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Income Tax -- Reallocation of Gross Income -- Controlled Corporations -- Commissioner v. First Security Bank of Utah, N.A.

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economic, not ethnic or racial. It is submitted that the rule of "per se" unconstitutionality is not applicable to the racially-cast eligibility guidelines, inasmuch as these ethnic qualifications are merely auxiliary, and constitute a reasonable means of pursuing a remedial purpose proclaimed in executive orders of the President. Furthermore, since the operation of the 8(a) program infringes upon no right claimed in this case which the law is prepared to recognize, the contention that one of the plaintiffs had been deprived of property without due process is without merit. In using its procurement powers to further the purposes proclaimed in the 1970 8(a) regulations, and to promote economic integrations at the entrepreneurial level, the government has chosen a valid and appropriate means of remedying the economic inequities which for too long have been characteristic of American life.

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Income Tax—Reallocation of Gross Income—Controlled Corporations—*Commissioner v. First Security Bank of Utah, N.A.*[1]—Respondent taxpayers, First Security Bank of Utah, N.A., and First Security Bank of Idaho, N.A. (the Banks), are national banks which were wholly owned subsidiaries of First Security Corporation, a publicly owned bank holding company. First Security Corporation (the Holding Company) also controlled Ed. D. Smith & Sons (the Management Company), Smith (the Insurance Agency) and, starting in 1954, an insurance company, First Security Life Insurance Company of Texas (Security Life).

In 1948, the Banks made arrangements to offer credit life insurance to their borrowers.[2] Until 1954, the Banks referred all borrowers deciding to purchase this insurance to two independent insurance carriers.[3] Federal banking laws prohibited the Banks from receiving sales commissions or other income from the credit insurance generated by

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[1] 405 U.S. 394 (1972).

[2] The Tax Court lists the reasons for the Banks providing this service:

> . . . (1) to offer a service increasingly supplied by competing financial institutions, (2) to obtain the benefits of the additional collateral which credit insurance provides by repaying loans upon the death, injury, or illness of the borrower, and (3) to provide an additional source of income—part of the premiums from the insurance—to Holding Company or its subsidiaries.

First Security Bank of Utah, N.A. v. Commissioner, 26 CCH Tax Ct. Mem. 1321, 1322 (1967).

[3] The Banks followed a certain routine in making this insurance available to their customers. The lending officer would describe the purpose and availability of credit life insurance. If the borrower wanted the coverage, the Banks would fill out the required form, deliver a certificate to the customer, and collect the premium or add it to his loan. The completed forms were then forwarded to the Management Company which maintained the insurance records, forwarded customer premiums to the independent insurer, and processed claims filed under the policies. The Banks' costs in providing these services were estimated at $2000. 405 U.S. at 396-97.

them.[4] Because of this prohibition, during the period 1948-1954, the independent carriers writing the insurance paid the sales commissions to Smith, the Insurance Agency subsidiary. The Management Company then reported these commissions as taxable income.[5]

This allocation continued until 1954, at which time the Holding Company organized Security Life, "a new wholly owned subsidiary licensed to engage in the insurance business."[6] With the formation of Security Life, a new procedure was instituted whereby the credit life insurance available to borrowers was to be written by another independent company, American National Insurance Company of Galveston, Texas (American National), and then reinsured by Security Life pursuant to a "treaty of reinsurance."[7] The plan provided that American National would furnish the actuarial and accounting services and would receive fifteen percent of the premiums. No sales commissions were to be paid from the balance. Rather, Security Life would retain the remaining eighty-five percent of the premiums in return for assuming the risk under the policies. During the tax years 1955-1959 inclusive, Security Life reported the total amount of the reinsurance premiums in its gross income. This allocation resulted in a lower tax liability for the Holding Company because the income of life insurance companies was then subject to a lower tax rate than that of regular corporations.[8]

In 1962, the Commissioner, relying on his power under Section 482 of the Internal Revenue Code of 1954 to reallocate income within controlled corporations to reflect the true income of corporate entities,[9] sent deficiency notices to the respondents based on a reallocation to

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[4] National Banks are not authorized to act as insurance agents when located in areas having a population in excess of 5000 inhabitants. 12 U.S.C.A. § 92 (1968). Section 92 of the National Bank Act was enacted in 1916. When the statutes were revised and re-enacted in 1918, section 92 was omitted. Recent editions of the United States Code have also omitted the section. Nonetheless, the Comptroller of the Currency still regards section 92 to be effective and includes it in his Regulations. 12 CFR §§ 2.1-.5 (1971). See 405 U.S. at 401 n.12. Section 92 does not explicitly prohibit national banks in localities of over 5000 inhabitants from functioning as insurance agents but courts have decided that it does so by implication. Saxon v. Georgia Ass'n of Independent Insurance Agents, Inc., 399 F.2d 1010 (5th Cir. 1968); see Commissioner v. W. Morris Trust, 367 F.2d 794, 795 (4th Cir. 1966).

