CORPORATIONS: A PARENT MAY NOT ALLOCATE TO ITSELF SUBSTANTIALLY ALL OF THE TAX SAVINGS RESULTING FROM CONSOLIDATED RETURNS

THE Internal Revenue Code permits the filing of consolidated income tax returns by an affiliated group of corporations.[1] Although the Code regulates the manner in which tax liability of the affiliated group will be apportioned among member corporations,[2] it makes no provision as to the allocation of tax savings which result from the consolidation. In *Case v. New York Cent. R.R.*[3] the New York Supreme Court, Appellate Division, held that a parent corporation with a net operating loss may not allocate to itself substantially all of the tax savings realized by its subsidiary through a consolidated return.

The parent, New York Central, owned eighty per cent of the common stock of Mahoning Railroad Company, and leased all of Mahoning's facilities under an agreement whereby it paid all maintenance and operating expenses and in addition paid to Mahoning forty per cent of gross income from that operation. As a result of an election to file consolidated returns during 1957-1960, New York Central's net operating losses eliminated entirely Mahoning's tax liability for those years, effecting a savings to Mahoning of $3,825,717.43. Pursuant to an agreement,[4] Mahoning allocated to

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[1] INT. REV. CODE OF 1954, § 1501; 8 MERTENS, FEDERAL INCOME TAXATION § 46 (Zimet rev. 1957). Most corporations are includible in an affiliated group; exceptions are listed in INT. REV. CODE OF 1954, § 1504(b). "Affiliated group" is defined as one or more chains of includible corporations connected by 80% stock ownership either directly by an includible parent corporation, or indirectly through subsidiaries of that parent. INT. REV. CODE OF 1954, § 1504(a). Consent by all members of the affiliated group is required to file a consolidated return; however, the making of that return is considered consent. INT. REV. CODE OF 1954, § 1501. The consolidated taxable income of the group is taxed at the normal rate increased by 2%, INT. REV. CODE OF 1954, § 1503(a), with exceptions as to certain types of corporations, including the railroad companies involved in *Case*, which are taxed at the normal corporate rate. INT. REV. CODE OF 1954, § 1503(b).

[2] Generally, the tax liability of the group may be allocated proportionately among those member corporations contributing taxable income to the consolidation or by any other method selected by the group with approval of the Secretary or his delegate. INT. REV. CODE OF 1954, § 1552.

[3] 19 App. Div. 2d 383, 243 N.Y.S.2d 620 (1963).

[4] Central and thirty-four of its affiliates were parties to that agreement; however, the affiliates other than Mahoning were either wholly owned by Central or were operated under leases obligating Central to pay all federal income taxes, or operated in such a way that expenses of the operation equalled income, resulting in no taxable

Central ninety-three per cent of the savings, leaving a net gain to to Mahoning of $268,725.28. The dividend expectancy of Mahoning's minority stockholders thus became $53,751.05, approximately one and one half per cent of the total tax savings.[5] In a derivative action brought by members of that minority, the appellate division, in a 3-2 decision, rescinded the allocation agreement and ordered an accounting for the entire amount allocated to Central, resulting in a retention by Mahoning of the total savings produced by the consolidation.

The court did not dwell long in finding Central's domination and control of Mahoning. At the time of the allocation agreement, there were seven members of Mahoning's board of directors,[6] all of whom were nominees of Central, and six of whom were officials of Central or other Central subsidiaries. Mahoning's officers were all officers or employees of Central or its subsidiaries. The allocation agreement had been prepared by Central's director of taxes, and no independent counsel had represented Mahoning in its preparation.[7]

Although the court failed to expressly state the standard used in determining that the allocation should be rescinded, it apparently followed the prevailing view adhered to in New York, the federal courts and a majority of the states. By that rule, contracts between affiliated corporations are voidable only for unfairness.[8] The rule recognizes that the complex corporate relationships existing today are

gain. In effect, the allocation agreement was operative only as to Central and Mahoning. *Id.* at 385, 243 N.Y.S.2d at 622.

[5] By the terms of the agreement, generally, all income tax savings were allocated to the member corporation contributing the loss, whereas the savings of the 15% tax on intercorporate dividends, resulting from the consolidation, were allocated to the corporations paying those dividends. *Id.* at 384-86, 243 N.Y.S.2d at 621-22. In his dissent, Steuer, J. suggested that the agreement allowed many methods of calculating the amount of that allocation, that the 93% to 7% distribution adopted by the majority opinion was the result of a calculation which would show the greatest disparity, and that if calculations had been by other methods, the benefit to Mahoning's minority stockholders would have been greater. *Id.* at 390, 243 N.Y.S.2d at 627.

