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# DISREGARD OF CORPORATE ENTITY FOR THE TAXPAYER'S BENEFIT: A CASE STUDY

David L. Samuels\*

At least since the days of *Gregory v. Helvering*<sup>1</sup> it has been well established that the Commissioner of Internal Revenue may "disregard the corporate entity" whenever it appears that on the basis of "form v. substance" this is necessary to effectuate the policies of the Internal Revenue Code. This is commonly considered a one-way street, favoring only the Commissioner and never favoring the taxpayer. The reasoning is that the taxpayer is free to choose the form in which he does business, and that having elected the corporate form, he cannot complain at having to bear the burden resulting from the election.<sup>2</sup> However, there are cases which controvert this assumption that the corporate entity will be disregarded only for the benefit of the Commissioner. The purpose of this article is to study some of these cases in an attempt to ascertain the attitudes of the courts and to determine the situations where the taxpayer may disregard the corporate entity for his own benefit.<sup>3</sup>

## SHAM CORPORATIONS—NO BUSINESS PURPOSE OR ACTIVITY

In *Moline Properties Inc. v. Commissioner*<sup>4</sup> a corporation sought to have its capital gains taxed to its sole shareholder and its corporate existence ignored for income tax purposes. Although this position was sustained by the Board of Tax Appeals,<sup>5</sup> the decision was reversed by the Court of Appeals for the Fifth Circuit.<sup>6</sup> The Circuit Court stated that since the taxpayer had "chosen the corporate form to conduct these affairs," both the shareholder and the corporation "must accept the tax disadvantages of the plan." The

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<sup>1</sup> 293 U.S. 465 (1935).

<sup>2</sup> *United States v. Morris & Essex R.R. Co.*, 135 F.2d 711 (2d Cir. 1943), *cert. denied*, 320 U.S. 754 (1943); *Moline Properties Inc. v. Commissioner*, 319 U.S. 436 (1943); *Skarda v. Commissioner*, 250 F.2d 429 (10th Cir. 1957).

<sup>3</sup> District Court decisions have been disregarded.

<sup>4</sup> 319 U.S. 436 (1943).

<sup>5</sup> 45 B.T.A. 647 (1941).

<sup>6</sup> 131 F.2d 388 (5th Cir. 1942).

decision of the Circuit Court was affirmed by the United States Supreme Court.<sup>7</sup>

Had the Supreme Court gone no further, it is unlikely that there would have been any problem, and there would have been no reason for this paper. In fact, however, the opinion of the Supreme Court took most of the effectiveness out of the wording quoted because the Court relied heavily on the business activities of the corporation to justify its conclusion that the corporation's separateness as a tax entity could not be disregarded. In this connection it stated:

The doctrine of corporate entity fills a useful purpose in business life. Whether the purpose be to gain an advantage under the law of the state of incorporation or to avoid or to comply with the demands of creditors or to serve the creator's personal or undisclosed convenience, so long as that purpose is the equivalent of business activity or is followed by the carrying on of business by the corporation, the corporation remains a separate taxable entity.<sup>8</sup>

As will be noted below, subsequent cases have affirmed the position that the corporate entity will be disregarded if the corporation is not formed for a "business" purpose, engages in no business activity and is merely a sham created for the convenience of its shareholders. However, there do not appear to be very clear rules as to when this theory will be invoked. Since several of the decisions seem to be inconsistent, decisions subsequent to the *Moline* case will be reviewed and an attempt made to analyze them. Only decisions in which it was the taxpayer who sought to have the corporate entity disregarded will be considered.

### *Taxpayer Successful*

In *Paymer v. Commissioner*<sup>9</sup> some quite clear lines were drawn. Two brothers had been operating as partners. In an attempt to conceal assets from the creditors of one of them, they formed two corporations and conveyed a separate parcel of real estate to each. The minutes of the organizational meeting of each corporation stated that conveyances to it were made only so that the corporation could hold title, beneficial interest being reserved to the two partner-shareholders, since the corporation had been formed for their convenience. No meetings other than the organizational meeting were held, and no officers or directors were elected subsequent to that meeting. Since they did not bother to assign to the corporations the outstanding leases in favor of tenants, the tenants of each of the

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<sup>7</sup> Note the prior inconsistent decisions of Circuit. 319 U.S. 436 (1943). Courts of Appeal are cited in footnote 1 to the Supreme Court decision. See footnote 21 *infra*.

<sup>8</sup> *Id.* at 438-9.

<sup>9</sup> 150 F.2d 334 (2d Cir. 1945).

buildings continued to treat the individuals as the owners of the property. The two individuals managed the real estate parcels, collected money, paid bills and divided the net profits between them.

