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AN ANALYSIS OF SECTION 129 OF THE INTERNAL REVENUE CODE

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NATURE OF SECTION 129: PREVENTION OF TAX AVOIDANCE

Section 120 of the Internal Revenue Code, enacted as part of Section 128 of the Revenue Act of 1943, is concerned with those acquisitions of control of corporations or of corporate property which are made primarily for the purpose of evading or avoiding income or excess profits tax by a distorted use of various provisions of the tax law.

The Section first appeared in Section 115 of the Revenue Bill of 1943, as it was introduced into the House of Representatives by Chairman Doughton of the Ways & Means Committee. It was retained by the Finance Committee, with amendments, and formed part of Section 122 of the Revenue Bill of 1943, as it was presented to the Senate by Chairman George of the Finance Committee. The Section underwent minor changes on the Senate floor and was sent to the Conference Committee as part of the bill. It emerged in Section 128 of the bill which was subsequently enacted into law.

The history of the Section reveals that "evasion" was not originally contained therein, but was first injected by the Finance Committee.[1] The Conference Committee retained it in view of its use elsewhere in the code, and to make clear that the result denoted in Section 129 by "evasion or avoidance" is that which would be referred to in ordinary usage either as "evasion" or as "avoidance", including cases not cognizable under the criminal or administrative penalty provisions of law.[2] Presumably it was the intention of Congress to avoid any niceties of definition, and to reach all the tax-reducing transactions which violate the policy of the Section, regardless of nomenclature.[3]

In order to more fully appreciate the position of this new Section in our

[1]FINANCE COMMITTEE REP. No. 627, 78th Cong., 1st Sess. (1943) 59.

[2]CONFERENCE COMMITTEE REP. No. 1079, 78th Congress, 2nd Sess. (1944) 55; U. S. Treas. Reg. 111, § 29.129-1(b) states that the phrase "evasion or avoidance" is not limited to cases involving criminal penalties, or civil penalties for fraud.

[3]Professor Powell stated in an address delivered before the American Law Institute that he finds "definitions difficult to frame and substantially useless when framed." 11 PROCEEDINGS OF AMERICAN LAW INSTITUTE 122 (1933).

tax structure, it is first necessary to examine the inroads which had already been made on tax avoidance prior to the enactment of Section 129 and the course of events which led to this legislation.

PRIOR STATUS OF TAX AVOIDANCE—JUDICIAL INROADS

In *Gregory* v. *Helvering*,[4] the Supreme Court stated that: ". . . The legal right of a taxpayer to decrease the amount of what would otherwise be his taxes, or altogether avoid them by means which the law permits, cannot be doubted. . . ." However, in construing the phrase "means which the law permits,"[5] the Court in the same case determined that a transaction which fell within a provision of the law, but not within its basic policy, would not be recognized. In other words, on being confronted with a transaction motivated solely by the desire to reduce taxes, the Court was not satisfied with mere literal compliance[6] with the statute. The *Gregory* case involved a statutory reorganization which, although fitting within the phraseology of the statute, had no purpose other than to camouflage the payment of a dividend. Although the case has been widely criticized,[7] it represents a wide-awake attitude of the courts to the problems of tax avoidance.

In *Griffiths* v. *Helvering*,[8] the Supreme Court again refused to recognize a corporation which had been created for the sole purpose of avoiding taxes. The taxpayer anticipated the receipt of money which he believed would constitute taxable income to him. To avoid taxes, he caused a wholly owned corporation to be formed and caused the corporation to receive the money in question. The Court, recognizing why the corporation was created, "pierced

[4]293 U. S. 465, 55 Sup. Ct. 266 (1935), *aff'g* 69 F. (2d) 809 (C. C. A. 2d, 1934).

[5]"The expression 'by means which the law permits' opens up a field of inquiry." Larkin v. United States, 78 F. (2d) 951, 954 (C. C. A. 8th, 1935).

[6]The doctrine of the *Gregory* case, however, is not applicable if the transaction is in substance what it appears to be in form. Chisholm v. Comm'r, 79 F. (2d) 15 (C. C. A. 2d, 1935), *cert. denied*, 296 U. S. 641, 56 Sup. Ct. 174 (1935); Humphreys v. Comm'r, 88 F. (2d) 430 (C. C. A. 2d, 1937); Morsman v. Comm'r, 90 F. (2d) 18 (C. C. A. 8th, 1937); Continental Oil Co. v. Jones, 26 F. Supp. 694 (N. D. Okla. 1939); Clara M. Tully Trust, 1 T. C. 611 (1943); John D. McKee, 35 B. T. A. 239 (1937); 1937-1 CUM. BULL. 15; W. P. Hobby, 2 T. C. 980 (1943). If the intermediary corporations in the *Gregory* case were more than mere "paper" corporations, the reorganization would probably have been recognized. Chisholm v. Comm'r, *supra*. The mere desire to avoid taxes is insufficient alone to condemn a transaction. See the cases cited in this footnote, and the *Gregory* case.

[7]Hendricks, *Developments in the Taxation of Reorganizations* (1934) 34 COL. L. REV. 1198, 1207; Satterlee, *The Income Tax Definition of Reorganization* (1934) 12 TAX MAG. 639; MONTGOMERY, FEDERAL TAX HANDBOOK, 1934-35, 176; MONTGOMERY, FEDERAL INCOME TAX HANDBOOK, 1935-36, 184; Seidman, *The Gregory Reorganization Case* (1935) 13 TAX MAG. 130.

[8]308 U. S. 355, 60 Sup. Ct. 277 (1939), *aff'g* 103 F. (2d) 110 (C. C. A. 7th, 1939).

the corporate veil" and taxed the entire proceeds to the taxpayer. Relying on *Lucas* v. *Earl*,[9] the Court declared that taxes cannot be escaped "by anticipatory arrangements and contracts however skillfully devised . . . by which the fruits are attributed to a different tree from that on which they grew."

The Supreme Court refused to tolerate the type of avoidance which was present in *Higgins* v. *Smith*.[10] There the taxpayer sold securities to a corporation, wholly owned by himself, at a loss, for the sole purpose of getting a present deduction. The Court sustained the Commissioner's refusal to allow the loss deduction to the taxpayer, regarding the transaction in the light of taxpayer's continued control as involving "no transfer at all." In other words, as the Court said, there was simply "a transfer by Mr. Smith's left hand, being his individual hand, into his right hand, being his corporate hand, so that in truth and fact, there was no transfer at all," rather than a transfer "out of Mr. Smith and into something that existed separate and apart from him." This doctrine has recently been reiterated by the Tax Court in *Crown Cork International Corporation* v. *Commissioner*,[11] where a parent corporation tried to deduct a loss sustained on the sale of securities to a wholly owned subsidiary. Section 24(b) was not applicable to the year involved in the *Smith* case, and did not include the transfer involved in the *Crown Cork* case. Thus, on the basis of established case law, the Tax Court disallowed the loss deduction.

The *Griffiths* and *Smith* cases should be distinguished from cases like *Moline Properties* v. *Commissioner*,[12] where there was a real business reason for forming the corporation and, also, where it was to the Government's advantage to recognize the existence and separateness of the corporate entity.[13]

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[9] 281 U. S. 111, 50 Sup. Ct. 241 (1930); Note (1930) 43 HAR. L. REV. 1282.

[10] 308 U. S. 473, 60 Sup. Ct. 355 (1940). Fundamentally, this case involved the difficult problem of the extent to which the tax law will recognize transactions between a corporation and its stockholders. In this respect, see the opinion in the recent case of National Investors Corp. v. Hoey, 144 F. (2d) 466 (C. C. A. 2d, 1944), in which this broader problem is discussed in terms of Burnet v. Commonwealth Improvement Co., 287 U. S. 415, 53 Sup. Ct. 198 (1933); Higgins v. Smith, 102 F. (2d) 456 (C. C. A. 2d, 1939), *rev'd* 308 U. S. 473, 60 Sup. Ct. 355 (1940); Moline Properties, Inc. v. Comm'r, 319 U. S. 436, 63 Sup. Ct. (1943); and Gregory v. Helvering, 293 U. S. 465, 55 Sup. Ct. 266 (1935).

[11] 4 T. C. —, Docket No. 1004, Sept. 21, 1944.

