THE TAXATION OF INTERCOMPANY INCOME

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An item of income realized by a corporation may be in the form of dividends, or interest, or profit on the sale of an asset, or compensation for services rendered, or income in the course of regularly conducted business such as merchandising, or may be in some other less usual form such as the income which may arise from the forgiveness of a debt. That part of the corporation's total income which is realized in transactions with another corporation (as distinguished from transactions with individuals) may in turn come in any one or more of these same forms.

If dealings between the two corporations are entirely at arm's length, as we may assume to be true when entirely different stockholders control the policies of the two corporations, the legislative problem is simpler, because, with the exception of dividend income, it is safe to treat intercompany income of a corporation exactly like its other income. The main reason for treating dividends in a different way is that a dividend is a distinctive type of income—a passing on by a corporation of profits which have already been earned by the declaring corporation, and taxed once to it.

A different problem arises when a corporation receives income in a transaction with a corporation owned or controlled by substantially the same corporate interest. Such transactions are analogous to transactions between husband and wife, or other family transactions, in that the parties may not be dealing at arm's length. Thus if a husband sells a tract of land to his wife for $10,000, this leaves us in doubt whether the value of the property is necessarily the selling price of $10,000; an element of gift one way or the other may be present. So in the case of corporations closely related by a common ownership or control, each transaction would have to be separately scrutinized, in order to find out whether its terms are real or artificial.

These peculiarities of the parent-and-subsidiary relationship, together with the practice of basing business decisions on consolidated balance sheets and income statements—well settled even before income taxation became established—have been the reasons underlying the practice of requiring or permitting consolidated returns

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by affiliated groups.[1] The two problems just mentioned—those involving the treatment of intercompany dividends and the treatment of transactions between affiliated corporations—are the ones discussed in this paper.

INTERCOMPANY DIVIDENDS

For taxable years prior to 1935 a corporation was not subjected to income tax with reference to dividends received from another domestic corporation. This was true whether the receiving corporation owned merely a small proportion of the stock of the declaring corporation or a large proportion. The underlying thought was that in such a case it is enough that an income tax shall be levied at two points—on the corporation that earns the income in the year when it is earned and on the ultimate *individual* stockholder when he receives the dividend. Indeed, for many years the individual stockholder was not required to pay any normal taxes on dividends, on the theory that one normal tax was enough.

In 1935 the Treasury recommended to Congress that the then existing law, which was worded so that a corporation receiving dividends was required to report them as a part of gross income and was allowed a deduction in the full amount of the dividends, be changed so that a deduction of only 85% of the dividends be allowed. The Act[2] as passed allowed a deduction of 90%, so that 10% remained for taxation, unless eliminated by other deductions. The Treasury's statement indicated that one purpose of doing away with the 100% deduction was to protect the graduated corporation income tax, so as to avoid any temptation for large corporations to complicate their structures for tax purposes by organizing a series of operating subsidiaries, but that a more important purpose was that of "encouraging the simplification of corporate structures." The present Attorney General, Robert H. Jackson, then Assistant General Counsel of the Treasury, made the statement in presenting the Treasury view:[3]

> "Intercorporate dividends are largely unnecessary transfers brought about and multiplied by complex corporate structures."

This statement, as to the soundness of which there may be different opinions, is characteristic of a period in the history of income tax legislation—a period perhaps not yet over—when revenue purposes are at various points subordinated to purposes of general reform. The beginnings go back at least to 1916, when the proposal had been unsuccessfully made that intercompany dividends should be taxed to their

[1] An affiliated group of corporations is one in which the constituent corporations are connected by ownership of at least 95% of stock; no foreign corporation is included in an "affiliated group" unless it is one which comes within a specific provision in §141(h), Internal Revenue Code, in being a foreign corporation organized under the laws of a contiguous foreign country to comply with the laws of such country, 100% of the capital stock (exclusive of qualifying shares) being owned or controlled by a domestic corporation, or unless it is a Pan-American Trade Corporation, as defined in §152, Internal Revenue Code, as amended.

