

Polak's Frutal Works, Inc., et al. v. Comm.

MAR. 19, 1954

Polak's Frutal Works, Inc., et al. v. Comm.

Decisions will be entered under Rule 50.

I. Herman Sher, Esq., for the petitioners.

Rigmor O. Carlsen, Esq., and William G. O'Neil, Esq., for the respondent.

PAGE 952

--

PAGE 953

Respondent determined deficiencies in income, declared value excess-profits and excess profits taxes of the petitioners for years and in amounts, as follows:

Petitioner	Docket No.	Tax	Year	Amount
Polak's Frutal Works, Inc	30131	Income	1945	\$ 26,870.90
	30131	Declared value		
		excess-profits	1945	1,114.29
	30131	Excess profits	1945	127,219.64
	46219	Income	1946	132,901.87
	46219	Income	1947	161,965.37
	46219	Income	1948	27,233.87
Jacob Polak	46220	Income	1946	54,712.99
	46220	Income	1947	112,850.79

Jacob Polak and Eliseba Polak,

husband and wife	46221	Income	1948	23,041.68
Emilie Polak Parser	46222	Income	1946	7,177.34
	46222	Income	1947	39,692.20
	46222	Income	1948	15,501.56

The petitioners acquiesce in certain of the adjustments made by respondent in arriving at his determination of deficiencies. By appropriate amendment to his pleadings, respondent has affirmatively raised an alternative issue with respect to each of the Docket Nos. 30131 and 46219. Respondent concedes that if he prevails on either his principal or alternative contention in Docket No. 46219, then petitioner therein is entitled to deduct from the allocated portions of the income of Frutal Export Co. amounts representing the New York State unincorporated business tax paid or incurred thereby in the calendar years 1946, 1947, and 1948, respectively. With respect

PAGE 953

--

PAGE 954

to Docket Nos. 46220, 46221, and 46222, respondent also concedes the impropriety of including within the gross incomes of the petitioners therein the full amounts determined by him to be respectively so includible. The disputed issues appearing in each case, follow:
Docket No. 30131.

1. Whether the organizational entity known as Frutal Export Co. should be disregarded for tax purposes and an allocated portion of the net income reported on partnership returns filed in its name for the fiscal year ended January 31, 1946, be included in the gross income of petitioner for the calendar year 1945 in accordance with section 22 (a), Internal Revenue Code; or
2. In the alternative, whether or not an allocated portion of the gross profits from the sales of petitioner's products, handled by Frutal Export Co. in the calendar year 1945, is includible in the gross income of petitioner for such year in accordance with section 45, Internal Revenue Code.

3. Whether petitioner is entitled to a deduction in the calendar year 1945 in the total amount claimed for compensation of several individuals, or whether respondent properly disallowed a portion thereof as being excessive. *Docket No. 46219.*

1. Whether the organizational entities known as Frutal Export Co. and Frutal Export Co., Inc., should be disregarded for tax purposes, and whether allocated portions of the net income reported on partnership and corporate returns filed in the respective names thereof should be included in the gross income of petitioner for the calendar years 1946, 1947, and 1948 in accordance with the provisions of section 22 (a), Internal Revenue Code, as determined by respondent; or

2. In the alternative, whether certain sums determined by respondent as being allocated portions of the gross profits from sales of petitioner's products handled by Frutal Export Co. in the calendar years 1946 and 1947 and by Frutal Export Co., Inc., in 1947 and 1948, are properly includible in the gross income of petitioner for the calendar years 1946, 1947, and 1948 in accordance with provisions of section 45, Internal Revenue Code.

3. Whether petitioner is entitled to deductions in the total amounts claimed in the calendar years 1946, 1947, and 1948 for compensation paid to several individuals, or whether respondent properly disallowed portions thereof, respectively, as being excessive.

PAGE 954

--

PAGE 955

Docket Nos. 46220, 46221, 46222.

1. Whether allocable portions of the amounts determined by respondent as representing constructive dividends received from Polak's Frutal Works, Inc., and Polak's Frutal Works, N. V., are properly so includible within the gross income of the respective petitioners for the taxable year involved in each case. FINDINGS OF FACT.

The stipulation of facts filed by the parties and the joint exhibits attached thereto are incorporated herein by this reference.

The petitioner in Docket Nos. 30131 and 46219 is Polak's Frutal Works, Inc. (hereinafter sometimes referred to as Frutal), a corporation organized under the laws of the State of New York. It filed its returns for the periods involved with the collector of internal revenue for the first district of New York at Brooklyn. The petitioner in Docket No. 46220, Jacob Polak, is an individual who filed his return for the taxable years involved with the collector of internal revenue for the fourteenth district of New York at Albany. The petitioners in Docket No. 46221 are Jacob Polak and Eliseba Polak, husband and wife, who filed a joint return for the period involved with the collector of internal revenue for the fourteenth district of New York at Albany. The petitioner in Docket No. 46222 is Emilie Polak Parser, an individual, who filed her returns for each year involved with the collector of internal revenue for the third district of New York at New York.

Frutal was incorporated in May 1921, with an authorized capital stock of 20,000, consisting of 200 shares of common stock of the par value of 100 per share which stock was increased, in February 1939, to 100,000, consisting of 1,000 shares of common stock of the par value of 100 per share. In July 1942, the authorized capital stock of Frutal was further increased to 300,000, consisting of 2,000 shares of preferred stock of the par value of 100 per share and 1,000 shares of common stock of the par value of 100 per share. The preferred shares entitled the holders thereof to cumulative annual dividends of 5 per share and no more; to 100 per share and all unpaid accrued dividends, but no more, in the event of dissolution or liquidation of the corporation, or any sale of its assets, or in the event of its insolvency, or upon any distribution of its capital; and to the same voting power as the common stock, that is, 1 vote for each share of stock.

At a meeting of the stockholders of Frutal, in May 1947, it was resolved that Frutal's authorized capital stock be increased to 800,000, consisting of 2,000 shares of preferred stock and 6,000 shares of common stock, all of the par value of 100 per share and with no change in the provisions of the preferred stock.

PAGE 955

--

PAGE 956

Frutal issued its authorized common stock, as above stated, to Polak's Frutal Works, N. V. (hereinafter sometimes referred to as N. V.), a limited company organized and existing under the laws of Holland, as follows:

Shares issued	Date of issuance	Consideration
10	May 1921	Cash at par.
90	May 1923	Cash at par.
100	July 1931	Stock dividend.
800	Apr. 1939	Cash at par.

N. V. owned and held the foregoing shares of common stock at all times from the respective dates of issuance until July 31, 1948, when it transferred the entire 1,000 common shares of Frutal to P. F. W. of America, Inc., a New York corporation organized in February 1948. This latter corporation has owned and held such common shares at all times thereafter.

Frutal issued its above stated authorized preferred capital stock on January 2, 1943, for cash at par, as follows:

	Shares
Eliseba Polak	1,000
Emilie Polak Parser	1,000

Each of the above paid for her respective shares and has, at all times, owned and held such shares.