[12] 319 U. S. 436, 63 Sup. Ct. 1132 (1943).

[13] See also Burnet v. Commonwealth Improvement Co., 287 U. S. 415, 53 Sup. Ct. 198 1933) and Interstate Transit Lines v. Comm'r, 319 U. S. 590, 63 Sup. Ct. 1279 (1943). In Gutbro Holding Co. v. Comm'r, 138 F. (2d) 21 (C. C. A. 2d, 1943), Judge Chase said: "As I understand the law, in transactions between a sole shareholder and his

Finally, we have *J. D. & A. B. Spreckels Co.* v. *Commissioner*,[14] a case more similar in nature to the type of transaction which gave rise to Section 129. There, a corporation purchased the stock of another corporation for the sole purpose of taking advantage, via consolidated returns, of the depreciation in value of the subsidiary's principal asset. After the purchase of the subsidiary for a nominal sum, the asset was sold and a large loss realized. The Court refused to permit the loss to be used by the purchasing corporation, via consolidated returns. It decided that the affiliation in question did not serve a business purpose, as distinguished from a tax-reducing purpose, and that the acquired company was not affiliated and could not be included in the consolidation. On the theory that the legislators did not intend, in permitting consolidated returns, that the privilege be enjoyed in cases where the affiliation relied upon as the basis for the privilege to make a consolidated return is without a business purpose, the Court refused to permit consolidated returns to be filed. It held that the privilege of filing consolidated returns was granted in order that the tax liability of a group of corporations which were combined for business purposes into one business unit might be based on the same net income of the business unit. It concluded that: "The same general problem of statutory construction, which is involved here, was involved in *Gregory* v. *Helvering,* 293 U. S. 465. The Supreme Court held in the *Gregory* case that a 'letter perfect' reorganization which served no business purpose was not within the intent of the reorganization exemption provisions of the statute. In this case, we find a parallel. The affiliation in question, although 'letter perfect,' served no business purpose, and it does not, in our opinion, come within the intent of the affiliation provisions of the statute."

Although the *Spreckels* case merely represents a decision of the Board of Tax Appeals, it is a good indication of the present judicial attitude with respect to tax avoidance. That is, the courts are prepared to scrutinize and defeat certain transactions which are purposeless beyond their effect to reduce taxes. Such being the case, Section 129 was perhaps unnecessary. It was the opinion of many tax practitioners[15] that the *Spreckels* case was the forerunner of a host of decisions which would prove that the practice of buying up corporate shells or property for tax avoidance purposes was just

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corporation the Treasury has the choice of treating them as real or as fictitious. Burnet v. Commonwealth Improvement Co., 287 U. S. 415; Higgins v. Smith, 308 U. S. 473."

[14]41 B. T. A. 370 (1940).

[15]Ways and Means Committee Rep. No. 871, 78th Cong., 1st Sess. (1943) 24; Finance Committee Rep. No. 627, 78th Cong., 1st Sess. (1943) 26.

another neat trick that didn't work. However, for reasons to be set forth later, the Section was enacted, approving the *Spreckels* decision as one of the principles established by judicial decisions, having that effect of preventing the avoidance of taxes which the Section is intended to codify and emphasize.[16]

Prior Status of Tax Avoidance—Statutory Inroads

In addition to the implications of the preceding line of cases, the limits of which are still uncertain, also in effect prior to the enactment of Section 129 are various provisions of the Internal Revenue Code which are designed to prevent specific types of avoidance otherwise having statutory sanction. It is interesting to speculate, with respect to some of these provisions, to what extent the courts would have reached the same result in the absence of specific legislation.

First is Section 45, which, in effect, prohibits tax avoidance by the distortion of income or deductions between separate, but related, organizations. The Commissioner is authorized to re-allocate income or deductions between such organizations so as to prevent avoidance, or to more clearly reflect the income of each organization. The Section recognizes the possibility of manipulation between related organizations, even within the language of the statute, so as to give a most advantageous tax result to the entire group. An example of the application of the Section is found in the *National Securities* case.[17] There the taxpayer was a subsidiary corporation. Its parent had purchased 1,000 shares of stock for about $140,000.00. The stock had declined in value to about $8,000.00. The parent then transferred the 1,000 shares to it, for its stock, in a tax-free exchange. Subsequently, the taxpayer sold the shares for about $7,000.00 and tried to deduct the $133,000.00 loss. He relied particularly on Sections 112 and 113 to sustain the deduction. However, the Court held that: "Section 45 is directed to the correction of particular situations in which the strict application of the other provisions of the act will result in a distortion of the income of affiliated organizations. In every case in which the section is applied, its application will necessarily result in an apparent conflict with the literal requirements of some other provision of the act. If this were not so, section 45 would be wholly superfluous." As a result, the Court affirmed the decision of the Board which permitted the Commissioner to reallocate the loss on the sale between the parent and the

[16] Ways and Means Committee Rep. No. 871, 78th Cong., 1st Sess. (1943) 49; Finance Committee Rep. No. 627, 78th Cong., 1st Sess. (1943) 58.

[17] 137 F. (2d) 600 (C. C. A. 3d, 1943), *cert. denied,* 320 U. S. 794, 64 Sup. Ct. 262 (1943).

taxpayer, that is, $132,000.00 (the difference between basis and the fair market value at the time of transfer to the subsidiary) to be deducted by the parent, and $1,000.00 to be deducted by the taxpayer (the difference between the fair market value when acquired and the selling price).

In addition, there is Section 24(b) which enacts and extends the doctrine of *Higgins* v. *Smith*[18] by disallowing losses between certain related taxpayers, and Section 24(c) which prevents such taxpayers from avoiding taxes by taking advantage of their different methods of accounting.

Then we have Sections 102 and 500 which are designed to prevent avoidance of tax on stockholders of a corporation by the unreasonable accumulation of earnings and profits in the hands of the corporation. These Sections are, by their very nature, applicable to close corporations. They strike at the practice of stockholders' avoiding income tax by causing the corporation to accumulate earnings and profits in years in which the stockholders have much other income, or in which tax rates are high, and to declare dividend distributions of earnings and profits in years in which tax rates are low, or in which the stockholders have losses or little income from other sources.

Again, there is the provision in Section 112(k). This Section was enacted in the 1939 Revenue Act to overcome the effect of *United States* v. *Hendler*[19] wherein it was decided that the assumption of liabilities in an otherwise non-taxable reorganization exchange was the equivalent of the receipt of cash or other property by the corporation whose liabilities were assumed, thus making the gain, if any, from the exchange, recognizable to the extent of the amount of the liabilities so assumed. Section 112(k) provides that the assumption of liabilities, or the taking of property subject to them, in connection with Section 112(b)(4) or (5) transactions, shall not be considered as "other property or money" received by the taxpayer, and shall not prevent the transaction from being tax-free. However, to prevent its abuse, the Section goes on to say "that if, taking into consideration the nature of the liability and the circumstances in the light of which the arrangement for the assumption or acquisition was made, it appears that the principal purpose of the taxpayer with respect to the assumption or acquisition was a purpose to avoid federal income tax on the exchange, or, if not such purpose, was not a bona fide business purpose, such assumption or acquisition (in the amount

[18] 308 U. S. 473, 60 Sup. Ct. 355 (1940).

[19] 303 U. S. 564, 58 Sup. Ct. 655 (1938), *rehearing denied*, 304 U. S. 588, 58 Sup. Ct. 940 (1938), *rev'g* 91 F. (2d) 680 (C. C. A. 4th, 1937), *which aff'd* 17 F. Supp. 558 (D. Md. 1936).

of the liability) shall, for the purposes of this Section, be considered as money received by the taxpayer upon the exchange.[20]

Also, we have the various basis provisions which prevent avoidance, or hardship in some cases, by providing for continuity of basis in certain tax-free exchanges; and Sections 115(g) and 112(c) which treat as dividends, distributions which are essentially equivalent to dividends, but which appear to be distributions in cancellation and redemption of stock, or "boot" in a tax-free exchange; and Section 115(h) which provides that non-taxable distributions of stock, property, or money shall not be deemed to reduce corporate earnings and profits; and Section 118 which disallows losses from sales or exchanges when the vendor repurchases, shortly after the sale, "substantially identical stock or securities" to those sold.