[2] Revenue Act of 1935, §102(h), 49 STAT. 1014, 1018.

[3] *Hearings before the Senate Finance Committee on the Revenue Act of 1935*, 74th Cong., 1st Sess. (1935) 226.

entire extent for the discouragement of holding companies, and at intervals the same issue has arisen.

When the Ways and Means Committee reported[4] to the House the Revenue Bill of 1936, it provided that dividends received by a corporation be included in income without any deduction provision such as has been described. It is to be noted that this proposal was a part of a plan to substitute an undistributed profits tax for all existing corporate income taxes—a plan whose main purpose was not primarily to get revenue but to force accumulated corporate earnings into the hands of individual stockholders and so promote spending.

The Senate modified the undistributed profits tax as proposed by the House, retaining some of the elements of the then existing corporate taxes. The Act[5] as passed, after changes in conference, allowed a *credit* against net income (instead of a deduction from gross income) equal to 85% of the dividends received. In 1938, the law[6] was modified to provide for a credit of 85% of intercompany dividends, *provided* the credit did not exceed 85% of the "adjusted net income." This provision is now included in the Internal Revenue Code.

As will be evident, our present laws, in dealing with this question, are not wholly consistent with either of the two general theories of corporate income taxation. One theory emphasizes the concept of a corporation as an entirely separate entity to be taxed on all its income just as an individual would be; the other emphasizes the idea that business corporations are operated in the last analysis for the benefit of individual stockholders, and that where individuals A and B own the stock of Corporation M, which in turn owns the stock of Corporation N, taxes imposed on Corporation M and Corporation N must, in general, diminish the property-interest of the individual stockholders A and B.[7]

It is significant that the British income tax continues to be founded largely on the latter theory. It designs to tax corporate earnings only once, and this applies no matter how many corporations the earnings pass through on their way to the ultimate stockholder. Each recipient of the dividend, including the individual who finally gets it, is relieved from "standard" tax, this relief being based on the fact that these earnings were tax-paid at the start; and super-taxes imposed on individuals are not imposed on corporations. The initial rate is made high enough to raise the needed revenue.

This method appears to be the best, from the standpoint of the government's interest.[8] In this country we started out in that direction. Our later deviations are due

[4] H. R. REP. No. 2475, 74th Cong., 2d Sess. (1936) 8; 1939—1 (Pt. 2) CUM. BULL. 672.

[5] Revenue Act of 1936, §26(b), 49 STAT. 1648, 1664.

[6] Revenue Act of 1938, §26(b), 52 STAT. 447, 467.

[7] The precise extent to which individual stockholders bear the burden of corporate taxes probably varies with conditions which affect the corporation's ability to pass on a part of the tax-burden to customers.

[8] It has been suggested that intercompany dividends ought not to be taxed less severely than intercompany interest where the receiving corporation is not in control of the paying corporation, since both represent the fruit of an investment. This overlooks an important tax difference in the two situations, namely, that interest represents a sum which has escaped being taxed to the paying corporation (by

in large part to an increasing tendency to use the income tax to accomplish non-revenue purposes, and to a feeling on the part of politicians that when additional revenue must be had, it is politically expedient to make some change in the revenue structure, instead of simply raising rates.

It will be noted that if provision for consolidated returns of affiliated corporations should be restored to our taxation system, intercompany dividends *within an affiliated group* would be eliminated from tax consideration along with other intercompany transactions, if business practice and the present practice in dealing with affiliated returns of railroads are followed. There would still remain a substantial number of corporations whose stock holdings in other corporations, while not amounting to a 95% interest, do not constitute mere investment holdings. To give one instance, manufacturing corporations sometimes find it useful to acquire stock in customer corporations; such holdings would be for purposes connected with the furtherance of the business, as distinguished from investment, and it would seem undesirable to tax any dividends received in that relationship as severely as might be tolerable in cases where stock holdings are pure investments.