N. V. was organized in 1914 by Jacob Polak and his brother Henri Polak, as a corporation under the laws of the Kingdom of the Netherlands, with its principal office and place of business at Amersfoort, in the Kingdom of the Netherlands, to engage in the manufacture in Holland, and sale throughout the world, of essential oils and allied products. With certain later changes hereinafter described, it thereafter successfully engaged in that business, enjoying a worldwide reputation with respect to the products which it manufactured and sold. From February 23, 1933, to July 31, 1948, when it was reorganized, the issued and outstanding capital stock of N. V. consisted of 30 class A shares and 370 class B shares. The class A and class B shares had the same voting rights, namely, 1 vote for each share of stock. They differed substantially with respect to the payment of dividends and the distribution of capital.

On July 31, 1948, with the consent of the Dutch Government, N. V. was reorganized as follows:

(1) N. V. transferred all of its assets located outside of the Netherlands to P. F. W. of America, Inc., in exchange for all of its authorized capital stock consisting of 15 class A shares and 185 class B shares with rights substantially the same as the capital stock of N. V.;

(2) N. V. transferred all of its assets located in the Netherlands to a new Dutch corporation, N. V. Polak's Frutal Werken, in exchange

PAGE 956

--

PAGE 957

for all of its authorized capital stock consisting of 15 class A shares and 185 class B shares with rights substantially the same as the capital stock of N. V.; and

(3) N. V. distributed to its shareholders, in exchange for its outstanding capital stock (which was surrendered and canceled), all of the capital stock of P. F. W. of America, Inc., and N. V. Polak's Frutal Werken.

Jacob Polak was the record holder of the 30 class A shares of N. V., issued and outstanding. Emilie Polak Parser (hereinafter referred to as Emilie) was the beneficial owner of 15 shares thereof. The stockholders of N. V. and the shares beneficially owned by each from before the year 1945 to July 31, 1948, when they were surrendered to N. V., pursuant to the foregoing reorganization, were as follows:

Stockholder	Shares owned	
	Class A	Class B
Jacob Polak	15	183
Bernard Polak	0	20
Frits J. Polak	0	1
Emilie Polak Parser	15	128

Ernest H. Polak	0	19
Ina M. Polak	0	19
Total	30	370

Jacob Polak (hereinafter sometimes referred to as Jacob) first entered the flavor business, i.e., the manufacture and sale of essential oils, concentrated oils, terpeneless oils, perfume compounds, synthetic materials, especially aromatics, fruit juices, natural flavors, and imitation flavors, in 1903 in Holland in his father's business which had been in existence since 1885. He first started with the firm of Polak and Schwarz, which his father, his brother Henri, and he, left in 1914, when they started their own firm, N. V. From 1914, N. V. engaged in this business and manufactured the above mentioned products, which it sold all over the world.

An essential oil is a volatile oil in a plant, e.g., a flower, leaf, gum, bark, root, spice, etc., which gives it its odor. This oil, when distilled from the plant, is the commercial essential oil. A concentrated oil is a natural oil, concentrated by a distilling process to the degree desired. Terpeneless oils are somewhat the same, except that terpenes are removed and the oils are highly concentrated, on occasion to 35 times or more. Concentrated oils, terpeneless oils, and perfume compounds are specialty products, i.e., they are made to order. So, also, are natural flavors and imitation flavors. N. V. was a specialty house and sold such products to the fruit industry, and the cosmetic, the perfume, and soap industries. The essential oil and aromatic synthetics

PAGE 957

--

PAGE 958

which it manufactured and sold were staples. Formulae and recipes have been of the utmost importance in the manufacture and sale of the products of N. V. These formulae, without which duplication of the compound is practically impossible, and so-called recipes, which are prescriptions giving details of the manufacture of some of the raw materials, are a very specialized part of the business. In the manufacture of the products of N. V., it has been of importance to exercise careful control of the quality of the material used. The same material, produced in different parts of the world, may be of different quality. All such materials purchased must be analyzed both chemically and olfactorily for conformance to required

quality. Some of the material is not readily available. Proper control of materials used requires expert knowledge of the sources of supply, chemical analysis, and olfactory sense.

Frutal was organized in 1921 to establish a sales agency to further the sales of N. V. products in the United States. N. V. also maintained a sales agency in England known as Soflar, Ltd., an English corporation, which was the sole channel for the supply in the British Isles of the products manufactured by N. V. In about October 1933, Frutal Manufacturing Co., Ltd., an English corporation, was organized and thereafter operated to manufacture and produce the products required by Soflar, Ltd. N. V. had a French subsidiary known as Societe Industrielle Frutal, S. A. It also had a Spanish subsidiary which seasonally operated a citrus plant in Spain. Jacob Polak was the leading man and made over-all policies for the business.

Frits J. Polak (hereinafter referred to as Frits) was born in Holland and grew up with the business of N. V., where he spent his vacations from school doing odd jobs. In that way, he, at an early age, assimilated the atmosphere and began to understand the workings of the business. In August 1932, he started to work full time for N. V. going through all of its various departments. He started to work with sales in 1933. In 1935, he went to England where he worked with N. V.'s English company. In the winter season of 1932-33, Frits went to Spain to work in the citrus plant of N. V.'s Spanish subsidiary and thus to learn that phase of the business. In the subsequent years, he went there to help run the plant. Following the death of N. V.'s export sales manager for the Latin American countries in 1936, Frits was directed into that field. Thereafter, from 1936 to 1940, he spent most of his time traveling in the Latin American countries as the export sales manager of N. V. for this territory. Frits was in the United States on business for N. V. from September 1939, to about March 1940, when he assisted in the organizing of manufacturing here and in the organization of the export business which it then appeared might be necessary to be operated from this country in case

PAGE 958

--

PAGE 959

of more serious developments in Europe. About March 1940, Frits went to Brazil, Argentina, and Uruguay on a sales trip for N. V. Frits returned to the United States in June 1940, and took

over the direction of both the domestic and export sales here. Since Frutal then had no personnel that were experienced in the export business, or in manufacturing, Frits trained such personnel. In 1940 and later, Frits coordinated production capacity with domestic and export requirements. He then also had responsibilities for purchasing.