Finally, there are some important changes in regulations, with respect to consolidated returns, which were promulgated by the Treasury Department[21] and approved on March 14, 1944. Although approved subsequently to the enactment of Section 129, they are here classified as a prior inroad on tax avoidance because they appear to apply to taxable years starting with 1943 rather than 1944, even though they were issued on next to the last day for filing returns for the calendar year 1943. Also, they properly fall together with the other incursions on tax avoidance which have just been mentioned and which may be availed of by the Commissioner when Section 129 is unavailing.

The new Treasury Decisions have apparently been promulgated to reach transactions in which affiliated groups are formed at any time after March 14, 1941, or in which new subsidiaries become members of the group after that date. Presumably, March 14, 1941, was chosen because it is the date on which the consolidated excess profits tax regulations, under Section 730 of the code, were first issued. The purpose of the changes is, broadly speaking, to prevent the use, by the acquiring corporation or group, of losses or excess profits credits of a subsidiary acquired after March 14, 1941, and to prevent the application of the losses or excess profits credits of the acquiring corporation or group to the income of a subsidiary acquired after such date unless, in either case, and to the extent that, the Commissioner determines that the allowance of the loss or credit will not distort the excess profits tax liability of the group.

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[20]For a very informative discussion of this section, as it corrects the unfortunate situation created by the *Hendler* case, and as it protects itself from avoidance, see S. S. Survey, *The Revenue Act of 1939 and the Assumption of Indebtedness on Tax-Free Exchanges* (1940) 50 YALE L. J. 3.

[21]T. D. 5340 and 5341, 1944 INT. REV. BULL. No. 6, at 9, 11.

The new Treasury Decisions go a long way in eliminating the type of avoidance which Section 129 is designed to reach and, in some respects, are even broader in scope. The most noticeable difference is their failure to require the existence of an avoidance purpose, although the Commissioner presumably should consider this factor in determining whether allowance of the loss or credit will distort the group's excess profits tax liability. It would seem that the effect of these changes can be avoided, in certain cases, by a tax-free liquidation under Section 112(b)(6), although the lateness of their issuance prevented this result for 1943 in those cases where the acquired corporation was unfortuitously kept apart.

Thus we see that even prior to the enactment of Section 129, a substantial body of law had developed to combat avoidance, that is, the reduction of taxes through transactions which had the favor of fitting within the technical framework of the tax law.

NEED FOR SECTION 129

With the enactment of the Excess Profits Tax on October 8, 1940, the problem of tax avoidance became more acute. Taxpayers craved certainty, wishing to know to what extent they could avail themselves of the literal provisions of the statute to avoid taxes, but the only answer was the negative statutory warnings and the *Gregory* v. *Helvering*[22] line of decisions. Despite these red lights, many corporations, faced with the highest tax rates ever imposed in the history of this country, decided to go ahead. They acquired corporations or corporate property, using appropriate sections of the Internal Revenue Code to the hilt, in order to get the benefit of depreciation deductions, losses in value, and past, present or future net operating losses, excess profits credits, and unused excess profits credits of other corporations. In many of these transactions, no pretense was even made at business purpose, the taxpayers relying on the fact that they had brought themselves within the letter of the statute and so were entitled to prescribed allowances. On the other hand, many reputable attorneys were advising their clients not to indulge in such acquisitions since they believed that the courts would interpret present law so as to deprive them of the tax advantage which they hoped to derive.[23]

To protect the revenue,[24] to put an end to the market for interests in cor-

[22]293 U. S. 465, 55 Sup. Ct. 266 (1935), *aff'g* 69 F. (2d) 809 (C. C. A. 2d, 1934).

[23]WAYS AND MEANS COMMITTEE REP. No. 871, 78th Cong., 1st Sess. (1943) 24; FINANCE COMMITTEE REP. No. 627, 78th Cong., 1st Sess. (1943) 26.

porations and corporate property which has tax avoidance as its purpose,[25] to give honest taxpayers and practitioners assurance that they were not going to be discriminated against in favor of tax dodgers,[26] and to permit honest taxpayers and practitioners to continue to conduct their affairs and business in the ordinary way without fear that they would bear a tax burden which others similarly situated would escape,[27] Congress enacted Section 129 in the Revenue Act of 1943. In opposition to this legislation, it was urged that the general principle of striking down purely tax avoidance transactions had already been established and that the proposed statute was merely a restatement of existing law,[28] but the pressure for such legislation and the outrageous character of the transactions which had been called to the attention of the members of Congress, made the legislation a foregone conclusion.

Nature and Scope of Section 129

Section 129 applies to acquisitions of corporations or of corporate property, made on or after October 8, 1940, for the principal purpose of evading or avoiding federal income or excess profits tax by securing the benefit of a deduction, credit, or other allowance which would not otherwise be enjoyed. It does not take the form of a general anti-avoidance statute. Rather, it is aimed directly at the type of transaction which gave rise to its existence, that is, acquisition of interest in corporations or property which have as their objective the reduction through artifice of the income or excess profits tax liability.[29]

Although aimed at specific types of avoidance, Congress deemed it wise that the Section should not be confined to a description of any particular methods for carrying out such avoidance,[30] but should include within its scope these devices in whatever form they might appear. It was believed that any attempt to encompass tax evasion and avoidance problems by a specific description of the tax avoidance schemes would catch within its net both intended transactions and those not intended, and would fail to catch some of those intended to be caught, in addition to catching those not so

[24] Ways and Means Committee Rep. No. 871, 78th Cong., 1st Sess. (1943) 24, 49-50; Finance Committee Rep. No. 627, 78th Cong., 1st Sess. (1943) 26.
[25] *Ibid.*
[26] *Ibid.*
[27] *Ibid.*
[28] *Hearings before Finance Committee on H. R. 3687,* 78th Cong., 1st Sess. (1943) 826.
[29] Ways and Means Committee Rep. No. 871, 78th Cong., 1st Sess. (1943) 49.
[30] The section was criticized in this respect. *Hearings before Finance Committee on H. R. 3687,* 78th Cong., 1st Sess. (1943) 593, 611.

intended.[31] It was also thought that the specific description would tend to center attention upon the form and technical character of the scheme, and let the substance of the tax avoidance escape.[32]

Fundamentally, the purpose of the Section is to prevent taxpayers from reducing their tax liabilities by distorting or perverting various sections of the tax law.[33] The distortion or perversion referred to consists of the abuse of various provisions of the law, such as Sections 112, 113, and 141, which were enacted to remove impediments from the bona fide conduct of business in the ordinary way. It is the use of these Sections to get the benefit of deductions, credits or allowances which the taxpayer would not be entitled to in the normal conduct of its business, rather than for the purpose for which the Sections were enacted, which constitutes the abuse, distortion, and perversion which Section 129 is designed to end.[34]

To illustrate, B is a typical defunct or deficit corporation with past losses, fixed assets with book values highly in excess of market values, and an invested capital with large offsetting deficits, etc. As such, the law permits B to carry over its past losses as offsets against its present profits,[35] to compute depreciation[36] and loss from disposition of assets[37] on the basis of the book value of its assets, to carry over its past unused excess profits credits[38] for the purpose of determining present war excess profits, to compute its invested capital credit on the basis of the amount originally invested without any reduction for past deficits, etc.[39] All these advantages depend upon B's making profits. But B, for war or other reasons, is on the way out. It is failing, if it hasn't already failed. Neither B nor its stockholders are able to take advantage of all these allowances, which would enable the recovery of a large amount of profits tax-free. The tax law intended these advantages for B to permit B to recoup itself.