[6] Brief for Plaintiff, p. 6.

[7] 19 App. Div. 2d at 386, 243 N.Y.S.2d at 623.

[8] Geddes v. Anaconda Copper Mining Co., 254 U.S. 590 (1921); Chelrob, Inc. v. Barrett, 293 N.Y. 442, 57 N.E.2d 825 (1944); Everett v. Phillips, 288 N.Y. 227, 43 N.E.2d 18 (1942); 3 FLETCHER, PRIVATE CORPORATIONS § 962 (perm. ed. rev. repl. 1947); BALLANTINE, CORPORATIONS § 72, at 181-82 (rev. ed. 1946). It is not uncommon for the decisions to be in terms of bad faith, unreasonableness, overreaching and the like, either in addition to or instead of the standard of fairness. However, it would seem that at least in the context of allocation agreements such as involved in *Case*, the standard of fairness is inclusive of all of those additional considerations, and is so used herein.

not necessarily undesirable. Directors with duties common to several corporations are free to approve intercorporate transactions, knowing that those transactions, if fair to both corporations, will not be disturbed. However, such transactions will be subject to judicial scrutiny when, as in *Case*, it is alleged that the interests of one corporation have been advanced by sacrificing the interests of the other.[9]

Affiliated groups are permitted to file consolidated returns only if eighty per cent of all voting stock and eighty per cent of each class of non-voting stock of each corporation is directly owned by one or more of the other corporations includible in the group.[10] Thus, agreements between those corporations allocating the resulting tax savings must inherently be subject to such judicial scrutiny. In the only two reported cases involving the allocation of consolidated return savings, agreements had been entered into by the affiliated corporations. The Ninth Circuit Court of Appeals, in *Western Pac. R.R. Corp. v. Western Pac. R.R. Co.*,[11] held that where the agreement allocated the entire savings to the profit corporation, that agreement may not be attacked by minority stockholders of the loss corporation. There the profit corporation retained as a gain the amount which it otherwise would have paid in tax, whereas the loss corporation relinquished its net operating loss which otherwise would have had potential value as a carryback or a carryforward. In *Alliegro v. Pan Am. Bank*,[12] where the agreement allocated all of the savings to the loss corporation, the Florida District Court of Appeals held the allocation to be an illegal dividend and ordered an accounting for the entire amount.

Thus, retention of the entire tax savings by the profit corporation may be fair; allocation of the entire savings to the loss corporation,

[9] The allocation of the burden of proof in this regard obviously might be determinative. The dissent in *Case* suggested that a great part of the effort by each party was made toward shifting that burden to the other; however, the majority did not expressly locate that burden. FLETCHER, *op. cit. supra* note 8, § 973 at 456, suggests the majority view to be that there is a presumption of unfairness, placing on the party who would sustain the transaction the burden of proving its fairness.

[10] See note 1 *supra*.

[11] 197 F.2d 994 (9th Cir. 1951), *rev'd and remanded for reconsideration of denial of petition for rehearing en banc*, 345 U.S. 247 (1953), *referred to division to hear petition for rehearing en banc*, 205 F.2d 374 (9th Cir. 1953), *petition for rehearing en banc denied*, 206 F.2d 495 (9th Cir. 1953).

[12] 136 So. 2d 656 (Fla. Dist. Ct. App. 1962), *aff'd per curiam*, 149 So. 2d 45 (Fla. 1963).

at least when it is the parent corporation,[13] is illegal; *Case* adds that allocation of ninety-three per cent of the savings to the loss contributing parent is unfair. The specificity of these holdings furnish but meager guidelines for the annual disposition of large amounts of corporate assets.

Fundamental to an analysis of the unique problem in any tax savings allocation situation is an understanding of what the allocations actually are. Although the result in *Alliegro* would seem desirable, it is unfortunate that the court chose to consider the allocation a dividend,[14] declaring it illegal, rather than subjecting the allocation to scrutiny for fairness. The tax savings allocated in any consolidated return situation are the product of a common undertaking by all members of an affiliated group, each contributing a net operating loss or current profit, resulting in a proportionate reduction or an elimination of the tax each profit corporation would have paid absent consolidation.[15] Conceptually, the savings cannot be considered as having been earned solely by the profit corporation. They would seem to be more in the nature of profit from a joint venture. That profit is a gain by the affiliated group constituting the venture, and thus cannot yet be considered an asset on the books of any member corporation.[16] Only that portion of the gain finally

[13] There had been previous years in which the subsidiary, having sustained a loss, had received payments from the parent, presumably pursuant to the same allocation agreement. *Id.* at 658.