Bernard Polak (hereinafter referred to as Bernard) started in the business of N. V. in Holland about August 1934. He started at the bottom as a laborer in the various departments, learning the work from the bottom up. He went through the entire plant, became familiar with its operations, and with purchases and sales. He went on the road with the salesmen, visited customers, learned and understood their problems, and then returned to the plant and worked with them. He spent approximately a year in the compound department and about a year in the chemical plant operation. He spent a number of months in the manufacturing plant as plant manager of N. V.'s English manufacturing company. In 1938, he became assistant production manager in the Holland plant. He was plant superintendent there for approximately 6 months before he came to the United States in September 1939. Before then he also did work in analysis in the perfume and flavor laboratories and in the research and development laboratory in Holland. He went to Spain on 2 occasions and helped operate the plant of the Spanish subsidiary of N. V. He went to England about the end of 1937 to N. V.'s English companies, partly as training and partly to teach others. He worked in the plant in England and learned about the operation of a chemical plant. He returned to Holland about April 1938. Bernard took over the work of production following the physical breakdown of Jacob Polak in April 1939. Upon his arrival in the United States in September 1939, Bernard proceeded to familiarize himself with the needs and wishes of the customers here. He began to investigate the possibility of setting up manufacturing facilities and worked on a layout for a new plant. He consulted architects. He changed and helped change some of the internal organization of Frutal in order to have a manufacturing setup similar to that of N. V. in Holland. He commenced hiring chemists and additional personnel and to train them for the laboratory and experimental work required before manufacturing could begin. In 1940, Bernard, with the others here, began preparation for manufacturing, including the expansion of the existing buildings of Frutal.

Alexander H. Micheels (hereinafter referred to as Micheels) joined N. V. in Holland in about 1934. There he worked in the packing

PAGE 960

room, doing general office work, clerical work, work in the factory and laboratories, and sales. He went with the salesmen and learned how to talk to customers and to understand their problems. He worked in the laboratories, etc., until 1936, during which period he did special work in testing, compounding, and production. Before 1936, he worked in all of the departments of N. V. About December 1935, he went to Spain, where he worked on production in the plant of N. V.'s Spanish subsidiary. He did that work for 2 seasons; and, in the available time remaining, he made trips to Portugal, North Africa, and the Near East. Between 1936 and 1938, he traveled to the Eastern Mediterranean countries to explore the markets for N. V. and to see how its products could be adapted to those markets. From 1937 to 1940, Micheels was the active manager of N. V.'s French subsidiary, Societe Industrielle Frutal, S. A. During this period he made frequent trips to the Near Eastern countries. In 1940, he was called back to Holland for military service. He came to the United States on September 25, 1940. Upon his arrival in the United States, Micheels assisted Frits and Bernard in reorganizing Frutal's plant in order to increase its manufacturing potential. This work led to Micheels' becoming plant superintendent.

Ernest H. Polak (hereinafter referred to as Ernest) was born in Holland and went to high school there. He attended junior college, a technical institute in Switzerland, for 2 years. He came to the United States in 1939. After his arrival, he attended Columbia University as a chemistry student. The invasion of Holland in 1940 necessitated Ernest's withdrawal from Columbia and required his working in Frutal's plant in order to assist the others in setting up all of the necessary manufacturing operations. Thereafter, while he was working full time in Frutal's plant, Ernest went to night school at the Polytechnic Institute of Brooklyn and at New York University. He studied chemistry and obtained a bachelor of science degree therein in 1943. Later he had a teaching fellowship at Iowa State College and obtained a master of science degree in 1944. His work for Frutal was mainly technical at first, and later scientific.

Holland was invaded by the Germans on May 10, 1940. On May 24, 1940, the Dutch Government in Exile in London, England, issued a decree providing, in part, as follows:

ARTICLE 1

(1) All claims on persons, corporations, partnerships, institutions and legal entities, which claims belong to natural persons or legal entities, residing in the Kingdom of the Netherlands, as well as all claims of these mentioned persons on gold deposits, as far as these receivables and claims, outside the Kingdom in Europe, could be cashed, hypothecated in whatever manner, are now to be

PAGE 960

--

PAGE 961

considered as owned by the State of the Netherlands represented by the Royal Netherlands Government temporarily residing and functioning in London * * *

(2) The foregoing is also applicable to all claims derived from confirmed letters of credit, participation in the capital of, and credits granted to, corporations and partnerships, (irrespective whether these claims are or are not in the form of shares, bonds or other securities) insofar as these mentioned claims are owned by natural or legal entities residing in the Kingdom of the Netherlands and insofar as these receivables and claims can be hypothecated, cashed, etc. in any form whatsoever outside the territory of the Kingdom in Europe.

(3) The State of the Netherlands shall use the right of ownership derived as a result of the above captioned articles only to safeguard the rights of the former owners.

N. V.'s plant in Holland was seized by the German Government which made a purported sale of its assets exclusive of the shares of capital stock of Frutal and its other subsidiaries. In April 1941, by decree of the Dutch Government in Exile, the legal seat of N. V. was transferred from Amersfoort, Holland, to Willemstad, Curacao, Dutch West Indies, as of October 1940.

All Dutch nationals who had not given up their legal residences in Holland, although not in Holland on and after May 14, 1940, and any Dutch corporation whose seat was transferred by the Dutch Government to Curacao, were regarded and treated by it as residing in the Kingdom of the Netherlands for purposes of the above stated Dutch Government decree of May 24, 1940. Jacob Polak came to the United States in September 1940. His legal residence

on May 14, 1940, was still in Holland, and, when he came here, he had, in addition to his stock interest in N. V., considerable real estate in Holland and substantial securities of Dutch corporations, the business of which was conducted in Holland. Jacob became aware of the foregoing decree at or about the time of his arrival in the United States and considered himself subject thereto.

Pursuant to such decree, the business and financial affairs of N. V., as a Dutch corporation whose seat had been transferred to Curacao, were subject to supervision and control of the Dutch Government in Curacao, the representatives of which considered all properties owned by it as likewise subject to the jurisdiction and control of such Government. Because of N. V.'s ownership of all of the common capital stock of Frutal, the latter was considered to be subject to such control and supervision. Frutal was required periodically to submit balance sheets and profit and loss statements. It was not allowed legally to dispose of any properties or conduct any business whatever without obtaining a special license to do so from the supervising authority, the permission of which was also prerequisite to the holding of any stockholders' meetings; the issuance of any additional stock, common

PAGE 961

--

PAGE 962

or preferred; and the declaration or payment of any dividends. All funds of N. V. and Frutal in the United States were subject to the control of United States Foreign Funds Control (Executive Order 8389 of April 10, 1940, as amended by Executive Order 8785 of June 14, 1941), which cooperated with the Dutch Government and did not release such funds without a license therefor having first been issued thereby. In 1946, the Dutch Government requisitioned all dollar balances from Holland residents. As to Dutch corporations which had been transferred to Curacao, a representative of the Dutch Government was directed to ascertain and report as to whether unused funds in dollar currency were available.

Upon his arrival in the United States in September 1940, Jacob Polak and the others began to expand manufacturing operations in this country, through the instrumentality of Frutal, to supply the customers of N. V. throughout the world. Shortly thereafter Jacob initiated action in

an attempt ultimately to free Frutal and its business from supervision and control by the Dutch Government. At this time, Frutal was indebted to N. V. in the amount of approximately 250,000 and was in need of additional working capital. Jacob and the other members of the Polak families feared that this indebtedness might be seized and claimed by the then Dutch Government or some successor thereof and that the stockholders of N. V. faced a threat of the loss of their investment. In June 1941, Jacob sought the permission of the Dutch Government in Curacao to have Frutal issue an additional 200,000 of capital stock to the stockholders of N. V. in exchange for the payment by them of Frutal's indebtedness in that amount to N. V. The purpose of this proposal was (1) to increase the capital of Frutal, and (2) to have the majority of its shares of its capital stock held directly by the Polak family rather than N. V. Although the Dutch Government did not approve the issuance by Frutal of additional common stock, it did authorize the issuance of the preferred stock above mentioned.