The only distinction between the operations of the two corporations involved a bank loan to one of them. In connection with that loan, papers were signed, representing to the lending bank that the corporation owned the leases involved, and the leases were assigned to the bank as collateral. The other corporation had no such borrowing activity. This distinction, held the Court of Appeals for the Second Circuit, warranted ignoring the corporate existence where no business activity was involved, but insisting upon recognition of the corporation which had borrowed funds and entered into the related activities, as a separate taxpayer.

The distinction made in the *Paymer* case was recognized a few years later by the Tax Court in another case involving the same brothers who were the litigants in *Paymer*. In *Raymer Realty Corp. Inc.*,<sup>10</sup> although it appeared that different corporations were involved, the facts were substantially the same, and only one of several corporations engaged in loan activities. Again, this was held sufficient to require treatment of it as a separate taxpayer, although the corporate entities were disregarded as to the other corporations.

Subsequent Tax Court decisions in which the taxpayers have been successful seem to have liberalized the interpretations of these two cases. Thus, in *John A. Mulligan*,<sup>11</sup> the court refused to tax a corporation on a gain from a sale of real estate where the real estate was held purely for the convenience of those interested in a probate estate and where the corporation's income and expenses were paid directly by the estate. At the death of the sole shareholder, the petitioner, who was appointed the administrator of the estate, took over the corporate stock. By direction of the Surrogate and petitioner's attorney, the property remained in the name of the corporation since the leases were up for renewal, and the officials of the Surrogate's Court did not want to upset any related plans. Petitioner was elected president and treasurer of the corporation, other directors were also elected, and several meetings were held. During the years in question, rent was collected from the properties and was deposited by the petitioner in the estate's bank account, which was the only account maintained in connection with the property. Checks payable to the corporation were endorsed by the petitioner and deposited in that account. Funds to meet expenses incurred in managing the property were withdrawn by the petitioner from the estate funds

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<sup>10</sup> 7 CCH Tax Ct. Mem. 262 (1948).

<sup>11</sup> 16 T.C. 1489 (1951).

held in the same bank account. In fact, all obligations, including mortgage payments, were so withdrawn on the signature of the petitioner as administrator, countersigned by the bonding company for the petitioner, and all concerned dealt with the estate as owner of the property. In September, of 1945, all the properties were sold and the proceeds deposited in the estate's bank account. Thereafter the corporation did not hold title to any assets nor did it do any business.

A tax return was filed by the corporation for the year 1945. Against the receipts there were claimed as deductions certain expenses, including the administrator's commissions as such, amortization payments of the mortgage, and a deduction of over \$47,000 described as "to estate of Thomas Mulligan, deceased—for stock." The latter deduction offset the inclusion in receipts of the net gain from sale of the properties.

The court stated that the facts brought the case within the group of decisions "where the holding of bare legal title to real property is found to be an insufficient ground for taxing income to a corporation having no other function."<sup>12</sup> This is of particular interest in connection with language used in certain other decisions, discussed hereafter, where the courts have refused to disregard the corporate existence because business had been transacted, and which indicated that after this had once taken place, the corporate existence could no longer be disregarded.

In *Henry T. Roberts*<sup>13</sup> the taxpayer was also successful in having the corporate veil pierced in connection with operations of a farm. The corporation was formed for the sole purpose of taking title to the farm, and after this had been accomplished the taxpayer continued to conduct the farming operations as an individual until several years later when the corporation was eventually dissolved and the property sold. The court distinguished between the corporation, on the one hand, and the individual taxpayer, on the other, as being distinct entities, and held that the losses resulting from the farm operations were properly deductible by the individual as the operator of the farm (with the rental value of the corporate-owned farmhouse living quarters being taxable to the individual as income in the absence of any agreement between the individual and the corporation). However, the individual was not allowed deductions for taxes, license fees, and interest payments on farm mortgages, in the absence of a showing that he had agreed or was otherwise obligated to make such payments—even though in fact he did make those

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<sup>12</sup> *Id.* at 1492.

<sup>13</sup> 7 CCH Tax Ct. Mem. 599 (1948).

payments. In other words, the court did not disregard the corporate existence entirely, but did follow the doctrine of the above cases by holding that the income of the farming operation should be taxable to the individual even though the property was owned by the corporation. However, the significant aspect of this case is that the court kept the two entities separated for the purpose of distinguishing between the obligations of the property owner (the corporation) and the obligations of the operator of the business (the individual).

