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Federal Income Taxation - Allocation of Income and Expenses - Imputation of Interest to Controlled Corporate Loans and Advances - Taxable Interest-Free Loans

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fect, numerous taxpayers would be subjected to an unanticipated tax. Without any precedent to follow the court was obviously reluctant to decide upon an issue with such far-reaching effects. Thus, the court chose to avoid the Commissioner's argument by determining that the issue was belatedly raised at trial.

Dielectric serves as the vehicle for the introduction of a new and interesting problem. Perhaps it will act as a catalyst for future presentation and resolution of this issue. The real problem, however, lies with the lack of lucidity and consistency between the aforementioned sections when dealing with the application of the accumulated earnings tax to unreasonable compensation. It is submitted that this lack of clarity is a matter which should ultimately be settled by Congress.

Richard M. Serbin

FEDERAL INCOME TAXATION—ALLOCATION OF INCOME AND EXPENSES—IMPUTATION OF INTEREST TO CONTROLLED CORPORATE LOANS AND ADVANCES—TAXABLE INTEREST-FREE LOANS—The Eighth Circuit Court of Appeals has held that section 482 regulations are constitutionally valid and therefore, the Commissioner is permitted to impute income to businesses which make interest-free loans to other members of a controlled group.

Kahler Corp. v. Commissioner of Internal Revenue, 58 T.C. 496 (1972), *rev'd*, 486 F.2d 1 (8th Cir. 1973).

The petitioner, Kahler Corporation, was engaged in the business of owning and operating hotel and motel properties. In 1960 petitioner decided to expand its business by establishing wholly-owned subsidiaries. The subsidiaries' capital structure was patterned according to the norms of the hotel-motel industry which required a 20-30 per cent capital investment with the remainder obtained through financing. A substantial number of advances[1] bearing no interest or definite maturity date were made by petitioner to the subsidiary. The Commissioner sought to "allocate" to petitioner a five per cent interest

1. It was determined that the petitioner owed the First National Bank of Minneapolis, Rochester Band, and North-Western Mutual Life Insurance Company over 6 million dollars, a part of which was used to make advances to the subsidiaries.

charge based on the average monthly balance of advances made during the taxable years in question. A proposed correlative adjustment was made to each subsidiary to increase its interest expense to reflect the interest income imputed to petitioner.

The new regulations[2] permit the Commissioner to impute interest at an arm's length rate when the taxpayer makes loans or advances to another member of a controlled group. The imputation of interest income is authorized even if the borrower does not realize income in the taxable year.

The Tax Court held that under section 482,[3] the Commissioner is authorized to distribute, apportion, and allocate income only where there is an *actual* shifting of income, deduction, credits or allowances.[4] The government appealed to the United States Court of Appeals for the Eighth Circuit which reversed the Tax Court and held that the

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2. Treas. Reg. § 1.482-2a (1), T.D. 6952, 1968-1 CUM. BULL. 218. This regulation states:

> (a) Loans or advances—(1) In general. Where one member of a group of controlled entities makes a loan or advance directly or indirectly to, or otherwise becomes a creditor of, another member of such group, and charges no interest, or charges interest at a rate which is not equal to an arm's length rate as defined in subparagraph (2) of this paragraph, the district director may make appropriate allocations to reflect an arm's length interest rate for the use of such loan or advance.
>
> (2) Arm's length interest rate. For the purposes of this paragraph, the arm's length interest rate shall be the rate of interest which was charged, or would have been charged at the time the indebtedness arose, in independent transactions with or between unrelated parties under similar circumstances . . . .

The method of allocation is determined by *id.* § 1.482-1(d)(1), which provides:

> (d) Method of allocation. (1) The method of allocating, apportioning, or distributing income, deduction, credits, and allowances to be used by the district director in any case . . . shall be determined with reference to the substance of the particular transactions or arrangements which result in the avoidance of taxes or the failure to clearly reflect income . . . .