Since the entire business of Frutal was being directed, operated, and developed by N. V.'s personnel on the basis of the formulae, processes, and the business and former customers of N. V., the directors of Frutal at a meeting of the board held on November 1, 1944, adopted the following resolution:

THAT, Polak's Frutal Works, Inc. pay to the N. V. a commission of 10 per cent of the export sales volume transacted by the New York corporation in each year since January 1, 1940, as full compensation for the use of the processes and formulae and for the customers turned over by the N. V. to the Incorporated.

PAGE 962

--

PAGE 963

Following the adoption of the foregoing resolution, one of the directors, who was not a member of either of the Polak families and who was also a director of N. V., submitted a further recommendation that beginning on January 1, 1945, the export business of Frutal which, he stated, really was the business of N. V., be separated from the regular domestic business of Frutal. He stated further that a separate firm could handle the export sales and

build up the export volume; that he wanted the export business to revert to N. V. when that could be properly done; that in the meantime it was believed more practical to have a separate firm take care of the export business; and that such a firm would obtain its products from Frutal at cost plus a reasonable profit. There was no dissent from such recommendations. They were regarded seriously and in good faith. They had been the subjects of informal discussions among the members of the Polak families and the directors, and were agreed to by all. The entire business conducted in the United States since the invasion of Holland had been conducted, operated, and developed by the members of the Polak families upon the basis of their individual skill and know-how and the formulae, processes, and business of N. V. The export business was regarded as being in reality that of N. V. and subject to being returned thereto after the war. The members of the Polak families were dissatisfied with the situation since the Dutch Government controls were exerted in 1940. The holders of N. V. stock were unable to receive dividends thereon. They constantly feared the loss of their investment therein by reason of possible confiscation. The younger members of the two families were threatening a complete break with Frutal and formation of a new, legally distinct enterprise in the same field because they were dissatisfied with the situation which prevented their building up any equities in the business for themselves.

To overcome, as much as possible, the foregoing difficulties, which resulted from control of Frutal by the Dutch Government, and to give an equity interest therein to the younger members, it was decided to place the export business in a new and separate firm. On January 1, 1945, Emilie, Ernest, Eliseba Polak (hereinafter referred to as Eliseba), Jacob, Frits, Bernard, and Micheels entered into a general partnership agreement under the laws of the State of New York to engage in the sale of essential oils and allied products, except in the United States and Canada, under the name of "Frutal Export Company" (hereinafter referred to as Export). Export commenced its business on February 1, 1945. Each of the partners then contributed,

PAGE 963

--

PAGE 964

in cash, to the original capital of Export from his or her separate property, and in addition thereto, on April 30, 1946, the respective amounts, as follows:

Partner	Capital contributed	
	Original	Additional
Emilie Polak Parser	\$ 7,000	\$ 7,000
Ernest H. Polak	3,000	3,000
Eliseba Polak	6,000	6,000
Jacob Polak	1,000	1,000
Frits J. Polak	1,000	1,000
Bernard Polak	1,000	1,000
Alexander H. Micheels	1,000	1,000
Total	\$ 20,000	\$ 20,000

The aforementioned agreement provided that salaries could be paid to any one or more of the partners as a majority in interest thereof would decide; and each was entitled to share in the net profits of the company, after salaries to partners, in accordance with his or her above stated contributions to the capital thereof.

On January 29, 1945, Frutal and Export entered into a written agreement wherein Frutal agreed, on order from Export, to manufacture essential oils and certain stated allied products for Export for sale by it to all parts of the world, except the continental United States and Canada. Frutal agreed not to sell any of its products to any purchaser in or for use in any country of the world except the United States and Canada. The price for which Frutal agreed to sell and Export agreed to buy the products manufactured by Frutal was fixed at the "cost of manufacture" to Frutal as defined in the agreement, plus a profit of 10 per cent of such cost. Export agreed to promote the sale of Frutal's products in all parts of the world except the United States and Canada, to advertise the same, and to employ salesmen and maintain an efficient selling organization. It agreed not to compete with Frutal in the United States and Canada and, except for any liability of Frutal by reason of any defect in the quality of its products sold to it by Frutal or because of stated unreasonable delay by Frutal in furnishing it

with its requirements, Frutal should not be liable for any debts, defaults, or obligations of Export. This agreement was entered into without the consent of the Dutch Government.

On March 25, 1947, Frutal Export Company, Inc. (hereinafter referred to as Export, Inc.), was incorporated under the laws of the State of New York with an authorized capital stock of 500,000, consisting

PAGE 964

--

PAGE 965

of 5,000 shares of the par value of 100 per share. On May 1, 1947, it issued, for cash at 100 per share, 1,000 shares of its authorized capital stock, which shares have since been held and owned, as follows:

Shareholder	Shares
Emilie Polak Parser	200
Ernest H. Polak	150
Ina Polak	150
Eliseba Polak	300
Jacob Polak	50
Frits J. Polak	50
Bernard Polak	50
Alexander H. Micheels	50
Total	1,000

Export ceased business operations on April 30, 1947. Export, Inc., began operations on May 1, 1947, and it has since continued the export business, previously conducted by Export, in the same manner and under the same operating agreement with Frutal. Frutal kept its books and made its Federal income tax and excess profits tax returns on the accrual basis of accounting and for fiscal years ended December 31.

Export and Export, Inc., respectively, kept their books and made their Federal income tax returns on the accrual basis of accounting and for fiscal years ended January 31. The sales made by Frutal in the calendar years 1945 to 1948 to Export and Export, Inc., respectively, which sales Frutal included in its income in its books and Federal income and excess profits tax returns for such years, and the composition thereof, are as follows:

Composition of the aggregate sales by Frutal to the Export partnership and
Export corporation

	1945	1946	1947	1948
(1) Cost of materials used	\$ 98,698.74	\$ 218,828.19	\$ 259,700.39	\$ 122,259.57
Manufacturing cost -- at				
per cent of item (1):				
(2) 33.6	33,162.78			
(3) 35.3		77,246.35		
(4) 35.7			92,713.04	
(5) 54.2				66,264.69
(6) Total -- items				
(1) to (5)	131,861.52	296,074.54	352,413.43	188,524.26
(7) Profit -- 10 per cent				
of item (6)	13,186.15	29,607.46	35,241.34	18,852.43
(8) Total sales	\$ 145,047.67	\$ 325,682.00	\$ 387,654.77	\$ 207,376.69

Item (1) above represents the actual cost to Frutal of the materials used by it in the goods sold to Export and Export, Inc.; items (2) to (5) above represent the ratio of Frutal's manufacturing cost of all

PAGE 965

--

PAGE 966

goods, to whomever sold by it, to its actual cost of the materials used by it in the manufacture of all goods to whomever sold by it. Items (2), (3), and (4) are based on the 3 years

immediately preceding the year in question, and item (5) is based on the year 1947. A more precise method of cost accounting was not practicable for Frutal. The method as used by Frutal was the same as that previously used by N. V. for determining the cost of its sales to Frutal and its other subsidiaries, and which experience had shown fairly and reasonably to establish the manufacturing cost of the goods sold.