[5] It is customary in the insurance industry for the party who generates the business to be paid a "sales commission" ranging from 40% to 55% of the net premiums collected. 405 U.S. at 397.

[6] Id. at 398.

[7] Id.

[8] 26 U.S.C. §§ 801 et seq. (1970).

[9] Int. Rev. Code of 1954, § 482 provides:

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

the Banks of approximately forty percent of Security Life's premium income during the tax years 1955-1959.[10] The Tax Court upheld the validity of the Commissioner's allocation on the basis of the decision reached by the Seventh Circuit in *Local Finance Corp. v. Commissioner*.[11] The Court of Appeals for the Tenth Circuit reversed the Tax Court's decision,[12] and the Supreme Court granted certiorari to resolve the conflict between the decision of the Seventh Circuit in *Local Finance Corp.* and the Tenth Circuit's decision in *First Security Bank*.

The issue before the Supreme Court was whether the Commissioner had erred in allocating to the Banks forty percent of the net premiums which Security Life received for reinsuring credit insurance during the tax years in issue. The narrow issue facing the Court was whether "the generation of the credit insurance business by the banks sustains the allocation of a portion of the premium income to them."[13] The Court HELD: The Commissioner's exercise of his section 482 power was unwarranted, and the premium income received by Security Life should not have been reallocated to the Banks in order to reflect the true taxable income of each. This note will examine the implications of the Court's decision so far as the Commissioner's power to reallocate income within controlled corporations under section 482 is concerned.

In deciding that the Commissioner's application of section 482 to the facts of the instant case was unreasonable, the majority rests its opinion on two premises. It is submitted that both are erroneous. The first ground was the Banks' non-receipt of the income in question: the Banks had neither received nor attempted to receive reinsurance premiums flowing from their borrowers' purchase of credit life insurance.[14] Yet the actual receipt of income is legally irrelevant under the applicable test of section 482. That section gives the Commissioner the power to reallocate income within controlled corporations "in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations. . . ."[15] The regulations provide that the Commissioner's authority to determine "true taxable income"[16]

> . . . extends to any case in which either by inadvertence or design the taxable income, in whole or in part, of a controlled taxpayer, is other than it would have been had the

[10] The Commissioner did not allocate any income which Security Life received for reinsuring risks on mortgage, twin dollar, and borrow-by-check insurance, all of which Security Life reinsured in addition to credit insurance. 26 CCH Tax Ct. Mem. at 1326 n.14.

[11] 407 F.2d 629 (7th Cir.), cert. denied, 396 U.S. 956 (1969). On facts parallel to those in *First Security Bank*, the Seventh Circuit held in *Local Finance* that the Commissioner's allocation to the finance company that generated the insurance commissions was valid.

[12] First Security Bank of Utah, N.A. v. Commissioner, 436 F.2d 1192 (10th Cir. 1971).

[13] Id. at 1196.

[14] 405 U.S. at 402.

[15] See note 9 supra.

[16] Treas. Reg. § 482-1(c) (1972).

> taxpayer in the conduct of his affairs been an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer.[17]

The purpose of section 482's broad delegation of authority to the Commissioner is to prevent "artificial shifting, milking, or distorting of the true net incomes of commonly controlled enterprises."[18] Under section 482, then, the Commissioner determines taxable income on the basis of whether the corporation *earned*—not whether it received—the income.[19] Moreover, the assignment of income cases have long held that mere non-receipt of income is insufficient to avoid taxation.[20] Thus the majority's emphasis on actual receipt of funds ignores the basic thrust of section 482 and is without foundation in relevant case law.

As Justice Blackmun points out in his dissenting opinion, the application of the "uncontrolled taxpayer dealing at arm's length"[21] test set forth in the regulations to the facts in this case underscores the unfairness of the result reached.[22] There is little doubt that in an arm's length transaction, an unrelated insurer would have paid sales commissions to the respondent Banks for their services.[23] However, as a result of the majority holding, the Banks' insurance affiliate reports the premium income and is taxed on it at the preferential rates allowed to life insurance companies, and so derives a significant advantage over an uncontrolled taxpayer in the same business.

The second premise for the Court's conclusion is that federal law prohibits the Banks from receiving the reinsurance premiums.[24] In the words of Justice Blackmun, the Court's reliance on that fact links "legality with taxability or, to put it better oppositely, . . . it ties

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[17] Treas. Reg. § 482-1(c) (1972).

[18] B. Bittker & J. Eustice, Federal Income Taxation of Corporations and Shareholders 15-21 (3d ed. 1971).