The district director may impute income according to *id.* § 1.482-1(d)(4), which provides:

> (4) If the members of a group of controlled taxpayers engage in transactions with one another, the district director may distribute, apportion, or allocate income, deductions . . . to reflect the true taxable income of the individual members under the standards set forth in this section and in § 1.482-2 notwithstanding the fact that the ultimate income anticipated from a series of transactions may not be realized or is realized during a later period . . . . Similarly, if one member of a group lends money to a second member of the group in a taxable year, the district director may make an appropriate allocation to reflect an arm's length charge for interest during such taxable year even if the second member does not realize income during such year . . . .

3. INT. REV. CODE OF 1945, § 482, allocation of income and deductions among taxpayers, provides:

> In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary or his delegate may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of such organizations, trades, or businesses.

4. Kahler Corp. v. Commissioner of Internal Revenue 58 T.C. 496, 509 (1972), *rev'd*, 486 F.2d 1, 4 (8th Cir. 1973).

newly promulgated regulations are constitutionally valid.[5] Therefore, the Commissioner may use an arm's length rate of interest to impute income on advances made by the lending corporation.

The issue confronting the Tax Court was whether the Commissioner[6] is authorized to impute interest under section 482 between two or more related corporations without regard to whether the borrowing corporation had gross income or used the funds to produce income.

The Tax Court concluded that the statute specifically requires "distribution, apportionment, or allocation" and the borrowing corporation must have realized income from the particular transaction[7] pior to any income allocation. The court explicitly stated that legislative history indicates allocation should be allowed only where there has been an *actual* shifting of the enumerated items in section 482 and not merely where the controlled corporations have the "power to devise such artifices."[8]

The purpose and intent of section 482 is to prevent the shifting of profits and to clearly reflect the true tax liability[9] by distribution, apportionment and allocation. The court stated that the regulations which permit the Commissioner to impute interest income are in direct contravention to the statute and without Congressional authority.

The Tax Court has interpreted section 482 consistently since its enactment (in the 1921 Revenue Act, section 240(d)(8)[10] and re-enactments in 1926 as section 240(f)[11] and as section 45[12] in 1928 and

5. 486 F.2d at 4.

6. The Commissioner argued that section 482 and the regulations permit him to "allocate" to petitioner a five per cent interest charge on the advances made to the four subsidiaries. The Commissioner described his imputation of income as an "allocation" but in fact he was imputing interest. The Tax Court stated ". . . the income which the Commissioner has 'allocated' to the petitioner was created solely through the application of the regulations promulgated under section 482 and did not exist as a result of the advances themselves." 58 T.C. at 511.

7. The Tax Court stated that a prerequisite to the Commissioner's allocation authority under section 482 is the existence of an item of income ". . . which had its genesis in the particular transaction . . . ." *Id.* at 506. The court cited P.P.G. Indus., Inc., 55 T.C. 928 (1971); Huber Homes, Inc., 55 T.C. 598 (1971); Smith Bridgman & Co. 16 T.C. 287 (1951), *acquiesced in*, 1951-1 CUM. BULL. 3.

8. 58 T.C. at 509.

9. "Section 45 authorizes the Commissioner to make an allocation of gross income among businesses controlled by the same interests in order (1) to prevent evasion of taxes, or (2) clearly to reflect the income of any of such businesses." Asiatic Petroleum Co. v. Commissioner, 79 F.2d 234, 236 (2d Cir. 1935).

10. INT. REV. ACT. OF 1921, ch. 136, § 240(d), 42 Stat. 260 (now INT. REV. CODE OF 1954, § 482).

11. INT. REV. ACT OF 1926, ch. 27, § 240(f), 44 Stat. 46 (now INT. REV. CODE OF 1954, § 482).

other similar enactments[13]) by finding that the Commissioner cannot allocate income where none exists. The lower court in *Kahler* cited the House Committee reports on section 45 of the 1928 Act[14] (predecessor to section 482) as "... evidence of its underlying purposes, in preventing . . . the evasion (by the shifting of profits, by the making of fictitious sales, and other methods frequently adopted for the purpose of 'milking'), and in order to clearly reflect their true tax liability."[15]

The cases interpreting section 482 and its predecessors can be divided into the following categories: (a) cases before the promulgation of the 1968 regulations; (b) cases rejecting the application of these regulations; and (c) cases applying the regulations.