Export and Export, Inc., made their sales primarily through local distributors, dealers, agents, and salesmen; special skill was needed to sell their products; and from 3 to 5 years of experience in this particular business was required to develop a competent salesman. Orders for export were received and accepted by Export and Export, Inc., respectively. They processed the orders, checked for quality, prices, and other pertinent matters, and ordered the required products from Frutal. Frutal then delivered the goods so ordered at the dock, usually in New York City, where Export or Export, Inc., as the case was, took title to the goods on delivery. Frutal billed Export or Export, Inc., for the price of the goods determined as shown above and for stated expenses such as packing, consular fees, freight, and insurance.

The partnership books were kept by the secretary of Frutal at his office and in the main offices of Frutal. Frutal had always maintained separate books and records on export sales so that when Export was organized, Frutal merely transferred this function thereto. Upon the formation of Export, two former employees of Frutal maintained its office which was located a few blocks from that of Frutal.

Export and Export, Inc., experienced difficulties in their export business with import restrictions in various countries to which they shipped goods; with customs penalties, exchange, and the blocking of funds and accounts (particularly in South American countries, where they sold on open account); and with finding competent salesmen who were willing to do the required traveling of from 9 to 11 months each year.

After formation of Export, the same customers formerly served by Frutal were then served by Export and later Export, Inc. The same sales agents were used as had formerly been used by Frutal. The list of Frutal's export customers was turned over to the export entity, as well as files relating to the export trade.

After Export was formed, it wrote letters to all of Frutal's former agents, advising that any agreements between the agents and Frutal

--

would remain unchanged except that the partnership "will be substituted" for Frutal. In an accompanying letter, Frutal advised these same agents that there would be no changes in price policies, quality of merchandise, or in the manner of packing and labeling the products. Frutal further advised that "* * * the transfer of all existing contracts between yourselves and you will merely involve the substitution of the name of Frutal Export Company to effect the contractual relationship between ourselves and the new company."

From the organization of Frutal in 1921, including the years 1945 to 1948, inclusive, Jacob has at all times been its principal executive. The principal executives immediately subordinate to him since 1940 have been Frits, Bernard, Micheels, and Ernest. Subject to the general supervision of Jacob, these individuals have been responsible for all policy matters. Each of these individuals has had his own particular work, but, because of his training and education, has been able to do all or much of the work of each of the others. All of them together, with Jacob, constituted a team which, from 1940, including the years 1945 to 1948, inclusive, was responsible for the operation and development of the businesses of Frutal, Export, and Export, Inc. This work has occupied all of the time of each of these individuals since 1940 to 1948, inclusive. Frits and Bernard have been vice presidents of Frutal since June 30, 1941. Frits served in the Armed Forces of the United States from about the end of July 1943 to July 1946. By 1943, Bernard was in charge of all technical production and maintenance matters, and customer service; and he continued with these responsibilities after 1943. During the absence of Frits in the Armed Forces, Bernard also worked in the sales and export departments. In 1947, Frutal located in Middletown, New York. Bernard was responsible for the designing of new buildings, facilities, and equipment; for training new chemists and technicians who were hired; and for moving. After 1940, Micheels made frequent trips to New England and the Eastern Seaboard territory; he took care of foreign customers; he interpreted reports received from agents and customers to produce the required products; he assisted in preparations at Middletown for Frutal's location there; and since 1948 he has been in charge of sales development for Frutal for the entire domestic market. Ernest has, since 1945, been in charge of Frutal's several laboratories, analytical control, chemical research and development, flavor

and perfume laboratories, a production laboratory for small-scale manufacturing, and an engineering shop where he has designed some of the special equipment required. At various times Ernest has been in charge of Frutal's flavor mixing plant, its essential oil and fruit juice

PAGE 967

--

PAGE 968

plant, and its perfume mixing plant; and he has worked in conjunction with the sales organization in order to produce what the customer requires. Jacob, Frits, Bernard, Ernest, and Micheels were the active workers in Export. Since before 1945, Jacob Polak has been able to speak and write Dutch, English, French, German, and Spanish, and has been able to read Swedish, Italian, and Portuguese; Frits has been able to speak and write Dutch, English, French, German, Spanish, and Portuguese; Bernard has been able to speak and write Dutch, English, French, German, and Spanish, and has been able to read Portuguese; and Micheels has been able to speak and write Dutch, English, French, German, and Spanish.

The net income of Export for its fiscal years ended January 31, 1946 to 1949, inclusive, the distributive shares of such net income of each of the alleged partners, and the actual distributions thereto in the calendar years 1945 to 1948, inclusive, are as follows:

	Years ended January 31			
	1946	1947	1948	1949
Net income of the Export				
partnership before				
salaries to partners	\$ 194,479.72	\$ 263,725.44	\$ 134,496.25	\$ 3,011.26
Distributive shares,				
including salaries,				
to partners:				
Emilie Polak Parser	52,777.29	76,553.91	39,198.69	1,053.94
Ernest H. Polak	24,618.84	37,808.82	19,299.44	451.69
Eliseba Polak	45,237.68	65,617.63	33,598.88	903.39

Jacob Polak	29,227.07	20,936.27	10,599.81	150.56
Frits J. Polak	7,539.62	20,936.27	10,599.81	150.56
Bernard Polak	17,539.61	20,936.27	10,599.81	150.56
Alexander H. Micheels	17,539.61	20,936.27	10,599.81	150.56
Total	\$ 194,479.72	\$ 263,725.44	\$ 134,496.25	\$ 3,011.26

Years ended December 31

1945 1946 1947 1948

Actual distribution

to partners:

Emilie Polak Parser	\$ 5,000.00	\$ 40,777.29	\$ 83,553.91	\$ 39,198.69
Ernest H. Polak	2,000.00	19,618.84	40,808.82	19,299.44
Eliseba Polak	5,000.00	34,237.68	71,617.63	33,598.88
Jacob Polak	21,687.45	6,539.62	21,936.27	10,599.81
Frits J. Polak		6,539.62	21,936.27	10,599.81
Bernard Polak	10,000.00	6,539.61	21,936.27	10,599.81
Alexander H. Micheels	10,000.00	6,539.61	21,936.27	10,599.81
Total	\$ 53,687.45	\$ 120,792.27	\$ 283,725.44	\$ 134,496.25