By abusing various provisions of the tax law, however, these benefits could be secured by an outsider for whom they were never intended. For example, A is a highly successful corporation with large profits. A is in a position to use B's offsets, although they were never intended for A. A contacts B's stockholders and offers to buy their stock at a price which

[31]FINANCE COMMITTEE REP. No. 627, 78th Cong., 1st Sess. (1943) 60.
[32]*Ibid.*
[33]WAYS AND MEANS COMMITTEE REP. No. 871, 78th Cong., 1st Sess. (1943) 49.
[34]FINANCE COMMITTEE REP. No. 627, 78th Cong., 1st Sess. (1943) 59.
[35]INT. REV. CODE §§ 23(s) and 122 (1939).
[36]INT. REV. CODE § 114 (1939).
[37]INT. REV. CODE § 111(a) (1939).
[38]INT. REV. CODE § 710(c) (1939).
[39]INT. REV. CODE § 718 (1939).

reflects the tax advantages which A will receive from owning the stock. Then A liquidates B tax-free,[40] and gets the basis of B's assets for the purpose of determining loss, depreciation, and the excess profits credit.[41] Even better, A could have had its stockholders acquire B's stock and then contribute the stock in A to B. B could then liquidate A into B tax-free,[42] in which case all of B's allowances would come to the benefit of A, including net operating losses and unused excess profits credits of former years. Or, instead of liquidating A, the corporations could file consolidated returns,[43] and thus many of B's advantages could be used by A. The multifarious ways in which the various sections of the tax law could be perverted to get undue advantages will best be illustrated when the devices actually contrived before the enactment of Section 129 come before the courts.

Considering the nature and purpose of the Section, there can be no doubt that that it will be construed liberally to include transactions which violate its underlying policy. In any event, the joy of not fitting within the Section may be short lived if the transaction in question abuses its policy. The Section, in effect, codifies and emphasizes the general principle set forth in the several Supreme Court and other judicial decisions as to the ineffectiveness of certain arrangements which have no purpose other than tax avoidance by the misuse of various provisions of the tax law.[44] Congress believed that the Section would more effectively secure its objectives if its scope were limited to cases in which the control of a corporation or corporate property was acquired on or after October 8, 1940, since such acquisitions are clearly those in which the opportunities for distortions and perversions are largest, both in method and result.[45] It assumed,[46] however, that the older types of avoidance scheme which are excluded from the scope of Section 129, if not within the scope of Section 45, will be governed by the principles which have been stated judicially. The Conference Committee clearly expressed[47] its desire that the circumstance that specific categories of tax avoidance or evasion are selected for specific statutory treatment for taxable years beginning after December 31, 1943, should not be treated as abridging, restricting, or limiting the full application of any applicable law or rule of law, whether

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[40]INT. REV. CODE § 112(b) (6) (1939).
[41]INT. REV. CODE §§ 113(a) (15), 718, 760, and 761 (1939).
[42]INT. REV. CODE § 112(b) (6) (1939).
[43]INT. REV. CODE § 141 (1939).
[44]FINANCE COMMITTEE REP. No. 627, 78th Cong., 1st Sess. (1943) 58-59.
[45]*Ibid.*
[46]*Ibid.*
[47]CONFERENCE COMMITTEE REP. No. 1079, 78th Cong., 2nd Sess. (1944) 55.

explicit or implicit, in the code, or in judicial decisions, whether as yet applied to particular situations or as yet decided. It stated, also, that as respects any taxable year beginning before, on, or after January 1, 1944, the Section should not be read as approving or validating by inference, implication, or otherwise, any tax avoidance or evasion device, action, or result, whether within or without the categories of the Section, or as diminishing in any manner the efficacy of any law or rule of law in the prevention of distortions or perversions. Thus, a transaction which does not fall within Section 129 may still be attacked under existing law, the principles of which have been reinforced by their adoption in Section 129.[48]

It may be argued that in an important respect, Section 129 goes even further than the established principles which it purports to codify. Perhaps under existing law it is not necessary that a business purpose be the dominant reason for the transaction in question. On the other hand, Section 129 in effect requires that the principal purpose of the deal is a business purpose. It is believed that the courts will look for the same kind of proof whether a transaction is sought to be condemned under Section 129 or judicial law. However, once the courts have the taste of the new Section they may be more apt to condemn even less flagrant transactions.

Prospective Operation

Section 129 is only applicable to taxable years beginning in 1944 or thereafter, and the determination of the law applicable to prior taxable years must be made as if it had not been enacted and without inferences drawn from the fact that it is not expressly made applicable to prior taxable years.[49]

When the Section first passed the House, it was made retroactive to all taxable years beginning after December 31, 1939.[50] The thought of the Ways and Means Committee was that the provision deals with devices which have always been palpable tax-dodging schemes, the legality of which was questioned from the beginning.[51] By making the Section retroactive, it was the intent of the Committee to avoid giving approval, even by implication, to any tax-dodging schemes already in operation. Before the Finance Committee some witnesses argued[52] that the retroactive feature was unfair, that

[48]U. S. Treas. Reg. 111, § 29.129-2.
[49]Revenue Act of 1943, § 128(c).
[50]Revenue Bill of 1943, H. R. 3687, § 115, as introduced into the House.
[51]Ways and Means Committee Rep. No. 871, 78th Cong., 1st Sess. (1943) 24.
[52]*Hearings before the Finance Committee on H. R. 3687,* 78th Cong., 1st Sess. (1943) 592, 594.

if the devices are illegal under the law existing prior to 1944, it should be so determined under that law. With respect to the approval, by implication, of previous tax-dodging schemes, should the provisions be made to operate only prospectively, it was urged that it could be declared specifically that the new provision should not be deemed to imply any approval of such schemes or to affect the decision of their legality under existing law.[53] Although the Finance Committee retained the House provision, despite this criticism, a floor amendment in the Senate restricted the operation of the Section to only taxable years beginning in 1944 or thereafter. As enacted, the prospective feature was retained, but with an amendment avoiding approval, by implication, of the legality of any schemes under prior law.[54] The Conference Committee stated its intention[55] that tax administration for prior taxable years should proceed upon the basis that existing law is fully operative.

Analysis of the Section

The two types of acquisitions to which Section 129 applies are:

(1) acquisitions, direct or indirect, of control of a corporation by any person or persons; and

(2) acquisitions by any corporation, direct or indirect, of property of another corporation, the basis of which property, in the hands of the acquiring corporation, is determined by reference to the basis in the hands of the transferor corporaton, *provided that* the acquiring corporation or its stockholders did not control, directly or indirectly, immediately prior to such acquisition, the transferor corporation.

An Acquisition

For Section 129 to apply, there must first have been an "acquisition." This is because the type of avoidance which the Section is designed to eliminate involved an "acquisition" of a corporation or of corporate property.[56]

Although "acquisition" is not specifically defined,[57] a broad construction is likely where the transaction in question violates the underlying policy of the Section. Presumably, "acquisition" includes transfers by way of gift or inheritance. For example, a taxpayer might ask his wife to buy up the stock of a defunct corporation and make a gift of the stock to the taxpayer's

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[53]*Hearings before the Finance Committee on H. R. 3687,* 78th Cong., 1st Sess. (1943) 611.

[54]Revenue Act of 1943, § 128(c).

[55]Conference Committee Rep. No. 1079, 78th Cong., 2nd Sess. (1944) 55.

[56]Ways and Means Committee Rep. No. 871, 78th Cong., 1st Sess. (1943) 49.

[57]The term is discussed by Randolph E. Paul in the third series of his *Studies in Federal Taxation,* pp. 63-65, in connection with reorganizations.

corporation. The latter could then effect a tax-free liquidation under Section 112(b) (6). Or, he might have her make a gift of the stock to him, so that he could contribute it to the capital of his corporation. The corporation would then liquidate the subsidiary, as above. Again, the taxpayer might be acquainted with a person who owns a defunct corporation. The latter might make a gift of his stock to the taxpayer or the taxpayer's corporation so that the losses and unused credits of the defunct corporation could be availed of. Of course, the donor might be related to the donee-taxpayer or, if unrelated, the donor might receive some benefit from the donee, such as a job in the latter's business. These illustrations may or may not seem remote, but they do serve the purpose of pondering upon the potential application of Section 129. "Acquisition" includes gift or inheritance receipts for the purposes of other provisions of the code, and presumably the same result would be reached here. If the transaction "distorts or prevents the natural business relationship between a deduction or credit and the enterprise which produced it," Section 129 might well be held to apply.

Does "acquisition" include the commencement of a business in corporate form? Although the formation of a corporation does result in the acquisition of control of a corporation, it is believed that Congress did not intend to take away the right of taxpayers to choose any form that they may desire for the conduct of business.[58] Certainly that is not what prompted the legislation to be enacted. For the same reason, it is believed that the statute does not apply to persons who incorporate a going business. Nor should it make any difference that the purpose to reduce taxes was uppermost in the minds of the incorporators.