The first category is exemplified by *Tennessee-Arkansas Gravel Co. v. Commissioner.*[16] Tennessee corporation agreed to rent equipment, at $1,000 per month during 1933, to a Mississippi corporation owned and controlled by the same interest as Tennessee. In 1934, the tax year in question, a leasing agreement was not transacted between the corporations. The Commissioner[17] allocated rental income to Tennessee when the Mississippi corporation sustained an operating loss and was unable to pay rent. The court concluded that the primary purpose of section 45 (now section 482) was to clearly reflect income by distribution, apportionment and allocation, but "not to set up income where none existed."[18]

Subsequently, in *Smith Bridgman & Co. v. Commissioner,*[19] the Tax Court held the Commissioner may distribute, apportion, or allocate income[20] when income exists and an adjustment[21] is made to the bor-

12. INT. REV. ACT OF 1928, ch. 852, § 45, 45 Stat. 806 (now INT. REV. CODE OF 1954, § 482).
13. INT. REV. CODE OF 1939, § 45, 53 Stat. 25; INT. REV. ACT OF 1938, ch. 289, § 45, 52 Stat. 474; INT. REV. ACT OF 1936, ch. 690 § 45, 49 Stat 1667; INT. REV. ACT OF 1934, ch. 277, § 45, 48 Stat. 695; INT. REV. ACT OF 1932, ch. 209, § 45, 47 Stat. 186 (now INT. REV. CODE OF 1954, § 482).
14. The 1926 Act eliminated consolidated returns as required by the 1921 Act, and thus the government needed power to realize the objectives of section 240(d).
15. H.R. REP. No. 2, 70th Cong., 1st Sess. 16 (1927), *reprinted in* 1939-2 CUM. BULL. 395.
16. 112 F.2d. 508 (6th Cir. 1940).
17. *Id.* at 510. The Commissioner argued that the rental agreement of 1933 served as a basis for the charge of $12,000 rental income for 1934. Notwithstanding any agreement, the Commissioner said Tennessee "should have charged" rent.
18. 112 F.2d at 510.
19. 16 T.C. 287 (1951), *acquiesced in,* 1951-1 CUM. BULL. 3.
20. *See* Epsen-Lithographers, Inc. v. O'Malley 67 F. Supp. 181 (D. Neb. 1946) (attempt by Commissioner to "impute" income to corporation from a partnership); E.C. Laster v. Commissioner, 43 B.T.A. 159 (1940), *modified on other issues,* 128 F.2d 4 (5th Cir. 1942) (transferred leases without any consideration even though oil payments were to be paid on such leases considered to be creation of income where none existed).
21. A correlative adjustment is an adjustment made to the borrowing corporation increasing interest expense to reflect the income that is imputed to the related corporation.

rowing corporation. Continental department stores owned the capital stock of Smith and through a board of directors resolution Continental borrowed an interest-free loan to retire debentures at 102 per cent of par value plus accrued interest. The Commissioner's argument[22] that interest should be imputed to Smith was rejected despite Continental's collecting four per cent interest on an outstanding loan to another corporation.

The cases in the next category were decided after the promulgation of section 482 regulations in 1968. In *Huber Homes, Inc. v. Commissioner*,[23] the corporation, Huber, transferred 52 houses to its wholly-owned subsidiary at cost. The subsidiary converted the houses into rental properties and realized gross rental income of $470,000 but sustained a net loss of $56,000.

The Commisioner allocated income to Huber based upon the difference between fair market value and cost on the houses transferred to the subsidiary.[24] Huber argued that no income could be allocated because no income was realized on the transfer.

The Tax Court held that the Commissioner cannot "create" income in a transaction which would have produced income had the parties dealt at arm's length. The court distinguished Treasury Regulations 1.482-1(d)(1) and 1.482-1(d)(4) as applying to the situation where a member of a controlled group sells to a controlled vendee at cost and

22. The Commissioner argued that ". . . Continental, in securing these non-interest-bearing loans from petitioner, was enabled to relieve itself from paying interest on its outstanding debentures." 16 T.C. at 293. He argued petitioner could have loaned the funds which Continental borrowed without interest to third parties at four per cent interest. *Id.*

23. 55 T.C. 598 (1971).