The table below shows, for Frutal per its books, its total net sales, gross profit from all sales (net sales less the cost to Frutal of the material used in the goods sold), other income, and net income for the calendar years 1921 to 1951, inclusive:

PAGE 968

--

PAGE 969

Income statements of Frutal per its books

Year	Net sales	Gross profit from sales	Other income	Net income ³
1921 ¹	\$ 28,853.10	\$ 6,373.50		\$ (10,192.81)

1922	69,762.47	24,451.18		(3,869.53)
1923	101,153.79	41,624.95		8,394.84
1924	98,519.75	38,071.58		(11.55)
1925	116,670.92	45,784.74		(3,717.46)
1926	150,210.98	67,352.02		2,353.48
1927	193,919.85	80,776.74		11,942.68
1928	187,334.12	82,838.83		10,481.21
1929	234,429.16	103,186.31		16,949.59
1930	222,571.17	99,711.11	\$ 309.94	6,449.48
1931	250,053.44	104,608.18	549.14	24,124.09
1932	151,498.81	57,227.60	799.04	(11,452.48)
1933	131,887.39	53,543.26	823.28	(1,784.27)
1934	124,500.16	52,964.10	539.82	1,585.46
1935	157,175.15	65,905.73	608.67	3,936.51
1936	215,419.85	92,675.78	295.00	9,031.72
1937	338,041.67	110,874.15	408.49	13,974.25
1938	299,513.51	131,052.13	1,885.56	21,972.87
1939	366,481.93	172,611.68	2,188.06	61,531.96
1940	447,453.04	234,653.23	981.64	59,512.30
1941	659,966.63	424,859.52	726.34	115,818.58
1942	768,226.32	451,104.03	694.31	90,986.40
1943	927,397.67	554,047.92	1,381.07	193,253.95
1944	1,031,038.63	676,781.53	879.01	⁴ 96,297.23
1945	758,834.98	416,139.83	2,352.38	22,438.78
1946	1,057,766.44	476,682.78	8,189.38	15,939.17
1947	1,057,532.16	597,853.28	4,515.53	73,957.94
1948	776,655.82	437,222.56	3,345.67	(70,911.82)
1949	804,438.27	510,781.91	783.18	72,957.80
1950	1,044,356.53	669,489.50	1,769.54	142,969.99

1951 1,214,875.09 655,126.89 ² 30,488.61 100,430.89

Before the invasion of Holland in May 1940, when Frutal did not manufacture the goods it sold but purchased them from N. V. in Holland, it paid N. V. therefor only the actual cost thereof, i. e., the cost of materials plus manufacturing cost.

During the calendar years from 1921 to 1951, inclusive, Frutal paid dividends on its issued and outstanding common capital stock as follows:

Year	Amount	Type dividend
1931	\$ 10,000	Stock.
1932	20,000	Cash.
1937	10,000	Cash.
1939	18,000	Stock.

The net sales, gross profit from sales, other income, and net income, both before and after salaries to the partners, of Export, per its books for the fiscal years ended January 31, 1946, to 1949, inclusive, follow:

PAGE 969

--

PAGE 970

	Years ended January 31			
	1946	1947	1948	1949
Net sales	\$ 423,231.79	\$ 727,114.76	\$ 360,210.00	
Gross profit from sales (net sales less cost of goods sold) ¹	250,503.51	373,561.79	196,986.76	
Other income			26.63	\$ 4,135.89
Net income:				
Before salaries to partners	194,479.72	263,725.44	134,496.25	3,011.26
After salaries to partners	150,792.27	218,725.44	111,996.25	3,011.26

The net sales, gross profits from sales, other income, and net income, before income and excess profits taxes of Export, Inc., for the fiscal years ended January 31, 1948 to 1952, inclusive, follow:

Year ended January 31	Net sales	Gross profit from sales ¹	Other income	Net income
1948	\$ 436,466.01	\$ 250,438.84		\$ 126,352.59
1949	438,035.22	229,247.83	\$ 185.20	92,183.46
1950	313,954.58	125,070.10		40,664.55
1951	443,076.05	221,916.30	2,393.66	122,039.68
1952	548,837.54	250,673.83		123,527.36

The gross profit percentages realized by Export and Export, Inc., per their respective books, but collected on a calendar year basis, are as follows:

Year	Gross profit percentage
1945	58.57
1946	51.58
1947	56.01
1948	53.15

The practice with respect to the compensation paid to members of the Polak families and other executives, commencing with N. V. and continuing with Frutal and Export, Inc., was to pay a fixed low salary and a bonus at the end of each year according to the services rendered. This policy was carried out for all years, and was employed for the purpose of encouraging the executives to exert their best efforts. The compensation paid to members of the Polak families and other executives by Frutal and Export, Inc., respectively, was a matter of continuous consideration by Jacob and the other members of their respective boards of directors; and was authorized by formal action of such boards of directors. N. V. paid compensation, consisting of fixed salary and bonus (based on profits), for the services to it in 1939 of Jacob, Bernard, and Frits aggregating, in guilders, the amounts of 85,000, 9,800, and 18,000, respectively; the exchange rate at that time was approximately 1.8 to the dollar. Frutal

paid total compensation for services to it in 1939 of Jacob and Bernard in the amounts of 12,000 and 1,400, respectively.

PAGE 970

--

PAGE 971

Frutal paid total compensation for services rendered to it in the calendar years 1940 to 1951, to individuals, as follows:

Calendar year	Total compensation paid by Frutal to					
	Jacob	Frits J.	Bernard	Alexander	Ernest H.	Emilie
	Polak	Polak	Polak	H. Micheels	Polak	Parser
1940	\$ 24,200.00	\$ 5,600.00	\$ 8,100	\$ 3,550	\$ 380.81	
1941	35,500.00	12,800.00	12,050	12,050	947.00	\$ 2,083.30
1942	35,500.00	12,800.00	12,800	12,800	600.00	5,000.00
1943	35,500.00	12,800.00	12,800	12,800		5,000.00
1944	39,166.66	12,800.00	13,800	13,800		5,000.00
1945	34,312.35	12,800.00	19,800	19,800	5,875.00	5,000.00
1946	40,999.80	18,987.50	19,800	19,800	11,000.00	5,000.00
1947	26,750.00	6,300.00	19,800	19,800	11,000.00	5,000.00
1948	15,000.00	6,300.00	12,319	20,800	6,650.00	5,000.00
1949	7,500.00	6,300.00	6,300	6,300	6,000.00	
1950	26,200.00	6,300.00	12,500	20,800	12,400.00	
1951	26,200.00	6,300.00	12,500	20,800	12,400.00	

In determining the deficiencies herein against Frutal for the calendar years 1945 to 1948, inclusive, the respondent allowed as deductions for the compensation which it paid for the services rendered to it in those years by Jacob, Frits, Bernard, Micheels, Ernest, and Emilie Polak Parser, respectively, the following amounts:

Compensation allowed by respondent

Executive	1945	1946	1947	1948
Jacob Polak	\$ 20,000	\$ 20,000	\$ 20,000	\$ 10,000
Frits J. Polak	12,800	3,700	0	0
Bernard Polak	4,700	3,800	8,000	8,000
Alexander H. Micheels	4,700	3,800	8,000	7,000
Ernest H. Polak	5,875	6,000	6,000	3,650
Emilie Polak Parser	0	0	0	0
Total	\$ 48,075	\$ 37,300	\$ 42,000	\$ 28,650

Export filed Federal partnership returns of income for its fiscal years ended January 31, 1945 to 1948, inclusive, and Export, Inc., filed Federal income tax returns for its fiscal years ended January 31, 1948 and 1949, wherein the former reported as its net income before salaries and the latter reported as its net income before Federal income taxes, the amounts shown in the table below:

Net income

Year ended January 31	Export, Inc.	Export
1946		\$ 194,479.72
1947		264,475.44
1948	\$ 126,352.59	134,496.25
1949	92,183.46	
Total	\$ 218,536.05	\$ 593,451.41

PAGE 971

--

PAGE 972

In determining the deficiencies herein against Frutal for the calendar years 1945 to 1948, inclusive, the respondent allocated to Frutal the entire net incomes of Export and Export, Inc., respectively, shown above, with some adjustments and converted by him on the basis of calendar years, as follows:

Calendar year	Income	Total added	to income of
	Export	Export, Inc.	Frutal
1945	\$ 162,812.59		\$ 162,812.59
1946	254,674.32		254,674.32
1947	176,778.63	\$ 132,527.60	309,306.23
1948		103,864.93	103,864.93
Total	\$ 594,265.54	\$ 236,392.53	\$ 830,658.07

Based upon the foregoing and all of the evidence of record, we make the following ultimate findings of fact:

Frutal Export Company and its successor, Frutal Export Company, Inc., were business enterprises during the taxable years separate and distinct from the business conducted by Polak's Frutal Works, Inc.

The organization of the export entities was for legitimate and bona fide business purposes and not for avoidance or evasion of income or excess profits taxes.

No part of the respective incomes of the export entities constituted income to Polak's Frutal Works, Inc., or is allocable thereto.

Compensation paid by Polak's Frutal Works, Inc., to Jacob Polak, Frits Polak, Bernard Polak, Ernest Polak, and Alexander Micheels, respectively, for services rendered in each of the taxable years was reasonable and not excessive. The compensation paid Emilie Polak Parser by Polak's Frutal Works, Inc., in each of the taxable years, was unreasonable and excessive.

OPINION

The first question for decision is whether respondent is correct in his determination that the incomes respectively reported by Export and its successor, Export, Inc., in the years involved are attributable to Frutal.

Respondent first takes the position that the two entities should be entirely disregarded for tax purposes and that the incomes reported by each, after proper adjustment to the calendar year basis, should be included within Frutal's taxable income under the broad provisions of

section 22 (a), Internal Revenue Code. In the alternative, respondent argues that should the entities be recognized for tax purposes, then and in that event, certain portions of the incomes of each, as

PAGE 972

--

PAGE 973

computed by him, are properly to be allocated to Frutal pursuant to section 45 of the Code.

As for respondent's first contention, our finding above that the two export organizations were separate entities from Frutal for tax purposes is dispositive thereof. No extended discussion of the matter is deemed necessary. Suffice it to say that the export business which had shortly before been transferred from N. V. to Frutal was removed from the latter to be carried on as a separate enterprise by Export and later Export, Inc., for what appeared to Frutal's directors at that time to be sound and sufficient business reasons.

Among such reasons was an ardent desire to free the export business as much as possible from the restrictive wartime control which was then being exercised by the Dutch Government over N. V. and Frutal. Under the organizational setup that then existed, all dividends declared by Frutal would be paid to N. V., thereupon be frozen by the Dutch Government, thereby denying the members of the Polak families any return on their investment. There was also constant concern over the security of such investment from possible confiscation. Furthermore, at the time of the separation of the export and domestic sales, there existed the firm intention to take the export business back to Holland and again operate it from there when that became possible. Finally, but not the least important reason was the desire to give the younger members of the two families an interest and stake in the business to forestall a threatened break and establishment thereby of a separate and competing business.

Whether or not the Dutch Government was in any position to enforce fully the control which it claimed to hold over Frutal as against a concerted and determined opposition of the parties involved is beside the point. The fact is that such parties felt that the business was subject to such control. With this thought in mind they took the step which they also thought, whether

rightly or wrongly, would free them, at least to some extent, therefrom. That such step was not influenced by any objectionable tax evasion scheme or any improper purpose is clearly established in the evidence. Moreover, the motive of tax avoidance for entering into a transaction or adopting a particular form of business has never been held to be sufficient, in and of itself, as a basis for liability unless the transaction first establishes such liability without it. *John Junker Spencer*, 19 T. C. 727; see *Chisholm v. Commissioner*, 79 F. 2d 14, in which Judge Learned Hand put at rest many of the bugaboos which the respondent sees emanating from the present transaction. Thus, a taxpayer is free to choose the type of organization or form in which he will cast his business activities to achieve a desired business or tax result. *John Junker Spencer, supra; Higgins v. Smith*, 308 U.S. 473. He is not required to adopt or continue with

PAGE 973

--

PAGE 974

that form of organization which results in the maximum tax upon business income. *Meldrum & Fewsmith, Inc.*, 20 T. C. 790. *Moline Properties, Inc. v. Commissioner*, 319 U.S. 436. Furthermore, if a taxpayer actually carries on business in the form chosen, the tax collector may not deprive him of the incidental tax benefits flowing therefrom, unless it first be found to be but a fiction or a sham. *John Junker Spencer, supra; Higgins v. Smith, supra; Rhode Island Hospital Trust Co.*, 7 T. C. 211. We do not and could not make such finding on the present record. Our view of the evidence at hand leaves us with no doubt as to the bona fides of Export, the partnership, or of Export, Inc., as taxable entities separate from their common progenitor, Frutal. Compare *Chelsea Products, Inc.*, 16 T. C. 840 with *Friedlander Corporation*, 19 T. C. 1197. In the former case, the taxpayer, a manufacturer of fans and blowers, which, for several years had sold its products through its own officers and agents, organized three sales companies to sell its products in three separate geographical areas. The stockholders of these sales companies were essentially the same as the stockholders of the taxpayer. Thereafter the sales companies acted as sales agents for petitioner and the income thereof was derived from sales of products manufactured by the taxpayer. That the formation of the sales companies was motivated by good business reasons and that they were not mere shams for the sake of gaining a tax advantage was borne out by the evidence adduced therein.