Future legislation regarding the taxation of dividends to corporate recipients seems likely to feel its way from year to year. It seems unlikely that any law will be passed more favorable than the present law to dividends received by corporations. On the other hand, more severe legislation may not be passed; those who believe in using the income tax as a regulating agency are likely to feel the need of encouraging investors to increase the capital available for business enterprises by buying corporate stocks, and they may also realize that the tax on dividends tends to nullify efforts which have been made to force corporations to distribute their earnings.

Furthermore, since dividends are already-taxed earnings in transit from the earning corporation to the ultimate stockholder, we may expect increasing recognition that to tax dividends to the recipient involves double or multiple taxation, in a system which in general aims at taxing each earning only once. The workability of income tax laws depends very largely on the cooperation of taxpayers, and the best way to maintain this is to make sure that the tax laws are respected as sensible and reasonable. The nearer we come to a consistent policy of taxing corporate earnings only once, the more smoothly working and the more productive, in the long run, is our revenue system likely to be.

CONSOLIDATED RETURNS

For taxable years before 1917, corporations had to file separate income tax returns, no matter how close their relation to other corporations. No provision for the consolidation of the returns of affiliated corporations appeared in the Revenue Act of 1917, but the Bureau of Internal Revenue made regulations[9] permitting such returns,

reason of an interest deduction which is allowed in calculating the net income of that corporation), whereas there is no such deduction for *dividends* paid; if dividends are treated as income to recipients, there is double or multiple taxation.

[9] U. S. Treas. Reg. 41 (1918) Arts. 77, 78.

and these regulations were later validated by a retroactive provision of law in the 1921 Act.[10] Invested capital as well as income was material under the 1917 law, and fantastic results would have been reached in income tax and excess profits tax if corporations which were really affiliated had been treated as wholly separate.

For the years 1917 to 1920, consolidated returns were *required* from affiliated corporations. From 1921 to 1933, inclusive, the provisions permitted such returns, but did not require them.

The Revenue Act of 1928, enacted during this period, contained provisions[11]—outlined later in this paper—which for 1929 and subsequent years made a great improvement in the administrability of the law.

During the period of thirteen years ending with 1933, when the choice whether or not to file consolidated returns lay with the taxpayer, the government was protected from suffering any prejudice because of an even broader power which the Commissioner had with reference to the consolidation of the accounts of different taxpayers whatever type of return they might file.[12] Thus the Commissioner had the power—and still has—in any case of two or more organizations (whether or not incorporated and whether or not affiliated) controlled directly or indirectly by the same interests, to apportion or allocate gross income or deductions between or among them, if he determines that such action is necessary clearly to reflect the income. Since the Revenue Act of 1928 he has also had the power to do this in such cases in order to prevent evasion of taxes. The Commissioner has exercised these powers in a great variety of cases, including those where, by reason of common ownership, there appeared to be an abnormal distribution of income or deductions among several businesses. When in 1934 affiliated corporations (except in the case of railroad corporations[13]) lost the privilege of filing consolidated returns, Congress left undisturbed the powers of the Commissioner referred to in this paragraph.

This trend away from consolidated returns shows which side, so far, has been the stronger of the opposing forces which have been engaged in a continuous tug-of-war for at least twenty-four years. Pulling at one end of the rope have been those who put nearly all the emphasis on establishing and maintaining a stable and highly productive revenue system. They have considered that, over any long period, the government gains fully as much as the taxpayer through the use of consolidated returns, that it is injurious to make temporary changes in the tax law applying to periods when losses predominate over gains, and that general social and regulatory aims should be ignored in drafting the income tax laws—not necessarily *all* tax laws—unless it is clear that they can be served without impairing the productivity of the law. Pulling the other way have been those who have been deeply interested in regulating holding companies and in forcing the simplification of complicated corporate structures, and who assume that the income tax is reliable enough to produce

[10] Revenue Act of 1921, §1331, 42 STAT. 227, 319.
[11] Revenue Act of 1928, §141, 45 STAT. 791, 831.
[12] Revenue Act of 1932, §45, 47 STAT. 169, 186, and corresponding provisions of prior revenue acts.
[13] Revenue Act of 1934, §141, 48 STAT. 680, 720.

needed revenue even when used for nonrevenue purposes. On one end, in general, have been the Bureau experts and the business men; on the other those who feel that there is an almost irreconcilable conflict between the aspirations of the common citizen having little or no capital, and the interests of business units of substantial size.