24. The Tax Court in *Huber Homes* relied upon cases such as Oil Base Inc. v. Commissioner 362 F.2d 212 (9th Cir. 1967), for the principle:

> The arm's length standard relied upon by the Commissioner has traditionally been upheld where it has served as the basis for a reallocation of income derived from dealings with third parties—*i.e.*, parties other than the controlled corporations which have engaged in transactions at less than arm's length.

55 T.C. at 606. It should be noted that the court relied on cases that were decided before the promulgation of the regulations. Treas. Reg. § 1.482-1(d)(4), T.D. 6952, 1968-1 Cum. Bull. 218, permits the district director to impute income. *Id.* § 1.482-2(e)(1) would seem to be directly applicable under the facts of *Huber Homes.*

> Where one member of a group of controlled entities . . . sells or otherwise disposes of tangible property to another member of such group . . . at other than arm's length price (such a sale being referred to in this paragraph as a "controlled sale"), the district director may make appropriate allocations between the seller and the buyer to reflect an arm's length price for such sale or disposition. An arm's length price is the price that an unrelated party would have paid under the same circumstances for the property involved in the controlled sale. Since unrelated parties noramlly sell products at a profit, an arm's length price normally involves a profit to the seller.

Id. According to this regulation the district director may charge an arm's length price to the corporation.

that vendee sells to a third party. The profit realized in that case must be allocated to the original vendor in order to prevent the shifting of profits, even though the sale does not occur until a subsequent year. This situation was not present in *Huber* because the houses were to be used for rental property and there was no intention to resell present.[25]

In *P.P.G. Industries, Inc. v. Commissioner*,[26] the evidence indicated that a revenue agent "imputed" a portion of the 1960 income at a five per cent interest rate[27] on a 1940 interest-free loan. The Tax Court concluded there was a "most tenuous connection between this 1940 balance . . . and income some 20 years later."[28] The court noted that it did not decide whether the Commissioner can impute income, which the court considered indistinguishable from an allocation of income, but limited itself to whether section 482 applied under the circumstances.[29]

The third category of cases would seem to adopt and to validate the regulations. The Tax Court in *Kahler* questioned the validity of the regulations even though *B. Forman Co. v. Commissioner*,[30] decided prior to *Kahler*, permitted interest income to be imputed to the controlled lending corporation.

In *Forman*, two separate family-owned corporations each made an interest-free loan of one million dollars[31] to a corporation owned by both. The United States Court of Appeals for the Second Circuit found those cases[32] which hold that the Commissioner is not authorized to

25. 55 T.C. 598 (1971). The Tax Court in finding the regulation not applicable stated, "We think that the regulations do not cover the present case where there was no intention to resell . . . ." *Id.* at 610.

26. 55 T.C. 928 (1971).

27. The Tax Court seemed to indicate that the revenue agents charge was arbitrary when it said:

> We do not see how respondent can seriously deny that he is creating an artificial interest charge when the very regulation he relies upon contemplates an adjustment to income based upon an 'arm's length interest rate.'

Id. at 1009.

28. *Id.*

29. The Tax Court in *P.P.G. Inc.*, intimated that imputation of income is indistinguishable from allocation of income, a break from prior precedent.

30. 54 T.C. 912 (1970), *aff'd & rev'd in part*, 453 F.2d 1144 (2d Cir.), *cert. denied*, 407 U.S. 934 (1972).

31 The loans to Midtown were three year notes bearing no interest and, on the due dates, the notes were replaced with similar notes in the same amount. 453 F.2d at 1149.