[19] In *Local Finance*, the Seventh Circuit stated that

> the two primary elements which must exist to sustain a section 482 allocation are the existence of commonly controlled companies and the *earning* of income by certain of these companies which in the absence of the Commissioner's reallocation would not adequately be reflected in the income they would otherwise report for federal income tax purposes.

407 F.2d at 632 (emphasis added).

[20] See Helvering v. Horst, 311 U.S. 112 (1940) (assignment of taxpayer's interest coupons attached to bonds); Lucas v. Earl, 281 U.S. 111 (1930) (assignment of one-half interest in taxpayer's salary to his wife); see generally Commissioner v. Sunnen, 333 U.S. 591, 604-10 (1948).

[21] See note 17 supra.

[22] 405 U.S. at 418 (dissenting opinion).

[23] Petitioner's Brief for Certiorari at 17, Commissioner of Internal Revenue v. First Security Bank of Utah, N.A., 405 U.S. 394 (1972). The issue under section 482 is whether the Banks' income was clearly reflected during the years when they performed selling and processing services for Security Life. "The answer to this question turns on federal tax law, not on federal banking law, and under the former, illegal gains, like legal gains, are taxable whether received or not." Petitioner's Brief for Certiorari at 29. See also James v. United States, 366 U.S. 213 (1961).

[24] See note 4 supra.

illegality to receive with inability to tax."[25] Such a linkage of illegality with nontaxability stands in sharp contrast to the principles enunciated by the Court in *James v. United States*[26] and represents a reaffirmation of the "claim of right" doctrine[27] which had emerged from the earlier case of *Commissioner v. Wilcox*.[28] Hence *First Security Bank* has important retrogressive implications.

In *Wilcox*, the Supreme Court reached the result that under the predecessor of section 61(a) embezzled funds were not income to the embezzler in the year of embezzlement.[29] The basis for the *Wilcox* decision was that a "taxable gain is conditioned upon (1) the presence of a claim of right to the alleged gain and (2) the absence of a definite unconditional obligation to repay or return that which would otherwise constitute a gain."[30] Since Wilcox obtained the funds by means of a criminal act and held it "without any semblance of a bona fide claim of right," being "at all times under an unqualified duty . . . to repay the money to his employer . . . ," the Court held that the embezzled funds were includible in gross income.[31] *Wilcox*, then, stood for the proposition that funds obtained from illegal sources were not taxable in the year of receipt. However, six years later, in *Rutkin v. United States*,[32] the Court held that extorted income was taxable to the extortioner in the year of the crime. The *Rutkin* Court attempted to distinguish *Wilcox* on the basis that an embezzler gains no title to the sums he appropriates while an extortioner gains a voidable title,[33] but the distinction was not persuasive.

Finally, in 1961, the *James* Court overruled the *Wilcox* rule and determined that illegal receipts were taxable as gross income in the year of receipt. Justice Warren, writing for the *James* majority, set forth a cogent analysis of the gains includible within the concept of "gross income" under section 61(a).[34] He stated that the starting point in the construction of the phrase "gross income" is the recognition of the intention of Congress "to tax all gains except those specifically exempted."[35] In addition, the language of section 61(a), "all income from whatever source derived," has been held to include "all accessions to wealth, clearly realized, and over which the taxpayers

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[25] 405 U.S. at 418 (dissenting opinion).

[26] 366 U.S. 213 (1961).

[27] The "claim of right" doctrine is a useful tool in the area of tax accounting to allocate receipts to a given tax year. If a taxpayer receives income under a "claim of right" and without restriction as to its disposition, he must report the income in the year of receipt.

[28] 327 U.S. 404 (1946).

[29] Id. at 408. Section 22(a) of the Internal Revenue Code of 1939 is the predecessor of Section 61(a) of the Internal Revenue Code of 1954.

[30] 327 U.S. at 408.

[31] Id.

[32] 343 U.S. 130, 139 (1952).

[33] Id. at 137.

[34] 366 U.S. at 219.

[35] Id.

have complete dominion."[36] Justice Warren then concluded that "these broad principles" mandate that income derived from both legal and illegal sources be reported in "gross income."[37] Under *James*, the test of nontaxability was whether there was a "consensual recognition express or implied of an obligation to repay. . . ."[38]

Nevertheless, the Court's decision in *First Security Bank* seems to render *James* inapplicable to the receipt of income within controlled corporations. The apparent effect of *First Security Bank* is that illegal income within a controlled corporation will no longer be required to be included in "gross income." In the case at bar, the Banks violated a federal statute by performing the services which generated the insurance premiums. The Court's decision means that the unlawfulness of the funds in the Banks' hands, together with the Banks' power to shift the income to an insurance affiliate, precludes the inclusion of the premiums in "gross income." The effect of the majority opinion, then, is to create a legal bar to the taxation of illegal income within controlled corporations.