In *Thomas G. Wilwerth*,<sup>14</sup> on the contrary, the Tax Court permitted the taxpayer to deduct various expenses arising out of the operations of certain real property, although title to the realty was held in the name of this wholly-owned corporation. Since the corporation engaged in no business activities, it was held to be a sham and was completely disregarded. Taxpayer had entered into an agreement with another individual to have the latter operate the property. In order to make certain that taxpayer would have no personal liability for the operations, the corporation was formed to take title. In 1947 he demolished the improvements in the course of renovating the building, and claimed deductions for the depreciated cost of the improvements destroyed, for expenses of demolition, and for depreciation of the buildings prior to demolition. Corporate tax returns were filed for subsequent years, which are not involved here. The court held that the taxpayer came within the rule of the *Paymer* case, and that there had not been sufficient business activity to require treating the corporation as a taxpayer. It emphasized that after the initial step of acquiring legal title, no other activity had been engaged in by the corporation, which had no bank accounts and had filed no corporate tax returns. During the years in question the taxpayer had reported the income and expenses on his individual income tax return in the same manner as certain other real estate holdings. The court noted that in a prior ruling it had recognized the expenditures for improvements as individual expenditures and not corporate ones.

Similarly, in *Joseph Czvizler*,<sup>15</sup> the Tax Court refused to distinguish between the activities of the individual and those of the corporation. The tangible assets of a restaurant were owned by the individual, who operated the business in his own name. Accordingly, the Tax Court held that the income and losses from the restaurant business were attributable to him, although the lease under which he occupied the premises, and a liquor license, were held for convenience by the corporation. At the time of taking over the restau-

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<sup>14</sup> 14 CCH Tax Ct. Mem. 987 (1955).

<sup>15</sup> 12 CCH Tax Ct. Mem. 386 (1953).

rant the taxpayer had intended to operate it as a sole proprietor, but found that the owner of the property on which the business was operated was unwilling to consent to an assignment of the lease by a corporation which was the tenant and which held the liquor license. It, therefore, was necessary for the taxpayer to buy the stock of this corporation in order to acquire the lease and the license. The record showed minutes of directors meetings recording transfer of the stock, electing the taxpayer and his representative as officers and directors, naming the taxpayer as operating manager of the bar, and fixing taxpayer's compensation at an amount which represented virtually all of the anticipated profits. However, the corporation did not otherwise carry on any active business and did not receive any income or incur any expenses.

In *Jackson v. Commissioner*<sup>16</sup> the Court of Appeals for the Second Circuit affirmed a Tax Court decision to disregard the corporate entity. In an involved transaction, a "dummy" corporation was used to transfer wife-taxpayer's interest in assets to her separate control in order to protect her against creditors of husband-taxpayer.<sup>17</sup> The court held the case resembled the *Paymer* case more closely than *National Investors Corp. v. Hoey*,<sup>18</sup> where the taxpayer was successful. It quoted from the decision of the Supreme Court in *Moline*, indicating that business activity or intention to carry on business activity is decisive. It then determined that no such intention or activity existed in the case before the court.

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<sup>16</sup> 233 F.2d 289 (2d Cir. 1956).

<sup>17</sup> Husband and wife taxpayers together owned one-third of stock of Empire Industries Inc., each of two other shareholders owning one-third. Empire owned several subsidiaries acquired through loans personally guaranteed by husband-taxpayer. Friction arose from his attempts to reduce the amount of this contingent liability. Thereafter corporation Lewis of Delaware was formed to acquire one-third of the assets of Empire, and to be operated by the Jacksons (the taxpayer). They proceeded to exchange their one-third interest for all of the Lewis stock by a series of transactions involving two corporations, Dumelle and Belgrade, which they wholly owned and controlled. The decision indicates that they first created Dumelle and then transferred their one-third interest in Empire to Dumelle for all of Dumelle's capital stock. Thereafter Belgrade, a pre-existing corporation wholly owned by wife-taxpayer and which had never conducted any business, purchased the Empire stock from Dumelle in exchange for \$1,000 cash and \$469,000 in interest bearing notes. Finally Belgrade received all of the stock of Lewis in exchange for the one-third interest in Empire previously held by Lewis. The activities of the two corporations, Belgrade and Dumelle, apparently were limited, Dumelle merely receiving Empire stock from the taxpayers and selling it to Belgrade, while Belgrade's activities were to purchase the Empire stock from Dumelle and exchange it for the Lewis stock with Empire, and hold the Lewis stock. The taxpayer's purpose in creating Dumelle and Belgrade was to insure that wife-taxpayer, as owner of all of the stock of Belgrade, would have as her sole and separate property, free of any claim of husband-taxpayer's creditors, any future increment in the value of the stock of the Lewis company. The court found that although Belgrade was intended to and did become owner of the Lewis stock, it did not exercise any functions with respect to management.

<sup>18</sup> 144 F.2d 466 (2d Cir. 1944).

There is a variation on the theme in *Paul C. F. Vietzke*.<sup>19</sup> Taxpayer had been fraudulently induced to buy shares in a newly formed insurance company. The Tax Court, in allowing the loss as one resulting from "theft," pierced the corporate veil, stating that "The corporate entity . . . [was] . . . a device to route the subscriber's money into the [promoter's] pocket." The net result, of course, was to convert what would otherwise have been a worthless security capital loss into a deductible theft loss.