32. The Second Circuit in *Forman* cited the following cases: Tennessee-Arkansas Gravel Co. v. Commissioner 112 F.2d 508 (6th Cir. 1940); P.P.G. Indus. Inc. v. Commissioner 55 T.C. 928 (1971); Huber Homes, Inc. v. Commissioner 55 T.C. 598 (1971); Atchison, Top. & San. Fe Ry. v. Commissioner 36 T.C. 584 (1961); Society Brand Clothes, Inc. v. Commissioner 18 T.C. 304 (1952); Smith Bridgman & Co. v. Commissioner 16 T.C. 287 (1951); Combs Lumber Co. v. Commissioner 41 B.T.A. 339 (1940).

impute interest on non-interest-bearing loans "are not in accord with either economic reality, or with the declared purpose of section 482."[33]

The court stated the regulations must prevail, for without the regulations, section 482 would be seriously impaired.[34] Interest income must be added to the taxpayers' incomes, provided a correlative adjustment is made to the borrowing corporation. The Commissioner, under the authority of Treasury Regulation 1.482-2 imputed interest income despite the borrowing corporation's losses for the years in question.

The United States Court of Appeals for the Eighth Circuit reversed the Tax Court in *Kahler*,[35] basing its decision upon the rationale in *Forman*. The court found no weighty reasons for overruling the regulations as being unreasonable or inconsistent with section 482.[36] The test applied by the court was ". . . whether or not the loans from the taxpayer to other members of a controlled group would have been made on an interest-free basis in arm's length dealings between uncontrolled taxpayers."[37]

The court concluded that the Commissioner can allocate income without showing that any part of the gross income was produced by the borrowed funds.[38] Furthermore, the court reiterated that the Commissioner has the discretionary authority to apply the regulations retroactively.[39]

The Tax Court is in conflict with the Second and Eighth Circuits as to whether imputation under the current regulations is permitted in light of section 482 statutory history.

It has been argued section 482 should be applied when some "traceable and definable monetary benefit accrues to the affiliates."[40] The intermediate "tracing" technique has been adopted in *Kerry Investment Co. v. Commissioner*.[41] There the parent corporation made interest-free advances to a subsidiary. These funds were used to make loans to third parties, to purchase real estate, and to make other investments.

33. 453 F.2d. at 1156.
34. *Id.*
35. 486 F.2d 1 (1973), *rev'd*, 58 T.C. 496 (1972).
36. *See* Commissioner v. South Texas Co. 333 U.S. 496 (1948). The Court reviewed legislative and administrative history, and judicial decisions citing, Faricus Mach. Co. v. United States, 282 U.S. 375 (1931); United States v. Moore, 95 U.S. 760 (1878).
37. 486 F.2d at 5.
38. *Id.* The Eighth Circuit in *Kahler* found "no support in legislative history . . . that transactions . . . be traced to the production of gross income." *Id.*
39. *See* Automobile Club v. Commissioner, 353 U.S. 180 (1957).
40. *See* Note, *Recent Extensions of Section 482 of the Internal Revenue Code*, 3 MEMPH. ST. L. REV. 106, 116 (1972).
41. 58 T.C. 479 (1972), *not acquiesced in*, 1972-2 CUM. BULL. 3.

The Commissioner determined that a five per cent interest charge on the total loans outstanding should be allocated to Kerry. The taxpayer failed to prove the Commissioner acted in an arbitrary, unreasonable or capricious manner in allocating this income.[42]

The Tax Court held that the Commissioner can allocate income to the parent if the subsidiary has gross income. This income must be traced to show that the borrowed funds were used to produce such income. The burden of proving[43] the contrary is on the taxpayer.

The *Kahler* decision differs from *Kerry* because the Commissioner in *Kahler* limited himself to the imputation of interest income without "regard to whether the interest-free, borrowed funds produced income."[44] If the Commissioner had argued the tracing technique as adopted in *Kerry*, he might have won.

Before the reversal of *Kahler*, the Tax Court reaffirmed its position in *Fitzgerald Motor Co. v. Commissioner*.[45] The court there held that if the debtor corporation earns income with the proceeds of a loan from the creditor corporation, the Commissioner may allocate income. The burden remained on the taxpayer to prove that gross income was not attributable to the loans in issue. The assertion of authority to *impute* income was argued by the Commissioner to no avail.[46]

In *Liberty Loan Corp. v. United States*,[47] the corporation was engaged in a small loan business. The parent corporation borrowed from lending institutions (*e.g.*, banks and insurance companies) at a reduced interest rate. The parent proceeded to loan this money to its subsidiaries at higher rates; the subsidiaries then loaned the money to con-

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42. *See* Marc's Big Boy-Prospect, Inc. v. Commissioner, 52 T.C. 1073 (1969), *aff'd*, 452 F.2d 137 (7th Cir. 1971); Huber Homes, Inc. v. Commissioner 55 T.C. 598 (1971). The taxpayer must prove the Commissioner acted in an arbitrary, unreasonable, or capricious manner.