[14] In declaring the allocations illegal dividends, the Florida court purported to follow a Tax Court decision, *Beneficial Corp.*, 18 T.C. 396 (1952) (facts essentially identical to *Alliegro*, 136 So. 2d 656, 661 (Fla. Dist. Ct. App. 1962)). In *Beneficial*, the Tax Court found the definition of taxable dividends, INT. REV. CODE OF 1939, § 115(a), broad enough to cover allocation agreement payments by the subsidiaries to the parent in excess of the tax liabilities properly allocable to the subsidiaries in the consolidated return. 18 T.C. at 399. As explained in the text supported by note 16 *infra*, it is at least arguable that such payments cannot be considered dividends for any purpose. Furthermore, as suggested by the defendant in *Case*, there are many instances in which the tax law treats a payment as a dividend where dividend consequences would not attach under state corporate law. Brief for Defendants-Respondents, p. 46. Some examples cited are: interest payments on corporate debt obligations, R.M. Gunn, 25 T.C. 424 (1955); principal amount paid in redemption of corporate debt obligations, Gooding Amusement Co., 23 T.C. 408 (1954); principal amount paid in redemption of common or preferred stock, INT. REV. CODE OF 1954, §§ 302(d), 306. The court, in *Case*, expressly reserved decision on whether the payments by Mahoning to Central were the equivalent of dividends. 19 App. Div. 2d 388, 243 N.Y.S.2d 625 (1963).

[15] See Western Pac. R.R. v. Western Pac. R.R., 345 U.S. 247, 277 (1953) (Jackson, J. dissenting from procedural remand).

[16] There is no direct authority for this proposition; however, Mr. Justice Jackson's dissent from procedural remand in *Western Pac. R.R.* strongly suggests a joint venture type approach to the problem. *Ibid.*

allocated to the individual corporation should be considered surplus[17] from which dividends might be declared by that corporation.

In any such situation, the ultimate question must be what is a fair allocation of the total tax savings. The sole contribution of each party to the consolidation is a current profit or a net loss. Either has value, if not committed to the consolidation, only for purposes of a net operating loss carryover,[18] and even then has value only to the corporation which generated that profit or loss. Hence, the "market value" of either can never be determined because neither is "salable" outside of a consolidated return situation, and there can never be arm's length bargaining between affiliated corporations.[19]

If the potential value of a loss or a profit for carryover purposes could always be realized,[20] the problem would have the simple solution of the equal division of the total savings. The net loss or profit could be given the full face value of its effect in a carryover situation; then when committed instead to a consolidation, the profit and the loss actually absorbed would be equal. Profit years, however, are not always preceded or followed by losses within the three year and seven year limits for the taking of carryover deductions;[21] nor are loss years always preceded or followed by profit. Thus, depending on the nature of the allocation agreement being drafted and the situation of the corporations involved, there must inevitably be some speculation by the contracting parties as to the value of the net loss or net profit to be committed to the consolidation. For this reason,

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[17] The term *surplus* as used here is consistent with the usage in corporation law, and should not be confused with the definition of dividends, for tax purposes, which encompasses generally any distribution of property from *earnings and profits*. INT. REV. CODE OF 1954, § 316.

[18] For example, in *Case*, Central's net operating losses for 1957-1960 would, generally, have been carried forward as a net operating loss deduction in any profit year within seven years after the year in which the loss had occurred, or carried back as a deduction in an amended return for a prior profit year. Mahoning had no prior net operating losses which could have been carried forward as deductions in any year during 1957-1960; therefore, the potential value of its net profits during those years for carryover purposes could be realized only in the unlikely event that it incur a loss in a subsequent year which could be carried back on an amended return as net operating loss deductions. INT. REV. CODE OF 1954, § 172.

[19] 19 App. Div. 2d 386, 243 N.Y.S.2d 623 (1963).

[20] See discussion note 18 *supra*.

[21] See discussion note 18 *supra*. Although most taxpayers may take net operating loss carryforward to each of the five years following the taxable year of such loss, a regulated transportation corporation may take them to each of the seven following years. INT. REV. CODE OF 1954, § 172(b)(1)(C).

courts should allow some latitude in determining the fairness of the allocation in each case.