On or After October 8, 1940

The condemned acquisition must have taken place on or after October 8, 1940. This is the date of the enactment of the Second Revenue Act of 1940, which embodied the wartime excess profits tax, after which date the crux of the flagrant avoidance devices which give rise to Section 129 took place.[59] Of course, any acquisition or other transaction occurring prior to this date would be subject to the application of other provisions of the law.[60]

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[58]*Hearings before the Finance Committee on H. R. 3687*, 78th Cong., 1st Sess. (1943) 46, testimony of Randolph E. Paul, then General Counsel of the Treasury: "The amendment in no way abridges the privilege of doing business in individual partnership, or corporate form, or the privilege of filing a separate or a consolidated return, or any of the numerous choices which the structure of the tax system is intended to afford."

[59]WAYS AND MEANS COMMITTEE REP. No. 871, 78th Cong., 1st Sess. (1943) 49.

[60]FINANCE COMMITTEE REP. No. 627, 78th Cong., 1st Sess. (1943) 58-59; CONFERENCE

Of Corporate Property or Control

The acquisition, on or after October 8, 1940, must be either of control of a corporation, or of property of a corporation not controlled by the acquiring corporation immediately prior to the acquisition.

"Control,"[61] for this purpose, is specifically defined[62] as the ownership of stock possessing at least 50 per cent of the total combined voting power of all classes of stock entitled to vote, or at least 50 per cent of the total value of shares of all classes of stock of the corporation.[63] Since the definition reads in the disjunctive, Section 129 would apply to a case in which 50 per cent or more of the voting power was held prior to October 8, 1940, but 50 per cent more of the total value of the stock was not acquired until after that date, or vice versa. However, it does not apply to cases in which the acquiring person or corporation owned, before October 8, 1940, at least 50 per cent of the voting power *and* at least 50 per cent of the total value of the stock of the acquired corporation, or of the corporation whose property was acquired. Nor does it make any difference that the percentage of control is increased after that date. That is, if 50 per cent control exists before October 8, 1940, it is of no consequence that complete control is subsequently acquired.

Section 129 does not contemplate that the stock constituting the 50 per cent control was all acquired after October 8, 1940.[64] Thus, if A owns 40 per cent of the stock of corporation X on October 7, 1940, and acquires on October 8, 1940, an additional 10 per cent of such stock, a vulnerable "acquisition" is made by A on October 8, 1940.

A difficult problem of valuation may arise, in determining whether control exists, as a result of the provision that the ownership of stock possessing at least 50 per cent of the total value of shares of all classes of stock may constitute control. For example, in Section 501(a) (2), relating to personal holding companies, a similar test exists for purposes of the "stock owner-

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COMMITTEE REP. No. 1079, 78th Cong., 2nd Sess. (1944) 55; U. S. Treas. Reg. 111, § 29.129-2.

[61]The term is discussed by Paul in *op. cit. supra* note 57, at 74-75.

[62]When introduced into the House, the Bill contained no definition of "control." The Finance Committee defined "control" as meaning "more than 50 per cent." FINANCE COMMITTEE REPORT No. 627, 78th Cong., 1st Sess. (1943) 58. The present definition resulted from further clarification in conference. CONFERENCE COMMITTEE REPORT No. 1079, 78th Cong., 2nd Sess. (1944) 17.

[63]INT. REV. CODE § 129(a) (1939).

[64]CONFERENCE COMMITTEE REP. No. 1079, 78th Cong., 2nd Sess. (1944) 17; also, U. S. Treas. Reg. 111, § 29.129-1(d).

ship" requirement. There, the regulations[65] suggest that the phrase "in value" shall, in the light of all the circumstances, be deemed the value of the corporate stock outstanding at such time, not including Treasury stock. This value is to be determined upon the basis of the company's net worth, earning and dividend paying capacity, and appreciation of assets, together with such other factors as have a bearing upon the value of the stock.[66] If, however, the value of the stock is greatly at variance with that reflected by the corporate books, the evidence of such value is required to be filed with the return. Where there are two or more classes of stock outstanding, the total value of all the stock must be allocated among the different classes according to the relative value of each class therein. Presumably, for the purpose of Section 129, the same factors affecting "value" may have to be sifted. Of course, it is presumed that 50 per cent of the value of stock refers to only outstanding stock, as is the case with comparable provisions in Section 24(b) (1) (c) and Section 501(a) (2).

Since the ownership of stock determines control, it is important to ascertain to what extent the ownership of stock may be imputed to a particular taxpayer. No comparable provision being included, it must be assumed that constructive ownership rules such as those found in Sections 24(b) and 503 do not apply here. In other words, in determining whether a taxpayer owns 50 per cent of the stock, stock held by his family or partner, or by a corporation, partnership, estate or trust, of which he is a stockholder, partner or beneficiary, respectively, or by a stranger subject to an option to acquire by the taxpayer, or by members of his family, would not be considered as owned by the taxpayer, without more.[67] Of course, under certain circumstances, stock may be deemed to be owned by the taxpayer "indirectly."[68]

The Section does not apply to mere shifts in the form of control.[69] In

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[65]U. S. Treas. Reg. 111, § 29.501-3.

[66]In Jenkins v. Smith, 21 F. Supp. 251, 253 (D. Conn. 1937), the Court quoted from Professor R. T. Ely, *Outlines of Economics*, p. 223, to the effect that "The price or value that might be expected to obtain rests upon opinion and judgment. No more tangible or definite basis can be found. Valuations, like demand and supply curves, are of the stuff that dreams are made of,—judgment, opinion, forecasts, of the future. Upon such foundations rests the modern business world."

[67]See A. G. Nelson Paper Co., Inc., 4 T. C. —, Docket No. 1553, Aug. 30, 1944, dealing with similar language under section 45: ". . . organizations . . . owned or controlled directly or indirectly by the same interests. . . ." Where a husband and wife each controlled a separate corporation, one corporation leasing property from the other, the husband and wife were not deemed to have the "same interests," the stock of the wife not being imputed to the husband.

[68]See notes 81 through 83 *infra*, and the related material in the text.

[69]FINANCE COMMITTEE REP. No. 627, 78th Cong., 1st Sess. (1943) 60.

other words, a mere shift in the form of control from direct to indirect, from indirect to direct, or from one form of indirect to another form of indirect, cannot amount to the acquisition of control within the meaning of Section 129. For example, if a controlled or affiliated group existed on October 8, 1940, transfers thereafter within the group would not amount to the acquisition of control by the parent or its controlling interest. Thus, control once acquired could not be again acquired, unless the group is in some way broken.

A transfer within a controlled or affiliated group frequently occurs by a Section 112(b) (6) liquidation or by a tax-free exchange under the reorganization or consolidated returns provisions of law. While a Section 112(b) (6) liquidation would change the form of control into a more direct form, it would hardly result in acquisition of control[70] under Section 129.[71] Transfers within a controlled or affiliated group under the reorganization or consolidated returns provisions of the law are more often than not precisely the same as Section 112(b) (6) liquidations in this respect. In either case, there is merely a shift in the form of control.

Suppose, however, that instead of shifting the stock of a subsidiary nearer the parent, as in Section 112(b) (6) liquidation, it is transferred farther down the chain of subsidiaries. In that case, the subsidiaries farther down the chain do acquire control of the shifted subsidiary under Section 129.[72] However, with respect to the parent or the subsidiaries farther up the chain, there is merely a shift in the form of control. For example, if A Corporation owned B Corporation prior to October 8, 1940, at which time B Corporation owned C Corporation, A has indirect control of C. The subsequent liquidation of C into B, making A's and B's control of C more direct, does not fall within the Section. Or, if in the above illustration B also controlled D Corporation, the transfer by B to C of D's stock does not constitute a new acquisition of control by A or B. However, in the latter case there is an acquisition of control within the Section by C of D.

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[70]A liquidation cannot occur under section 112(b) (6) unless there is an 80% control of the liquidated corporation. If this 80% control exists, there exists also control (for the purpose of section 129) of each corporation of which the liquidated corporation owned an interest of 50% or more.