43. 58 T.C. at 490.

44. The Tax Court in *Kahler* concluded:

> . . . [W]e wish to make it clear that we rest our decision herein on the fact that the respondent, in his deficiency notice, at trial, and on brief, limited himself to the issue of straight imputation of interest without regard to whether the interest-free, borrowed funds produced income. Consequently, we do not have before us the issue which we faced and decided this day in *Kerry Investment Co.*, 58 T.C. 479 (1972). We hold, therefore, that the imputation of income by the Commissioner with respect to the Kahler advances was unreasonable and arbitrary and we do not sustain the determination of the Commissioner.

Id. at 512.

45. 60 T.C. No. 101 (September 29, 1973).

46. The Tax Court in rejecting the Commissioner's argument stated:

> To sustain him on that ground would be at odds with our long-standing position on section 482 which we have so recently reaffirmed, and we decline to do so.

Id.

47. 359 F. Supp. 158 (E.D. Mo. 1973).

sumers. A number of subsidaries were not charged interest for the taxable year because of an "impaired capital" position.

The district court noted the Commissioner has authority under the regulations to impute income but this power should not "produce a wholly ficitious result which does not clearly reflect income."[48] The decision was limited to the facts of the case. When the parent corporation borrowed from the lending institutions the parent charged the group as a whole interest based on the amount it had to pay the institution on behalf of the group. The court in a footnote recognized that other courts differ on the question of the necessity of proving realized income from borrowed funds, but found it unnecessary to reach the issue.[49]

A number of diverse results have been reached since the promulgation of the regulations. In accordance with precedent, *Kahler* has held the Commissioner may not impute income but may do so when there is an *actual* shifting of income, deductions, credits or allowance. In *Kerry*, the court ruled that the Commissioner may allocate income where the income may be traced to the proceeds. The Second Circuit in *Forman* held that the Commissioner may impute income to the creditor corporation even if income does not exist.

The apparent utility of the "tracing" approach sanctioned by *Kerry* is misleading.[50] If, for example, the borrower used the money for real estate purchases, would rental income be attributable as "rental" or "interest" income?[51] Furthermore, if the borrower should not decide to utilize the funds until a later period, continuous policing would be required. In a complex transaction[52] the court would be left with great administrative problems. The Tax Court, however, applied the rationale of *Kerry* despite Judge Featherston's admonishment in *Kerry* that the tracing concept "places a premium on accounting sophistication and lays a 'trap for the unwary.' "[53]

48. *Id.* at 164.
49. *Id.* at 165.
50. The dissenting Judge Featherston in *Kerry* stated:

> As I read section 482 and these regulations, the applicability of that section does not depend upon the realization of pretax profits from a particular non-arm's-length transaction or, in the case of borrowed funds, the use to which they are placed. The section refers to 'gross income' and 'deductions' and does not specify the source from which they may be derived. . . . [T]he concept gives birth to a mischievous rule . . . . [I]t places a premium on accounting sophistication and lays a 'trap for the unwary.'

58 T.C. at 495.
51. *See* Hamlin, *Section 482 in the 1970's: Commissioner's Authority to Allocate, When, How, and to Whom*, 25 S. CAL. 1973 TAX INST. 701.
52. *Id.* at 715.
53. 58 T.C. at 495.

In holding that the Commissioner may impute interest on loans between related entities, the Second Circuit in *Forman* necessarily concluded that the new regulations are in accord with the scope and purpose of section 482.[54] The *Forman* rationale[55] has been criticized, since Congress re-enacted section 45 after the Tax Court in *Tennessee* declared succinctly that income cannot be "created" where none exists.[56] As a corollary, Congress had impliedly accepted the Tax Court's interpretation of section 45, therefore, the Second Circuit's decision in *Forman* should be overruled. Further, the regulations had the same scope and purpose before the promulgation of the 1968 regulations,[57] and the *Tennessee* decision would have necessarily reflected the intended scope of section 45(482).

