25 T.C. 70 (1955)

Under Section 45 of the Internal Revenue Code, the Commissioner can allocate income, deductions, credits, or allowances between commonly controlled entities to prevent tax evasion or to clearly reflect income, but such allocation must be justified by a distortion of income caused by the common control.

Summary

The Friedlander Corporation challenged the Commissioner of Internal Revenue's decision to allocate income and deductions between the corporation and a partnership, Louis Friedlander & Sons. The Tax Court, following a mandate from the Fifth Circuit, considered whether the corporation and partnership were commonly controlled under Section 45 of the Internal Revenue Code. The court found common control existed. The court also addressed whether specific allocations were justified, determining that some allocations of expenses were appropriate to clearly reflect income, while others were not. The court determined whether the allocation of expenses was valid under Section 45, focusing on whether the expenses were appropriately allocated to reflect income.

Facts

Louis Friedlander was the president and majority shareholder of The Friedlander Corporation. He transferred shares to his sons, who later formed a partnership with Louis, and I.B. Perlman. The partnership, Louis Friedlander & Sons, acquired assets from the corporation. Louis Friedlander, as president, exercised administrative control of the corporation and, as business manager and treasurer of the partnership, managed its affairs. The Commissioner determined that the corporation and partnership were owned or controlled by the same interests during the years in question and made certain allocations of income and expenses between them under Section 45 of the Internal Revenue Code.

Procedural History

The Commissioner determined tax deficiencies, including the income of the partnership into the corporation's income. The Tax Court originally sided with the Commissioner, but on appeal, the Fifth Circuit reversed, stating that the partnership was recognizable for tax purposes. The case was remanded to the Tax Court to address whether the allocations should be made under section 45 of the Internal Revenue Code. The Tax Court then considered the applicability of Section 45 and the propriety of specific allocations. The Tax Court followed the mandate, and the case resulted in a determination under Rule 50.

Issue(s)

1. Whether The Friedlander Corporation and Louis Friedlander & Sons were owned or controlled directly or indirectly by the same interests from July 1, 1943, to March

31, 1946.

2. Whether an allocation should be made to the partnership for certain costs incurred by the corporation related to merchandise inventory transferred to the partnership.

3. Whether an allocation should be made to the partnership for certain general and administrative expenses incurred by the corporation during 1943, 1944, and 1945.

Holding

1. Yes, because Louis Friedlander and his family, as well as I. B. Perlman and his wife, maintained an 80/20 ownership ratio in both the corporation and the partnership, constituting common control.

2. No, because the merchandise inventory was sold at its full fair value, and no further allocation was warranted.

3. Yes, in part, because the court determined specific amounts of certain expenses, such as those related to shared office space and employee services, were properly allocable to the partnership.

Court's Reasoning

The court relied on Section 45 of the Internal Revenue Code, which allows the Commissioner to allocate income and deductions between organizations under common control to prevent tax evasion or clearly reflect income. The court considered whether the relationship between the corporation and the partnership constituted common control. The court referenced *Grenada Industries, Inc.*, emphasizing that control under Section 45 is determined by the reality of control. The Court found that Louis Friedlander and his family held a majority interest in both the corporation and the partnership and exercised control over both entities. The Court concluded that the common control existed, which triggered the potential application of Section 45. Then the court examined specific allocations.

The Court addressed the issue of the merchandise inventory transfer by focusing on the price at which the inventory was sold. Because the inventory was sold at fair market value and the transaction happened at a time of slow sales, the Court determined there was no income distortion and declined to allocate additional income from that transfer. The Court also identified several categories of general and administrative expenses that were properly allocated. The court specified the amounts of rent, bookkeeping, and phone expenses attributable to the partnership's operations.

The court's decision was supported by a concurring opinion from Judge Raum, emphasizing the importance of common control as well as demonstrating income distortion before applying Section 45.

Practical Implications

This case is a strong reminder of the broad scope of Section 45 and the importance of understanding the factors that constitute “control” for tax purposes. The case illustrates the importance of determining whether transactions between commonly controlled entities are conducted at arm’s length or if they distort income. Businesses with related entities must ensure that intercompany transactions are appropriately priced and documented. The court’s focus on the “reality of control” suggests that the substance of the relationship is more important than the formal structure. This case underscores the Commissioner’s power to allocate income and deductions when needed to prevent tax evasion or to reflect income clearly. Moreover, *Friedlander Corp.*, as well as the court’s reliance on the reasoning in *Grenada Industries, Inc.*, emphasizes the importance of ensuring intercompany transactions are at arm’s length and documented to avoid disputes with the IRS.