This result is inconsistent with section 61(a)'s requirement that "all income from whatever source derived" be reported as well as with the *James* decision. Section 61(a) requires that the true earner of income be taxed.[39] Even if James had written a check to his daughter for the amount of the embezzled funds before he received those funds, the Supreme Court would almost certainly have determined that "the exercise of power to dispose of income and procure the payment of it to another is the equivalent, for federal tax purposes, of the realization of income . . . ."[40] Since sections 61 and 482 are both designed to tax the true earner of income, the result should be the same under each. It is apparent, then, that *First Security Bank*'s imposition of the receipt-of-income and illegality tests on section 482 sets up a conflict between that section, as so interpreted, and section 61(a) and *James*.

Moreover, the *Wilcox* "claim of right" rule, once overruled in *James*, now appears revitalized as a principle of law in this area. *First Security Bank*'s virtual reaffirmation of the *Wilcox* rule places the holding company in an advantageous position vis-à-vis the unaffiliated corporation. The holding company can divert income to a subsidiary to avoid surtaxes[41] or to offset the latter's net operating losses. Should one of its subsidiaries engage in unlawful solicitation of insurance sales or charge more than the lawful rate in a regulated industry, the holding company can redirect the illegal funds to an unregulated affiliate.

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[36] Id., quoting Commissioner v. Glenshaw Glass Co., 348 U.S. 426, 431 (1954).

[37] 366 U.S. at 219.

[38] Id.

[39] Lucas v. Earl, 281 U.S. 111, 114-15 (1930).

[40] Petitioner's Brief for Certiorari, supra note 23, at 22. In support of this statement, Petitioner's Brief cites Lucas v. Earl, 281 U.S. 111 (1930), and Helvering v. Horst, 311 U.S. 112 (1940).

[41] Int. Rev. Code of 1954, § 11, places a surtax of 26% on corporate income over $25,000.

As a result of the Court's decision, the Commissioner no longer possesses the authority under section 482 to reallocate income to a subsidiary which has not in fact received the prohibited funds.

Another example of a potential abuse encouraged by the majority can arise where "captive insurance companies" are involved.[42] In a typical situation of this sort, a finance company establishes a subsidiary life insurance company that issues customer policies in connection with the parent's business. The subsidiary then charges excessive premiums on this business and succeeds in diverting a portion of the parent's income to it.[43] At the time of the passage of the Life Insurance Company Tax Act for 1955,[44] Congress was concerned about this problem and was advised that under section 482 the Commissioner had power to prevent such diversion by reallocating income.[45] The holding of the Court in *First Security Bank* seems to ignore this congressional concern.

In sum, *First Security Bank* can be said to encourage the formation of subsidiaries that will absorb the parent's income obtained from illegal sources and will be taxed at lower rates than would the parent on income diverted by the parent to the subsidiaries. The Commissioner's power to reallocate income to effectuate the purposes of section 482 is no longer an effective weapon against such practices. The majority's reliance on the actual receipt of income is at odds with the assignment of income cases as well as with section 61(a) and section 482 as previously interpreted, both of which incorporate the doctrine that income is taxed to the true earner thereof.[46] Finally, the Court's linkage of illegality with nontaxability resurrects the *Wilcox* "claim of right" doctrine and makes it available in cases of intercorporate transfers of income. The revitalization of the *Wilcox* rule with respect to controlled corporations may be expected to stimulate corporate formation of tax protectorates.

HARRIS J. BELINKIE

Federal Income Taxation—Section 165(a)—Losses: Corporate Loss Deduction Denied on Sale of Realty Because Property Was Not Held for Use in Trade or Business—*International Trading Co.*[1]—Petitioner, a brewery supply business[2] in Wisconsin, purchased thirteen

[42] 405 U.S. at 425 n.14 (dissenting opinion).

[43] Id. If the subsidiary charges excessive premiums on the parent's life insurance policies, the latter thereby obtains a greater "ordinary and necessary" business deduction under § 162(a) and thus reduces its taxable income. The subsidiary then reports the excessive premiums in its income for that year.

[44] Act of March 13, 1956, Pub. L. No. 429, 70 Stat. 36, as amended by the Life Insurance Company Tax Act of 1959, Act of June 25, 1959, Pub. L. No. 86-69, 73 Stat. 112, as amended, 26 U.S.C. § 801 et seq. (1970).

[45] 405 U.S. at 425 (dissenting opinion).

[46] See text at notes 19 and 39 supra.

[1] 57 T.C. 455 (1971).

[2] In addition petitioners "held real estate and collected rents therefrom." Id. at 456.