[71]As it passed the House, section 129 was sufficiently broad to include section 112(b) (6) liquidations. But strong opposition of leading tax practitioners before the Finance Committee caused it to be changed to exclude such transfers. *See* the testimony of Harry J. Rudick and of Ellsworth C. Alvord, respectively in the *Hearings before the Finance Committee on H. R. 3687,* 78th Cong., 1st Sess. (1943) 463 and 593.

[72]FINANCE COMMITTEE REP. No. 627, 78th Cong., 1st Sess. (1943) 61.

Split-ups

It may be feasible for a large corporation to split-up into several smaller corporations in order to get the benefit of a $10,000.00 specific exemption for excess profits tax purposes for each corporation. Does Section 129 apply to such a split-up?

Although the regulations reply affirmatively,[73] it is believed that Section 129 does not include and is not intended to include split-ups.[74]

In order for Section 129 to embrace split-ups, they must come within the language of the statute. The statute[75] requires that the acquiring corporation secure the benefit of an allowance which it would not otherwise enjoy. In the case of a split-up, it is the subsidiary which gets the additional allowance, and not the acquiring corporation. However, the parent does benefit indirectly and, therefore, Section 129 should be construed broadly to include split-ups if it is found that Congress intended this result. It is my opinion that this result was not intended.

In 1934, Congress was confronted with a situation in which there had been, after October 8, 1940, wholesale acquisitions of corporations and corporate property for the purpose of reducing taxes. The acquisitions involved situations where persons or corporations went outside of themselves to purchase corporations or corporate property to improve their tax position. It was this "market" which had developed, for interests in corporations or corporate property, for tax purposes, which Section 129 was designed to end.[76] It is clear, therefore, that a split-up is not the kind of transaction comprehended under Section 129.

The basic distinction between the transaction which Section 129 is intended to discredit and the split-up is that in the former case the corporation goes beyond itself in its dealings, whereas the latter situation merely involves an internal reorganization. Only the former transaction serves to distort or pervert the natural business relationship between a deduction or credit and the enterprise which produced it.[77] The split-up merely represents an exercise of the right to do business in any form,[78] the form of control being

[73]U. S. Treas. Reg. 111, § 29.129-3.

[74]The following material merely represents my argument on a much debated subject among tax practitioners. Of course, since the validity of the regulations is now in issue, as a practical matter my position is considerably weakened.

[75]Section 129 requires that a "person . . . acquire . . . control of a corporation, . . . securing the benefit of a . . . allowance which such person . . . would not otherwise enjoy. . . ."

[76]WAYS AND MEANS COMMITTEE REP. No. 871, 78th Cong., 1st Sess. (1943) 24, 49; *Hearings before the Finance Committee on H. R. 3687,* 78th Cong., 1st Sess. (1943) 45.

[77]*Ibid.*; FINANCE COMMITTEE REP. No. 627, 78th Cong., 1st Sess. (1943) 45.

[78]*Ibid.*

changed from direct to indirect. It is in effect a transfer within a controlled or affiliated group.[79]

It might be noted in this respect that a great incentive for the corporate split-up has come from a provision in the very Act of which Section 129 is a part, that is, the provision increasing the specific exemption for excess profits tax purposes from $5,000.00 to $10,000.00. Also, that the Section is not so worded as to defeat *any* transaction which is motivated by the desire to reduce taxes by getting an allowance which would not otherwise be enjoyed. Rather, it is directed solely and specifically at the two types of acquisitions which had been so flagrant since October 8, 1940, that is, acquisitions of corporations and of corporate property.[80]

Directly or Indirectly

It makes no difference that the acquisition of control or of property, on or after October 8, 1940, is indirect. For example, the result is the same if the taxpayer acquired control of, or property directly from, a third corporation, or if the taxpayer enjoyed effective control or ownership by having a subsidiary make the acquisition. On the other hand, if indirect control or property ownership existed prior to October 8, 1940, the subsequent shift in the form of control or ownership does not constitute a violation of the statute.[81]

It was suggested, previously,[82] that control means stock ownership and that the rules of constructive ownership found elsewhere in the code do not apply here. Certain cases of constructive ownership under Sections 24(b) and 503, however, would properly be treated as indirect (actual) ownership under Section 129. For example, a taxpayer would probably be held to own, indirectly, stock held by a corporation which he owned, or a proportionate share of stock held by a corporation or partnership of which he was a stockholder or partner. On the other hand, in the absence of manipulation, a taxpayer would probably not be treated as the indirect owner of stock held by his wife.[83]

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[79]WAYS AND MEANS COMMITTEE REP. No. 871, 78th Cong., 1st Sess. (1943) 24, 49; *Hearings before the Finance Committee on H. R. 3687,* 78th Cong., 1st Sess. (1943) 45; FINANCE COMMITTEE REP. No. 627, 78th Cong., 1st Sess. (1943) 60.

[80]Of course, a decision that split-ups are not comprehended within section 129 might in the same breath be accompanied by the holding that the split-up in question offends established case law and so must be disregarded.

[81]See notes 69 through 72 *supra,* and the related material in the text.

[82]See note 67 *supra,* and the related paragraph in the text.

[83]See A. G. Nelson Paper Co., Inc.; 4 T. C. —, Docket No. 1553, Aug. 30, 1944. The tax law is still many light years away from recognizing the oneness of the family unit.

By Any Person or Persons, or Corporation

Again, it has been suggested[84] that two types of acquisitions fall within Section 129: first, acquisitions of control of a corporation; secondly, acquisitions of property of a corporation. But, whereas the Section includes acquisitions of control of a corporation by "any person or persons," defined in the Internal Revenue Code Section 3797(a) (1) to include individuals, partnerships, or corporations, it includes acquisitions of property of corporations made only by corporations. This difference is consistent with the type of avoidance which the Section is designed to reach. Whereas this type of avoidance could be accomplished by the acquisition or control of corporations by individuals or corporations, it could only be achieved by the corporate acquisition of the property of other corporations. This is because the heart of the acquisition of corporate property as an avoidance device is the retention of the transferor's basis of the property. The latter result can only be achieved, within the framework of the code, by a corporate acquisition.

"Persons," presumably, includes acquisitions by partners or joint owners, acting jointly, and also acquisitions by previously unassociated persons. For example, A, B, C, and D may be partners in a business. They acquire X, a defunct corporation, for the purpose of securing the benefit of X's losses. Section 129 applies. But suppose A, B, C, and D are completely unrelated and own, individually, successful businesses. They each acquire a specific interest in X, less than 50 per cent for each, intending to contribute their business to X's capital. Have "persons" acquired control within the meaning of the Section? Or, suppose A, B, and C have high-basis, low-value properties, and D has a very profitable piece of property. They form X Corporation and transfer to it tax-free, their properties, for stock under Section 112(b) (5). Neither of them receives a 50 per cent stock interest. Are their interests to be considered together, so that they meet the test that "any . . . persons acquire" control of a corporation, for the purposes of Section 129? Such would be the result under Section 112(b) (5). Since the new Section is intended to be construed broadly, it will probably be interpreted to embrace the aforementioned cases. It is believed that the failure to repeat "persons" in the latter part of the Section[85] is of no significance.

Of Corporate Property

Where the acquisition is one of corporate property, Section 129 requires

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[84]See introductory material in the part of this article dealing with "Analysis of the Section," *supra* p .

[85]It reads "which such person . . . would not otherwise enjoy."

that the basis of such property in the hands of the acquiring corporation be determined by reference to the basis in the hands of the transferor corporation. It was suggested previously that this requirement exists because such an acquisition would not otherwise create the type of avoidance, if any, which the Section is meant to end. By acquiring the transferor's basis, the acquiring corporation receives back tax-free more than it invested. But if its basis is cost, it would receive back tax-free only the amount of its investment. In the latter case, there would be no perversion within the meaning of the tax law and Section 129. For example, B Corporation is operating at a loss. Its principal asset has a basis far in excess of its then market value. B Corporation is willing to dispose of such property at a price which reflects its market value, and is willing to take payment in voting stock of A Corporation. A, in high tax brackets, will have tax savings far in excess of cost if it can take depreciation, or a loss, using B's basis of the property. So A acquires the property from B in exchange solely for A's voting stock. This is a tax-free exchange under Sections 112(b) (4) and 112(g), so under Section 113(a) (6) A may use B's basis for tax purposes. This acquisition, being principally to avoid taxes, falls within Section 129.