The regulations have been rejected not only by the Tax Court, but also by academicians and scholars. One author has stated that the regulations are unsupported by judicial authority and that the ". . . application of the arm's length doctrine, without consideration of the end result of a transaction or series of transactions between affiliates, does not necessarily reach the right result."[58] A literal interpretation of section 482 supports the conclusion that gross income must exist before allocation.[59] The *Kahler* court stated, "If an interest charge is to be placed indiscriminately on loans between related entities without consideration of whether loans produced realized income, we feel that it is the Congress, and not this court, which should so provide."[60]

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54. Treas. Reg. §§ 1.482-1(a), (b) (1954).

55. The Second Circuit in *Forman* stated that section 482 has been interpreted liberally and cited Asiatic Petroleum Co. v. Commissioner, 31 B.T.A. 1152, *aff'd*, 79 F.2d 234 (2d Cir.), *cert. denied*, 296 U.S. 645 (1935), for the principle that 'gross income' in section 45 (predecessor to section 482) is to be construed broadly. 453 F.2d at 1152.

56. *See* Comment, *Section 482-Allocation-Interest Free Advances to Controlled Subsidiaries Held to Create Income Allocable to Controlling Taxpyers—B. Forman Co. Inc. v. Commissioner of Internal Revenue*, 6 N.Y.U.J. INT'L L. & POL. 169 (1973).

57. Treas. Reg. § 1.482-1 (1954), sets forth the scope and purpose of section 482. This regulation existed before the enactment of the Internal Revenue Code of 1954 and was utilized to interpret section 482 and its predecessors. The 1968 regulations have given an expansive interpretation to section 482 broader than the interpretation given by prior precedent.

58. Jenks, *The Creation of Income Doctrine; A Comment on the Proposed Section 482 Regulations*, 43 TAXES 486 (1965).

> The consolidation of accounts, that is, a consolidation of the particular transaction or series of transactions between related enterprises, may be preferable to the approach in the proposed regulation. It would appear to avoid the two principal defects of the proposed regulation, which are: (a) the taxation of income prior to its realization by dealings outside the controlled group, and (b) the taxation of fictitious income . . . .

Id. at 493. *See* Hamlin, *Correct Allocations Under Section 482 Are Still Difficult Despite New Regulations*, 33 J. TAXATION 358 (1970).

59. *See* note 48 *supra*.

60. 58 T.C. at 511.

In view of Treasury Regulation 1.482-1(d)(4) and the *Forman* case, the Tax Court's rationale in *Kahler* should be rejected. The holding that the Commissioner can only allocate income where it actually exists is unequivocally arbitrary. The Commissioner should be able to impute income between members of a controlled group on interest-free loans. The purpose underlying section 482 is to prevent the shifting of profits and the evasion of taxes; and to allow a clear reflection of the income of such corporations.

If, for example, the *A* corporation loans funds to *B* corporation and the borrowing corporation invests in non-taxable bonds, the lending corporation would incur no taxable income according to *Kerry*. Further, assuming the Commissioner made a correlative adjustment to the borrowing corporation as in *Smith*, the Tax Court would rule that income was not produced in retiring the bonds. In the second hypothetical the use of non-interest-bearing proceeds allowed the borrowing corporation to retire bonds profitably without incurring any expense. Under both hypotheticals the Tax Court would not have permitted the Commissioner to allocate income because no income was produced by use of the borrowed funds.

The proceeds in both hypotheticals actually injected capital that either *produced* income or *released* other capital for productive use. The Tax Court's interpretation in *Kahler* permits corporations to shift income without any recognition and thus indirectly to shift profits in contravention of section 482.

The immediate recognition of income by imputation precludes the indirect shifting of profits and avoids the continuous policing and administrative problems inherent in *Kerry*. To allow the Commissioner to impute interest will prevent an astute lawyer or accountant from furthering this diversion of profits.

Patsy A. Iezzi, Jr.