Fairfax Auto Parts of Northern Virginia, Inc. v. Commissioner, 67 T. C. 815 (1977)

For corporations to be considered a brother-sister controlled group, each shareholder counted towards the 80% ownership test must own stock in all corporations involved.

Summary

In Fairfax Auto Parts of Northern Virginia, Inc. v. Commissioner, the Tax Court clarified the criteria for a brother-sister controlled group under IRC section 1563(a)(2). The IRS argued that Fairfax Auto Parts of Northern Virginia, Inc. (NOVA) and Fairfax Auto Parts, Inc. (FAP) constituted such a group, thus limiting each to a $12,500 surtax exemption. The court rejected the IRS's interpretation of the statute, holding that a shareholder's stock must be considered for the 80% test only if they own stock in each corporation. This ruling impacts how corporations assess their eligibility for full surtax exemptions and emphasizes the importance of common ownership in controlled group determinations.

Facts

Fairfax Auto Parts of Northern Virginia, Inc. (NOVA) and Fairfax Auto Parts, Inc. (FAP) were Virginia corporations engaged in the wholesaling of auto parts. William Herbert owned 55% of NOVA and 100% of FAP, while Joseph Ofano owned 45% of NOVA. Both corporations claimed a full $25,000 surtax exemption for 1971 and 1972. The IRS determined they were a brother-sister controlled group, limiting their exemptions to $12,500 each, based on the stock ownership pattern meeting the statutory 50% test but not the 80% test under their interpretation.

Procedural History

The IRS issued notices of deficiency to both corporations, which then petitioned the U. S. Tax Court. The case was submitted under Rule 122, with all facts stipulated. The Tax Court reviewed the case and issued a decision in favor of the petitioners, rejecting the IRS's interpretation of the controlled group statute.

Issue(s)

1. Whether the ownership pattern of NOVA and FAP satisfies the 80% test of IRC section 1563(a)(2)(A) for brother-sister controlled group status.
2. Whether the IRS's regulation interpreting section 1563(a)(2) is valid.

Holding

1. No, because the 80% test requires that each shareholder counted towards the test must own stock in each corporation involved.
2. No, because the IRS's regulation interpreting section 1563(a)(2) is invalid as it

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contradicts the statutory language and legislative intent.

Court’s Reasoning

The Tax Court emphasized the statutory requirement that the same five or fewer persons must own at least 80% of each corporation to constitute a brother-sister controlled group. The court rejected the IRS’s interpretation, which allowed a shareholder’s stock to be counted towards the 80% test even if they owned stock in only one corporation. The court found this interpretation contrary to the plain language of the statute, which requires identical stock ownership for the 50% test and, by extension, the 80% test. The court also considered legislative history, which aimed to target corporations capable of operation as a single entity, further supporting the requirement of common ownership and control. The court invalidated the IRS’s regulation as inconsistent with the statute and legislative intent, citing United States v. Cartwright, 411 U. S. 546 (1973).

Practical Implications

This decision clarifies that for a corporation to be part of a brother-sister controlled group, all shareholders counted towards the 80% test must have stock in every corporation in the group. This impacts how corporations determine their eligibility for surtax exemptions and how they structure ownership to avoid controlled group status. Legal practitioners must ensure clients understand the necessity of common ownership across all corporations when planning corporate structures. The ruling also sets a precedent for challenging IRS regulations that extend beyond statutory language. Subsequent cases, such as those involving similar ownership structures, will need to align with this interpretation, potentially affecting tax planning strategies for businesses operating through multiple corporations.

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