Viewing the transaction from the time of trial rather than from the date of its inception,[22] the court in *Case* found that even if Central had filed separate returns for 1957-1960, its net operating losses for those years would have "never ripened into operating loss deductions."[23] Unfortunately, the court apparently did not consider the extreme improbability of Mahoning's ever incurring net operating losses which could be carried back to 1957-1960, or the fact that there had been no prior losses which could have been carried forward during 1957-1960. Those losses could not exist because by the terms of its lease agreement with Central, Mahoning was "practically guaranteed taxable income into the indefinite future."[24] Thus, as a practical matter, neither Central's net loss nor Mahoning's net profit for 1957-1960 had any significant carry-over value for separate return purposes; yet, when committed to a consolidated return they generated a very significant common gain. It would seem that if an equal division of the gain could be justified when, in the hypothetical, the full potential of each could have been realized by the filing of separate returns, an equal division of the tax savings would also be justified where neither the loss nor profit had significant separate return value. In fact, if the court had viewed the agreement from the time of its inception, a less than equal division, in favor of Central, would have been fair. Central at least continued its existence in anticipation of profit,[25] whereas Mahoning, under its lease agreement, could hardly have expected to incur a loss.[26]

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[22] An important question, not expressly answered by the court in *Case*, would seem to be the extent to which courts should utilize the advantage of hindsight in determining the fairness of allocation agreements entered into years before.

[23] 19 App. Div. 2d 386, 243 N.Y.S.2d 623 (1963). This was correct so far as carryback deductions were concerned; however, it is not so clearly correct as to carry-forward deductions. As of the dates of the trial and of the appellate division's decision there remained some time within the seven year limit for operating loss carryforward deductions. INT. REV. CODE OF 1954, § 172(b) (1) (C).

[24] 19 App. Div. 2d 384, 243 N.Y.S.2d 621 (1963).

[25] Central had seven years to generate profits against which its losses during 1957-1960 could have been applied as net operating loss deductions. INT. REV. CODE OF 1954, § 172(b) (1) (C).

[26] Mahoning could have carried back as net operating loss deductions only losses incurred within three years after each profit year involved. INT. REV. CODE OF 1954, § 172(b) (1) (A) (i). The possibility of that happening had practically expired by the date of the appellate division's decision.

The court obviously felt the 93% to 7% allocation to be unfair. It would seem, however, that by ordering an accounting in favor of Mahoning for the entire allocation it reached an equally unfair result. The allocation agreement gave Mahoning's minority stockholder 1½% of the total tax savings. The court's order gives them 20%. Yet, if the consolidated return is considered in the nature of a joint venture, the minority stockholder's "equity" in that venture would seem to have been no more than 10%.[27] Furthermore, because a stockholder's derivative action is representative rather than personal,[28] the rights of Central's stockholders, who in reality are Mahoning's majority stockholders, should also have been considered. Their "equity" in the joint venture was at least 90%,[29] whereas, after the accounting they will realize only 80% of the gain. The New York cases indicate that courts of equity, in which derivative actions are brought, have rewritten the price terms of executed contracts between affiliated corporations to obtain results which are fair to all stockholders involved.[30] There would seem to be no sound reason why that same remedy should not be equally applicable to executed allocation agreements such as the one involved in *Case*.

The unique character of allocation agreements will always make them subject to judicial scrutiny. When so scrutinized, it would seem that the consolidated return can realistically be considered only in the nature of a joint venture; and, where the profits of such a venture are found to be unfairly allocated, the remedy in a court of equity need not be merely rescission of the agreement but rather a rewriting of its terms to obtain a fairness to all parties concerned.

[27] Their "equity" would be their 20% participation in Mahoning's equal, or 50%, participation with Central in the joint venture, *i.e.*, 10%. Furthermore, their "equity" might be considered less than 10%, if a less than equal division was found to be justified because of the unequal probabilities of future profits by Central and future losses by Mahoning. See note 29 *infra*.

[28] 13 FLETCHER, *op. cit. supra* note 8, § 5939.

[29] In an equal division of the savings, their "equity" would be their 100% participation in Central's equal, or 50%, participation plus their 80% participation in Mahoning's 50% participation in the joint venture, *i.e.*, 90%. Furthermore, the fact that eventual profit by Central seems more likely than losses by Mahoning might justify some unequal division, in favor of Central, although not as unequal as the 93% to 7% division effected by the allocation agreement.

[30] Ripley v. International Rys. of C.A., 8 N.Y.2d 430, 171 N.E.2d 443, 209 N.Y.S.2d 289 (1960); Chelrob, Inc. v. Barrett, 293 N.Y. 442, 57 N.E.2d 825 (1944).