Official statements about this problem have steadily supported the conclusion that as a continuous rule of the income taxing system, provision for consolidation of returns is in the government's interest. Thus a report of the Finance Committee of the Senate favoring the consolidated returns provisions of the Revenue Act of 1918 contains the following:[14]

> "So far as its immediate effect is concerned consolidation increases the tax in some cases and reduces it in other cases, but its general and permanent effect is to prevent evasion which cannot be successfully blocked in any other way. . . .
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> ". . . While the committee is convinced that the consolidated return tends to conserve, not to reduce, the revenue, the committee recommends its adoption not primarily because it operates to prevent evasion of taxes or because of its effect upon the revenue, but because the principle of taxing as a business unit what in reality is a business unit is sound and equitable and convenient both to the taxpayer and to the Government."

In 1927 the Joint Committee on Internal Revenue Taxation made a special study of income tax problems, and recommended[15] among other things that the consolidated return as such be discontinued or abandoned, but that the net loss of one affiliated corporation, with the written consent of the corporation sustaining it, might be offset or charged against the net income of any other corporation or corporations with which it was affiliated. The committee did not question the previously recognized advantages of consolidated returns, and its recommendation was mainly based on certain very real difficulties of interpretation and administration, which were listed at length in the report. As a result of this recommendation the Ways and Means Committee reported[16] a bill in which it omitted any provision for consolidated returns for the year 1929 or subsequent years, consolidation being permitted for 1927 and 1928 with the idea of providing a transition period.

The Finance Committee of the Senate did not agree. It favored the continuance of consolidation, and proposed to eliminate the difficulties which had been met with in practice by authorizing the Commissioner to make regulations attempting to determine, one way or the other, the various disputed points, and by requiring the taxpayer, as a condition to enjoying the privilege of consolidated returns for the year 1929 or any subsequent year, to assent to the validity of such regulations. The Revenue Act of 1928,[17] as enacted, embodied these views of the Finance Committee. The following excerpts are taken from the report[18] of the Finance Committee submitted in connection with these amendments.

[14] SEN. REP. No. 617, 65th Cong., 3d Sess. (1918) 9; 1939—1 (Pt. 2) CUM. BULL. 123.
[15] REPORT OF THE JOINT COMMITTEE ON INTERNAL REVENUE TAXATION (1927) 13-14.
[16] H. R. REP. No. 2, 70th Cong., 1st Sess. (1927) 20-21; 1939—1 (Pt. 2) CUM. BULL. 397-398.
[17] Revenue Act of 1928, §141, 45 STAT. 791, 831.
[18] SEN. REP. No. 960, 70th Cong., 1st Sess. (1928) 13-15; 1939—1 (Pt. 2) CUM. BULL. 417-419.

". . . Your committee has considered the matter very carefully and is convinced that the elimination of the consolidated returns provision will not produce any increase in revenue, will not impose any greater taxes on corporations, and will in all probability permit of tax avoidance to such an extent as to decrease revenues.

"The permission to file consolidated returns by affiliated corporations merely recognizes the business entity as distinguished from the legal corporate entity of the business enterprise. Unless the affiliated group as a whole in the conduct of the business enterprise shows net profits, the individuals conducting the business have realized no gain. The failure to recognize the entire business enterprise means drawing technical legal distinctions, as contrasted with the recognition of actual facts. . . ."

Subsequent experience in auditing the years 1929 to 1933, inclusive, showed that the 1928 Act satisfactorily eliminated controversy as to practically all the enumerated points.

In 1934, a subcommittee of the Ways and Means Committee recommended, in an unpublished report, abolishment of consolidated returns, but the Committee itself, on the recommendation of the Treasury,[19] favored retention of the then existing permissive provisions, coupled with a 2% flat addition to the income tax rate when consolidated returns were filed.