In the *Friedlander* case, *supra*, the petitioner therein, prior to taxable years involved, had operated a general merchandise business in a number of towns in Georgia and Alabama. In 1943, petitioner's president and vice president, along with their respective wives, formed a partnership with the 3 sons of the former, who were at that time serving in the armed services, for the purpose of acquiring and operating 6 of the 9 stores being conducted by petitioner. Reasons given for the formation of the partnership were to give the sons a business which they could manage and control upon their return from military service, to put to use and develop the ideas and business capabilities of the sons, and to provide a satisfactory means of settling an unhealthy dispute between the sons and petitioner's vice president with regard to internal policy. The alleged purposes, however, were not supported by the facts of record. To the contrary, the evidence showed and we found as a fact that the partnership was a sham created for the sole purpose of siphoning off the profits of petitioner with resulting tax benefits being the ultimate goal. Here the evidence shows the reasons for the organization of the export entities to have been legitimate and bona fide business purposes.

Each case must be decided on its own facts. The facts and principles in the instant case are more nearly analogous to those in the

PAGE 974

--

PAGE 975

Chelsea case, *supra*, and on the authority thereof we hold that the respective incomes of Export and Export, Inc., may not be attributed to Frutal for any of the years involved. Respondent's determination to the contrary is, therefore, reversed. Cf. also *Grenada Industries, Inc.*, 17 T. C. 231, *affd.* 202 F. 2d 873.

Section 45 of the Code, on which respondent's alternative argument is based, provides, as follows:

SEC. 45. ALLOCATION OF INCOME AND DEDUCTIONS.

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 Commissioner is authorized to 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.

On the present record it is manifest that the export entities and Frutal were "* * * owned or controlled directly or indirectly by the same interests * * *" within the meaning of the statute invoked. See *Grenada Industries, Inc., supra*, wherein it was said, *inter alia*:

The existence of the requisite common ownership or control is not sufficient, however, to justify the application of section 45. The Commissioner may make a distribution, apportionment or allocation under section 45 only "if he determines [that it] is necessary in order to prevent evasion of taxes or clearly to reflect the income of such [owned or controlled] organizations, trades, or businesses." The purpose of section 45 is not to punish the mere existence of common control or ownership, but to assist in preventing distortion of income and evasion of taxes through the exercise of that control or ownership. It is where there is a shifting or deflection of income from one controlled unit to another that the Commissioner is authorized under section 45 to act to right the balance and to keep tax collections unimpaired. *Asiatic Petroleum Co. v. Commissioner* (C. A. 2), 79 F. 2d 234, 236, certiorari denied 296 U.S. 645; Treas. Regs. 111, sec. 29.45-1; cf. *Gordon Can Co.*, 29 B. T. A. 272.

In determining whether, in the instant case, income really earned by Frutal was shifted or diverted to the Export entities, one helpful guide is whether the charges made by Frutal thereto for its services were unreasonably low and hence disproportionate to the value thereof. *Grenada Industries, Inc., supra*.

It is respondent's position that the prices actually charged by Frutal were unreasonably low and that in adjusting these prices to reasonable ones, he has arrived at the figures, here advocated by him, which result in restoration of gross profits enjoyed by Frutal prior to the formation of Export. Frutal, on the other hand, maintains that its charges to Export and later

Export, Inc., were fair and reasonable. Both parties indulge in a manipulation of various figures

PAGE 975

--

PAGE 976

to support their respective views, and to show the absurdity of those advanced by the opposite party. The evidence before us supports the view held by Frutal. All probative evidence of record is to the effect that Frutal received from the export entities what would be considered in the trade of which it was a part as fair and reasonable prices for its services. Respondent offers no countervailing evidence. Nor does he say what, in his opinion, would constitute such fair and reasonable price. Rather, he would arbitrarily allocate each year whatever percentage of income of the export entity involved is sufficient to bring Frutal's earnings to approximately the level they held in the years prior to the organization of Export.

As was said in *Seminole Flavor Co.*, 4 T. C. 1215, 1235: "Actually, the principal force behind all of the Commissioner's argument is that the petitioner could as well have done all the things that the partnership did and reaped all of the earnings of the related enterprises. Since petitioner could have had the earnings, the Commissioner would make it so by exercising the authority conferred by section 45 * * *" Such argument we there rejected. See also *Miles-Conley Co.*, 10 T. C. 754. Moreover, a similar argument was disposed of in *Koppers Co.*, 2 T. C. 152, with the following language, which is also apposite here after due allowance is made for factual differences:

The answer, however, to this argument is that petitioner did not do this. It was free to and did use its funds for its own purposes. It was under no obligation to so arrange its affairs and those of its subsidiary as to result in a maximum tax burden. On the other hand, it had a clear right by such a real transaction to reduce that burden. *Helvering v. Gregory*, 293 U.S. 465; *Chisholm v. Commissioner*, 79 Fed. (2d) 14; *Commissioner v. Gilmore Estate*, 130 Fed. (2d) 791; *Coca-Cola Co. v. United States*, 47 Fed. Supp. 109; *Commissioner v. Kolb*, 100 Fed. (2d) 920.

On the record made, we hold that section 45 is inapplicable in the instant situation. Respondent's proposed allocation thereunder is, accordingly, set aside.

Inasmuch as our disposition of the foregoing issue is based on the weight of evidence adduced in this record, the question raised by both parties as to the burden of proof becomes academic and requires no comment.

The next item is the question of salaries. That is to say, whether respondent is correct in his disallowance, as excessive, of part or all of the amounts claimed by Frutal to have been paid to the various parties involved. It is Frutal's position that the salaries in question were not excessive. It has introduced evidence specifically bearing upon the reasonableness of the compensation paid to Jacob, Frits, Bernard, Ernest, and Micheels during the years involved. Respondent has failed to go forward with any evidence in refutation. Consequently, since no reason appears to discount the testimony, we have

PAGE 976

--

no alternative to holding for Frutal on this point. The record, however, is completely devoid of any evidence touching upon the payments made to Emilie during the taxable years. Respondent's determination with regard thereto is sustained.

The original pleadings contain a fourth issue -- whether or not the distributions made by the Export entities during the years involved are includible in the gross incomes of Jacob, Eliseba, and Emilie as constituting constructive dividends received from Frutal and N. V. However, the premise upon which such question was based has been effectively resolved by our holdings herein with regard to the Export entities, and there remains no need for any further consideration thereof.

Decisions will be entered under Rule 50.

¹ Proceedings of the following petitioners are consolidated herewith: Polak's Frutal Works, Inc., Docket No. 46219; Jacob Polak, Docket No. 46220; Jacob Polak and Eliseba Polak, Husband and Wife, Docket No. 46221; and Emilie Polak Parser, Docket No. 46222. ¹ For the period June 1 to December 31, 1921. ² This item includes capital gain of 26,232.47.

³ Before Federal income and excess profits taxes. The figures in parentheses represent losses.

⁴ After the deduction of 159,653.86 for commissions to N. V. on Frutal's export sales for the years 1940 to 1944, inclusive.

¹ Substantially all of the cost of goods sold consisted of the cost of goods purchased from Frutal. ¹ Net sales less the cost of goods purchased from Frutal.

Enjoyed this document?

See more from **Tax Notes Research**

[EXPLORE MORE](#)