Forman's and McCurdy's v. Commissioner, 52 T. C. 937 (1969)

Section 482 requires actual, practical control over two or more businesses by the same interests to impute income.

Summary

Forman's and McCurdy's, two department stores, formed Midtown Holdings Corp. to develop Midtown Plaza. The IRS attempted to impute interest income on loans from the stores to Midtown under Section 482, arguing control based on common business interests. The Tax Court disagreed, ruling that without actual control, the IRS could not impute income. Additionally, the court disallowed deductions for payments made to prevent kiosks in the mall, finding them to be disguised capital contributions.

Facts

Forman's and McCurdy's, department stores in Rochester, NY, each owned 50% of Midtown Holdings Corp. , created to develop Midtown Plaza. The project exceeded budget, leading to loans from the stores to Midtown without interest. The IRS imputed interest income to the stores under Section 482. The stores also paid Midtown to keep kiosks out of the North Mall, claiming these as business expenses.

Procedural History

The IRS issued notices of deficiency to Forman's and McCurdy's for imputed interest income and disallowed deductions. The taxpayers petitioned the Tax Court, which heard the case and issued its opinion in 1969.

Issue(s)

1. Whether the IRS can impute interest income to Forman's and McCurdy's under Section 482 based on their 50% ownership in Midtown Holdings Corp.
2. Whether payments made by Forman's and McCurdy's to prevent kiosks in Midtown Plaza's North Mall are deductible as ordinary and necessary business expenses.

Holding

1. No, because the stores did not have actual, practical control over Midtown Holdings Corp. necessary for Section 482 application.
2. No, because the payments were disguised capital contributions rather than ordinary and necessary business expenses.

Court's Reasoning

The court focused on the requirement of Section 482 for actual, practical control by

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the same interests over two or more businesses. It rejected the IRS's argument that common business interests constituted control, citing the need for direct or indirect ownership or control. The court reaffirmed its decision in Lake Erie & Pittsburg Railway Co. , emphasizing that a theoretical partnership between the stores could not be inferred from their common objectives. For the kiosk payments, the court found that Midtown had already decided to keep the North Mall free of kiosks in its own interest before the payments were made, thus the payments were not for a current benefit to the stores but rather disguised capital contributions. The court noted the equal payment amounts despite differing store revenues and the potential tax benefits of the arrangement as further evidence of the true nature of the payments.

Practical Implications

This decision clarifies that for the IRS to impute income under Section 482, there must be actual control over the related entities, not just common business interests. Taxpayers can structure joint ventures without fear of automatic income reallocation if no single party has control. The ruling also warns against disguising capital contributions as deductible expenses, requiring careful scrutiny of payments between related parties. Subsequent cases have applied this principle to various business arrangements, emphasizing the need for genuine arm's length transactions to support deductions. Legal practitioners must ensure that intercompany transactions reflect economic reality and are not merely tax-driven.

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