The Finance Committee of the Senate adopted[20] this view, but the Senate adopted an amendment introduced by the late Senator Borah, eliminating all provision for consolidation. In conference, an exception was adopted allowing railroad corporations as defined in the bill to file consolidated returns. Only detail changes in this part of the law having since been made, the Internal Revenue Code in its present form gives the privilege of consolidated returns only to railroad corporations and to Pan-American Trade Corporations.

The following excerpts from speeches in the Senate supporting Senator Borah's amendment show how large a part the speakers' critical attitude toward holding companies and "big business" played in the changes which were then made with regard to consolidated returns—changes which affected a very much wider field than that merely of holding companies.

Thus Senator Borah said, among other things:[21]

"It seems to me, Mr. President, that above all things tax laws should be fair, they should be just to all alike, and that the consolidated returns giving the advantage to these large holding companies is a great disadvantage to all independent corporations paying taxes.

[19] ". . . the Department believes that the abolition of consolidated returns might well be a backward step, which would result in little, if any, additional revenue. On the other hand, there are considerable savings to the Treasury, as well as to taxpayers, in the present arrangement. The administration of the law is simpler since it conforms to established business practice. The Treasury need deal with only one corporation, the parent. On the taxpayer's side, the requirement of separate returns would cause largely increased expense to set up separate sets of books for tax purposes, an undesirable result in itself. The present law permits a return in accord with business practice, and gives the Treasury broad powers to make the necessary rules and regulations to prevent escape from the tax. In the judgment of the Department, the law should not be changed in this particular." *Statement of the Acting Secretary of the Treasury Regarding the Preliminary Report of a Subcommittee of the Committee on Ways and Means* (1933) 13.

[20] SEN. REP. No. 558, 73d Cong., 2d Sess. (1934) 17-18; 1939—1 (Pt. 2) CUM. BULL. 599-600.

[21] 78 CONG. REC. 6463 (1934).

It puts the small corporations—the independents—under a handicap which, when added to the disadvantage which the small corporations have in other respects, makes it impossible for small corporations to continue in business. The result is that day by day and year by year the small independent corporations are compelled to accept merger—another word for extinction. Why should the Government, through its tax laws, favor the large corporations?"

Senator Couzens referred to "one of the large tire companies," saying:[22]

"... It can open up a branch in California or in Michigan or elsewhere, and may lose money from the operation of such branch, but it may make a profit on a branch in Ohio. It wipes out its profit in Ohio by charging up the losses in Michigan or California, while independent manufacturers or merchants or whatever the organization may be in those localities cannot wipe out their profit by charging off losses in some other community. To that extent there is a very great disadvantage in the systems of consolidated returns to the competitive business situation."

Senator Norris, speaking of the holding company, said:[23]

"... If it prospers, the burden, in the end, falls upon the people who have to support these pyramided companies which are built up in the air and controlled in the end by men who own but a very small proportion of the stock. A few men, with a comparatively little investment, can control millions of dollars' worth of property and are doing it now. Sometimes they fall by their own weight."

adding:

"... it has grown to be a mammoth evil in this country, and I think in a great many instances has been organized for the very purpose of escaping taxation."

To these men, deeply interested in reforming certain phases of American business, and not addressing themselves for the moment to the problem of determining what provisions of the federal income tax law will produce the best and most continuous tax yield over a considerable period of time, the income tax appeared to be the most quickly available means of accomplishing the business reforms they sought. The fact seems to be, nevertheless, that they were wrong in opposing consolidated returns and that their success in eliminating them as a general policy of the law has worked against the public interest. However useful in the regulatory field, the change in the law was by no means valuable enough to the government to counterbalance the serious damage to the revenue system which occurs when taxable income is distorted by ignoring parent-and-subsidiary relationships. A government can get along, even though methods of private business continue to need reforming, but any government's safety from moment to moment—and even its existence—depends on the effective and continuous working of its revenue system. Taxes on income have so far proved splendidly useful, but their success depends on delicately adjusted factors, and the best view seems to be that they cannot be relied on for continuous heavy duty unless they are drafted and administered for one purpose—revenue.

[22] *Id.* at 6464. [23] *Ibid.*