In addition to the requirement of receipt of the transferor's basis, an acquisition of corporate property is vulnerable under the Section only if the acquiring corporation or its stockholders, immediately prior to such acquisition, did not control the corporation whose property it acquired. Congress did not intend to affect transactions between related organizations,[86] believing that[87] existing law[88] was adequate to cope with avoidance in such cases. Such transfers were literally within the Section as it first passed the House,[89] but the Senate eliminated them from its scope in order to emphasize the special function of Section 129, and the Conference Committee approved.[90]

Where a corporation acquires property from a controlled corporation, but corporate control was acquired after October 8, 1940, the initial acquisition is subject to attack under Section 129. However, if the initial acquisition of

[86]FINANCE COMMITTEE REP. No. 627, 78th Cong., 1st Sess. (1943) 59-60.

[87]FINANCE COMMITTEE REP. No. 627, 78th Cong., 1st Sess. (1943) 58-59.

[88]INT REV. CODE §§ 45 and 141 (1939), and the regulations thereunder; also Higgins v. Smith, 308 U. S. 473 (1940). Section 128 of the Revenue Act of 1943 also amended section 45 of the Internal Revenue Code by enlarging the phrase "gross income or deductions" to read "gross income, deductions, credits, or allowances." The purpose was to clarify the scope of section 45 in existing law. Since section 129 was intended not to overlap into the field of section 45, it was important that the intended scope of section 45 be explicitly stated so as to prevent certain technical arguments against the inclusion of certain transactions.

[89]Revenue Act of 1943, § 115(a).

[90]CONFERENCE COMMITTEE REP. No. 1079, 78th Cong., 2nd Sess. (1944) 54.

control was not principally motivated by tax avoidance, the subsequent transfer for the purpose of avoidance may not be impeached under Section 129, since it falls into the excepted category of transfers between related corporations. Of course, the time lapse between the acquisition of corporate control and the subsequent intercorporate transfer of property will reflect on the purpose for which corporate control was first acquired.

Suppose that there is an acquisition of property from a corporation which controls, rather than is controlled by, the acquiring corporation. Does the Section apply? For example, A is the parent and B is the subsidiary. If A liquidated B into A, the acquisition by A of B's property would not be subject to Section 129. But, instead, A contributes some property to the capital of B. Section 129 does not apply if B or its stockholders controlled, directly or indirectly, A. But B's stockholder is A, and thus we are reduced to the question of whether A controls A. Rather than to attempt a play on words, it is believed best to refer to the preceding material for the answer. It was not the intent of Congress to affect dealings between related or affiliated organizations.[91] It was thought that[92] such transactions are already covered by the existing law[93] with respect to avoidance. Consequently, it is believed that Section 129 does not apply to the case in question.

The Section does not apply to an acquisition of property from a corporation already controlled by the acquiring corporation or its shareholders. Suppose, then, that A owns X Corporation and B owns Y Corporation. X desires to make use of Y's high-basis, low-value property. If X acquires the property from Y for voting stock, the transaction is vulnerable. But, suppose that B first buys absolutely a nominal amount of X's stock from A, thus becoming a stockholder of X, and X then acquires the property from Y for voting stock. The transaction then seems to fall outside of the Section since "immediately prior to such acquisition" by X, Y was controlled by X or its stockholders. Of course, it might still be attacked under established cases if not under Section 129. In fact, the acquisition by B of stock in X, for the sole purpose of avoiding the Section, might well be the death blow in fitting the basic transaction within *Gregory* v. *Helvering*.[94] Of course, if B

[91]FINANCE COMMITTEE REP. No. 627, 78th Cong., 1st Sess. (1943) 59-60.

[92]FINANCE COMMITTEE REP. No. 627, 78th Cong., 1st Sess. (1943) 58-59; CONFERENCE COMMITTEE REP. No. 1079, 78th Cong., 2nd Sess. (1944) 54-55.

[93]INT. REV. CODE § 45 (1939); National Securities Co. v. Comm'r, 137 F. (2d) 600, *cert. denied,* 320 U. S. 794 (1943).

[94]308 U. S. 355 (1939), *aff'g* 103 F. (2d) 110 (C. C. A. 7th, 1939); although it is believed that technically the *Gregory* case is not applicable, it is not yet known just how far the doctrine of that case will be extended.

were a 50 per cent stockholder of X for many years before,[95] the purchase would have a better chance of surviving attack.

Principal Purpose

Whether the acquisition be of control of a corporation or of property of a corporation, to be within Section 129, "the principal purpose" for which such acquisition was made must be the evasion or avoidance of federal income or excess profits tax by securing the benefit of a deduction, credit, or other allowance which the acquiring person or corporation would not otherwise enjoy.

As it passed the House, the Section engrossed transactions where "one of the principal purposes" was avoidance.[96] But this provision was bitterly attacked before the Senate Finance Committee[97] on the ground that such a provision would make any transaction vulnerable since a prudent business man would, before entering into any transaction, first consider its tax consequences and try to effect the transaction in a way which would be as economical tax-wise as possible. Thus, they argued, it could be said that "one of the principal purposes" in any such transaction was avoidance. As a result, the provision was rephrased to include only transactions in which "the principal purpose" is avoidance or evasion.

"Principal purpose" is a question of fact. The taxpayer has a negative burden of proof in such a case. That is, it must be able to prove that the "principal purpose" of the acquisition in question was not evasion or avoidance. Each case will depend on its own peculiar facts. The determination of the purpose for which any acquisition was made, will necessarily require a scrutiny of the entire transaction or course of conduct, with all its surrounding circumstances.[98] Thus the taxpayer has the burden of tying all the facts together in such a way as to prove that the "principal purpose" is not evasion or avoidance.

The regulations[99] state that if the purpose to evade or avoid federal income

[95]See *e.g.*, A. G. Nelson Paper Co., Inc., 4 T. C. —, Docket No. 1553, Aug. 30, 1944, where the husband controlled X Corporation, in which the wife had a one-sixth interest, and the wife controlled B Corporation.

[96]Revenue Bill of 1943, § 115(a).

[97]*Hearings before the Finance Committee on H. R. 3687,* 78th Cong., 1st Sess. (1943), Mr. Alvord's brief on behalf of the U. S. Chamber of Commerce, p. 611, and Mr. Chapman's brief on behalf of the Comptrollers Institute, p. 825.

[98]FINANCE COMMITTEE REP. No. 627, 78th Cong., 1st Sess. (1943) 59. U. S. Treas. Reg. 111, § 29.129-2 suggests that an important fact to be considered is conduct of the business of the taxpayer." Of course, the "germane" test introduces another difficult question of fact.

[99]U. S. Treas. Reg. 111, § 29.129-3.

or excess profits tax exceeds in importance any other purpose, it is the principal purpose. It is believed that the test must be a subjective one, to determine the factor which was most important to the taxpayer in causing the acquisition. It is not difficult to imagine cases involving numerous motivating factors, where it is impossible to conclude that any one reason was the principal reason and where no one reason can propertly be regarded as the "principal reason" or "last straw." It must, however, be constantly remembered that the burden of proof is on the taxpayer.

If the taxpayer is able to show a more important reason for making the acquisition than tax avoidance, he would seem to have met his burden. It would probably be sufficient to prove that the acquisition would not have been made but for the suggested business reason, the tax advantage being considered only to the degree that any prudent business man would deem wise. However, it is not necessarily sufficient to prove the converse, that the acquisition would have been made even if the tax reducing factor was not present.[100] In the latter case, the tax reason could still be the principal one. In the former case, the business reason is clearly most important.

The "principal purpose" may be a "business purpose," although the choice of acquisitions is motivated primarily by tax avoidance. For example, A Corporation needs a factory. It can buy one of many, but buys for voting stock the one with the highest tax base and lowest fair market value. Here the "principal purpose" for the acquisition of one, as compared with another, is taxes, but business reasons caused the acquisition in the first place. This kind of transaction is more in the prudent man category than in the cold-blooded avoidance class at which Section 129 was directed. Consequently, it is not believed that the Section applies.

