B. Forman Co. v. Commissioner, 54 T. C. 912 (1970)

The IRS cannot use Section 482 to impute interest income on loans between entities not controlled by the same interests.

Summary

In B. Forman Co. v. Commissioner, the U. S. Tax Court ruled that the IRS could not impute interest income to two department stores, B. Forman Co. and McCurdy & Co. , on loans made to a shopping center corporation they jointly owned, Midtown Holdings Corp. The court held that Section 482 of the Internal Revenue Code, which allows the IRS to allocate income among commonly controlled entities, did not apply because the two department stores were not controlled by the same interests. Additionally, the court found that annual payments made by the department stores to Midtown to prevent the installation of kiosks in the shopping center were not deductible as ordinary and necessary business expenses, as Midtown had independently decided against kiosks for its own benefit.

Facts

In 1958, B. Forman Co. and McCurdy & Co. , two competing department stores in Rochester, NY, formed Midtown Holdings Corp. to build and operate Midtown Plaza, an enclosed mall shopping center adjacent to their stores. Each store had a 50% stake in Midtown and equal representation on its board. The construction costs exceeded expectations, leading the department stores to loan money to Midtown, including a $1 million loan from each in 1960, which was renewed in 1963 and 1966 without interest. In 1964, the department stores agreed to pay Midtown $75,000 annually to keep kiosks out of the mall's north section, which was used for non-commercial events. The IRS sought to impute interest on the loans and disallow the kiosk payments as business deductions.

Procedural History

The IRS determined deficiencies in the department stores' federal income taxes and imputed interest income on the loans to Midtown under Section 482, while disallowing deductions for the annual kiosk payments. The department stores petitioned the U. S. Tax Court for a redetermination of the deficiencies, arguing that Section 482 did not apply and that the kiosk payments were deductible business expenses.

Issue(s)

1. Whether the IRS may use Section 482 to impute interest income to the department stores on the loans made to Midtown.
2. Whether the annual payments made by the department stores to Midtown to prevent the installation of kiosks are deductible as ordinary and necessary business expenses under Section 162.

Holding

1. No, because Section 482 requires that the entities be owned or controlled by the same interests, which was not the case here as B. Forman Co. and McCurdy & Co. were not controlled by the same interests.
2. No, because by the time the payments were made, Midtown had already decided against installing kiosks in the north mall for its own independent business reasons, making the payments disguised capital contributions rather than deductible business expenses.

Court’s Reasoning

The court reasoned that Section 482 requires actual, practical control of the entities by the same interests, which was not present. B. Forman Co. and McCurdy & Co. had no common shareholders, directors, or officers, and their 50% ownership in Midtown did not give either control over it. The court reaffirmed its prior decision in Lake Erie & Pittsburg Railway Co. , rejecting the IRS’s argument that a common objective between the department stores could create the requisite control.

Regarding the kiosk payments, the court found that Midtown had independently decided against kiosks in the north mall by April 1962, long before the payments began, to use the space for non-commercial events that benefited the entire shopping center. Therefore, the payments were not necessary to prevent kiosks and were instead disguised capital contributions, not deductible expenses. The court noted additional factors supporting this conclusion, including the equal payment amounts despite the stores’ differing sales volumes, Midtown’s need for cash, and the tax benefits of the arrangement.

Practical Implications

This decision limits the IRS’s ability to use Section 482 to impute income on transactions between entities not controlled by the same interests, requiring a clear showing of control rather than just a common business objective. Taxpayers should carefully document the lack of control between related entities to avoid Section 482 allocations.

The ruling also highlights the importance of the substance over form doctrine in determining the deductibility of payments between related parties. Payments that are not necessary to achieve the stated purpose, but instead support the recipient’s independent business strategy, may be treated as non-deductible capital contributions rather than business expenses. This is particularly relevant in arrangements where the payor and payee have intertwined business interests.

Subsequent cases have cited B. Forman Co. for its holdings on both Section 482 and the deductibility of payments between related parties, reinforcing its significance in these areas of tax law.