17 T.C. 231 (1951)

Section 45 of the Internal Revenue Code gives the Commissioner authority to reallocate income between commonly controlled entities to prevent tax evasion or to clearly reflect income, but this power is not unlimited and must be exercised reasonably.

Summary

Grenada Industries, Inc. and National Hosiery Mills, Inc., along with two partnerships, Hosiery and Abar, were under common control. The Commissioner of Internal Revenue reallocated income from the partnerships to the corporations. The Tax Court held that while the Commissioner has broad authority under Section 45 of the Internal Revenue Code to allocate income, the allocation of Abar's income to both corporations, and Hosiery's income to National Hosiery Mills, Inc. was unreasonable, but the allocation of Hosiery's income to Grenada Industries, Inc. was justified to prevent tax evasion and clearly reflect income.

Facts

Jacob and Lazure Goodman, along with Henry Kobin and Abraham Barskin, controlled Grenada Industries, Inc. (Industries), National Hosiery Mills, Inc. (National), and partnerships Grenada Hosiery Mills (Hosiery) and Abar Process Company (Abar). Industries manufactured unfinished hosiery, National dyed and finished hosiery and had a sales force, Hosiery provided styling and merchandising services for Industries' hosiery, and Abar salvaged yarn and mended defective hosiery. The Commissioner sought to reallocate income from Hosiery and Abar to Industries and National, arguing that these entities were used to shift income improperly.

Procedural History

The Commissioner determined deficiencies in the income and excess profits taxes of Grenada Industries and National Hosiery Mills, based on the reallocation of income from two partnerships. Grenada Industries and National Hosiery Mills petitioned the Tax Court for a redetermination of these deficiencies. The Tax Court consolidated the proceedings for hearing.

Issue(s)

1. Whether the Commissioner erred in allocating the income of Abar Process Company to Grenada Industries and National Hosiery Mills under Section 45 of the Internal Revenue Code.
2. Whether the Commissioner erred in allocating the income of Grenada Hosiery Mills to Grenada Industries and National Hosiery Mills under Section 45 of the Internal Revenue Code.

Holding

1. No, because the allocation of Abar’s income was arbitrary and unreasonable as Abar operated as a separate entity, paying and receiving fair market prices in its transactions, thereby not causing a distortion of income.
2. Yes in part. The allocation of Hosiery’s income to National Hosiery Mills was unreasonable because National received fair compensation for its services. However, the allocation of Hosiery’s income to Grenada Industries was justified because Industries did not receive fair compensation for its goods.

Court’s Reasoning

The Tax Court recognized the Commissioner’s authority under Section 45 of the Internal Revenue Code to allocate income to prevent tax evasion or clearly reflect income among commonly controlled entities. However, this power is not absolute. The court stated, “The purpose of section 45 is not to punish the mere existence of common control or ownership, but to assist in preventing distortion of income and evasion of taxes through the exercise of that control or ownership. It is where there is a shifting or deflection of income from one controlled unit to another that the Commissioner is authorized under section 45 to act to right the balance and to keep tax collections unimpaired.”

In Abar’s case, the court found no such distortion, as Abar paid and received fair market prices. As such, the income was valid and not a target for reallocation.

Regarding Hosiery, the court found that its income was, in effect, earned by Industries. Hosiery performed styling and merchandising services, but Industries at all times owned the hosiery being sold. Industries was not receiving fair value for the finished products, so reallocation of Hosiery’s income back to Industries was fair. National, however, was receiving fair payments for its dyeing, finishing, and sales services, so income should not be reallocated from Hosiery to National.

Practical Implications

This case illustrates the boundaries of the IRS’s power under Section 45 to reallocate income. While the IRS has broad discretion, it cannot act arbitrarily. The court emphasizes that the IRS must show that the allocation is necessary to prevent tax evasion or to clearly reflect income. Moreover, the court underscores that a taxpayer can rebut an allocation by demonstrating that the controlled entities engaged in arm’s length transactions, thereby negating any distortion of income.

This case is cited to show that a reallocation must be connected to a shifting or deflection of income, so the IRS cannot use Section 45 solely to punish the existence of commonly controlled entities.