Again, suppose Mr. A wants to go into business. Taxes being too high, he doesn't want to risk his capital. However, he finds an unsuccessful corporation which he wishes to develop because its excess profits credit is high enough to assure no corporate excess profits tax liability. If he did not find such a corporation, he would not go into business. This acquisition merely assures a greater return after taxes. It is not believed that, in light of the purpose of Section 129, it could successfully be argued that the principal purpose for which such acquisition was made is avoidance of a tax, regardless of the fact that no acquisition would have been made if Mr. A did not find a corporation with a suitable excess profits tax base. The principal pur-

[100] U. S. Treas. Reg. 111, § 29.129-3 provides that: "this does not mean that only those acquisitions fall within the provisions of section 129 which would not have been made if the evasion or avoidance factor was not present."

pose was a business purpose and Mr. A merely acted prudently. The answer would probably be different if the corporation purchased was a defunct "empty shell," not particularly suited to the purchaser's needs.

What about the defunct corporation that gets new capital and buys a successful corporation only because its backers are aware of its large credit and past losses. It is believed that such a transaction is not covered since it involves only one acquisition, the principal purpose of which is a "business purpose."[101] It might be different if the defunct corporation were first purchased by new owners. In the latter case, two acquisitions would be involved, the first of which might well be for the "principal purpose" of avoiding taxes.

Federal Income or Excess Profits Tax

Section 129 is concerned with avoidance of "Federal income or excess profits tax." The term "Federal income or excess profits tax" refers to any federal tax imposed by Congress upon an income base.[102] Thus, the Section includes acquisitions made for the purpose of avoiding any tax or combination of taxes in Chapter 1 and Chapter 2 of the code, including the normal tax, surtax, Section 102 tax, personal holding company tax, declared-value excess profits tax, and the excess profits tax.

Deduction, Credit, or Other Allowance

The avoidance contemplated by the Section is the enjoyment for tax purposes of the benefit of a "deduction, credit, or other allowance" which properly belongs to another. The expression "deduction, credit, or other allowance" has reference to any provision which has the effect of diminishing the tax liability resulting from the gross amount of any item of income or the aggregate of the gross amounts of any or all items of income.[103] Thus it includes current, past, or prospective credits, deductions, net operating losses, and unused excess profits credits.[104]

As the Section now reads, it includes only cases where the person or cor-

[101] Of course, it should be expected that the Government will invoke the "germane" test, and argue that the business acquired is not "germane" to the activities of the defunct corporation.

[102] U. S. Treas. Reg. 111, § 29.129-1(c).

[103] WAYS AND MEANS COMMITTEE REP. No. 871, 78th Cong., 1st Sess. (1944) 49. U. S. Treas. Reg. 111, § 29.129-(a) states that the term "allowance" includes "an adjustment, an exemption, or an exclusion." Query whether the privilege afforded to Western Hemisphere Trade Corporations (Int. Rev. Code §§ 15 and 107) constitutes an "allowance" under section 129.

[104] U. S. Treas. Reg. 111, § 29.129-3.

poration making the acquisition secures the benefit of the deduction, credit, or other allowance. Despite the absence of specific language, as contrasted with other parts of the Section, presumably it makes no difference whether the acquiring person or corporation secures the particular benefit "directly or indirectly." For example, A has a successful business. He buys a defunct corporation for a nominal sum and transfers the business to the defunct corporation, so that the latter's losses will offset the income of the business. Since the corporation is a separate entity, A secures the benefit of its losses only indirectly. Yet Section 129 was intended to apply to such a transaction and, it is expected, will be so held to apply. As previously suggested, Congress intended a flexible statute, one which would be broadly construed, in light of its underlying policy.[105]

Section 129 presumably applies whether the acquiring corporation is seeking to enjoy its own deduction, credit, or other allowance, or that of the corporation or property acquired. For example, a prosperous corporation may acquire a defunct corporation to avail itself of the latter's unused allowances. On the other hand, a corporation with unused credits or losses may acquire another going corporation to make use of its own unused allowances. In both cases, the effect is to secure the benefit of an allowance which would not otherwise be enjoyed. In the former case, however, the "principal purpose" will usually be more obvious.[106]

Extent of Disallowance

Since Section 129 comprehends certain acquisitions whose principal purpose is avoidance by securing the benefit of an allowance which would not otherwise be enjoyed by the one making the acquisition, the punishment meted out is the disallowance of the allowance sought.

In order that the disallowance may be consistent with the purpose and appropriate scope of the Section,[107] the Commissioner is authorized[108] (1) to allow any part of the amount otherwise disallowed, which is consistent with the prevention of the avoidance for which the acquisition was made, and/or (2) to allocate the gross income, deductions, credits, or allowances in such

[105]Ways and Means Committee Rep. No. 871, 78th Cong., 1st Sess. (1944) 49, ". . . The scope of the terms used in the section is to be found in the objective of the section, namely, to prevent the tax liability from being reduced through the distortion or perversion effected through tax avoidance devices." At any rate, Higgins v. Smith, 308 U. S. 473, 60 Sup. Ct. 355 (1940), would probably be held to apply.

[106]In the latter case the "germane" test will probably be decisive.

[107]Ways and Means Committee Rep. No. 871, 78th Cong., 1st Sess. (1944) 49.

[108]Int. Rev. Code § 129(b) (1939).

manner, between the corporations and properties involved, as he determines will not result in the avoidance for which the acquisition was made. The thought in the first case is to enable the Commissioner to reflect in the deductions, credits, and allowances the purchase in substance by the acquiring interest.[109] The second category provides for the more complex cases where reflecting the acquisition in substance may require the allocation or distribution of a deduction, credit or allowance between or among the corporations or properties involved.[110]

The authority granted to the Commissioner is like that existing under Sections 45 and 141.[111] Consequently, his abuse of such authority should similarly be subject to review and reversal. There is a difference in the manner in which the authority is given, but it is believed that such difference is of no consequence. That is, under Sections 45 and 141 the Commissioner is authorized to perform the positive act of reapportioning income and deductions. If he exercises such authority, in a proper case, it will be to the taxpayer's disadvantage. But under Section 129, the entire deduction, credit, or allowance is first disallowed. Thus, if the Commissioner then exercises his authority in a proper case, it is to the taxpayer's advantage. However, as suggested before, the purpose of Section 129 is to be effectuated. So, where a deduction or credit is disallowed entirely under Section 129 and the Commissioner, in a proper case, does not restore part of the item disallowed, this negative action will be subject to review for abuse of authority. For example, if A Corporation acquired control of B Corporation for the sole purpose of acquiring the benefit, through consolidated returns, of part of B's excess profits credit, such part would be disallowed. But it would be a violation of Section 129, subject to review and reversal, for the Commissioner to disallow the use of a portion of B's excess profits credit against B's excess profits net income, and to carry backward or forward the unused portion of such credit.

In the case of an acquisition of corporate property, the Commissioner would be required to treat the acquiring corporation at least as well as if it had purchased the property outright and no tax-free exchange were involved.[112] In other words, the acquiring corporation is at least entitled to

[109]FINANCE COMMITTEE REP. No. 627, 78th Cong., 1st Sess. (1943) 49.
[110]*Ibid.*
[111]*Ibid.*
[112]FINANCE COMMITTEE REP. No. 627, 78th Cong., 1st Sess. (1943) 61. ("Thus, the consideration passing upon the acquisition or the income of the corporations or properties involved, both prior to and after the acquisition, may, in appropriate cases, be an important factor in determining a proper credit, deduction, or allowance.")

compute its invested capital credit or depreciation or loss on the basis of the fair market value at the time of the acquisition. For example, if A Corporation acquired for voting stock B Corporation's sole asset, having a basis of $100,000.00 and fair market value of $10,000.00, A would be entitled to have a basis of at least $10,000.00 allowed.

Conclusion

After considering the nature of Section 129, no one can legitimately find fault with its purpose or underlying policy. However, the great objection to the legislation is the broad power which it gives the Commissioner. As Mr. Alvord testified before the Senate Finance Committee, it is "a general power to haul in everything that the Commissioner might want to haul in." But it must, in fairness, be remembered that the enactment of Section 45 was objected to for the same reason. Yet experience shows us that Section has generally not been abused by members of the Bureau of Internal Revenue. Let us hope that Section 129 will be handled the same way, not as a club to force taxpayers into submission on other issues, but legitimately, to achieve the object of preventing circumvention and distortion of the tax laws.