoning

Regarding the imputed interest, the court emphasized that Section 45's purpose is to prevent manipulation or improper shifting of income and deductions. Citing *Tennessee-Arkansas Gravel Co. v. Commissioner*, the court stated that Section 45's application

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