In *United States v. Lanterman*,<sup>20</sup> the Supreme Court of Michigan rendered a decision supporting the contention of the taxpayer that the corporate entity should be disregarded. The U.S. Attorney General's office had contended that income was taxable to the corporation. A decedent had owned several parcels of real estate in the vicinity of Detroit, and all of the heirs resided outside of the State of Michigan. For convenience in securing signatures whenever leases, deeds, mortgages, and other documents were to be executed, the heirs formed a corporation and transferred their respective interests in the real estate to that corporation. Their intent was to sell the properties as soon as market conditions were favorable. Meanwhile, leases were entered into by the corporation.

All stock was issued to an individual who had been the decedent's attorney, and who continued to act for the estate and the heirs, as well as for the corporation. Otherwise, however, he had no interest in the estate or the corporation. Since a management firm was employed by the corporation for the purpose of handling the real property, nothing was ever done by the corporation in this respect. Decisions were made by the heirs, rather than the board of directors, and the heirs received, from time to time, not only their respective shares of income, but all proceeds of any sales of property. No income was reinvested.

The Michigan court held that the corporate entity would be disregarded on the grounds that the corporation was the alter ego of the heirs and acted solely as their agent, distinguishing *Moline* in that there the corporation was not the alter ego of the sole owner. Nevertheless, it is interesting to note that there was a business purpose for the formation of the corporation here, namely, the business convenience of the heirs. In addition, all property was leased in the name of the corporation, which received the rentals before turning them over to the heirs, and which executed deeds in the name of the corporation.

The above cases appear to have reaffirmed the doctrine adopted

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<sup>19</sup> 37 T.C. 504 (1961).

<sup>20</sup> 321 Mich. 708, 33 N.W.2d 126 (1948).



by certain other cases before the *Moline* decision. As noted in the opinion of the Supreme Court in the *Moline* case, certiorari was granted because of conflicting decisions in appellate courts of various circuits. The various Circuit Courts of Appeal and also the Tax Court had previously disregarded the corporate entity for the benefit of shareholders.<sup>21</sup>

This summary of cases in which the taxpayer has been successful is sufficient to illustrate that the decisions are not entirely consistent. As will be seen, those cases in which the taxpayer was unsuccessful probably add to the confusion. However, none of the decisions favoring the Tax Collector denies the existence of the rule that the corporate entity will be disregarded where the corporation is a mere sham, not formed for a business purpose and engaging in no business activities. The question in each instance is one of applying the doctrine to a particular set of facts. Accordingly, the facts involved and the language used by the courts in denying relief to the taxpayer-shareholders are interesting.

#### *Taxpayer Unsuccessful*

In accepting and following the rule of the *Paymer* case, the Tax Court has been quite consistent and impartial. In *Tatem Wofford*<sup>22</sup> a state court had held, in settling a civil suit between two shareholders to prevent one of them from taking advantage of the other, that the corporation in question was merely a trustee for the benefit of co-owners. The Tax Court quite properly distinguished between the effect of this decision on the civil rights of the individuals involved, on the one hand, and the income tax implications, on the other hand. The corporation had operated the business long before trouble arose between the litigants and was therefore not to be disregarded for tax purposes.

In *Abraham J. Halprin*,<sup>23</sup> the taxpayer had formed a corporation to take title to real estate obtained on foreclosure, in order to protect him from personal liability in connection with the financing of the real estate. Although no corporate stock certificates were is-

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<sup>21</sup> See, e.g., 112 West 59th Street Corp. v. Helvering, 68 F.2d 397 (1933); United States v. Brager Building & Land Corp., 124 F.2d 349 (4th Cir. 1941); North Jersey Title Ins. Co. v. Commissioner, 84 F.2d 898; Inland Development Co. v. Commissioner, 120 F.2d 986 (3d Cir. 1936); Carling Holding Co. v. Commissioner, 41 B.T.A. 493 (1940); Mayer v. Commissioner, 36 B.T.A. 117 (1957); Abrams Sons' Realty Corp. v. Commissioner, 40 B.T.A. 653 (1939); Thrift Realty Co. v. Commissioner, 29 B.T.A. 545 (1933); Moro Realty Holding Corp. v. Commissioner, 25 B.T.A. 1135 (1932), *aff'd*, 65 F.2d 1013 (2d Cir. 1933); Forshav v. Commissioner, 20 B.T.A. 537 (1930).

<sup>22</sup> 5 T.C. 1152 (1945).

<sup>23</sup> 4 CCH Tax Ct. Mem. 789 (1945), *aff'd*, 154 F.2d 112 (2d Cir. 1946).

sued, and the corporation had no office, employees, or assets other than the title to the realty in question, the corporation had been formed for the business purpose of protecting taxpayer against personal liability, rentals were made in the name of the corporation, and appropriate payments were made by the corporation. In light of these facts the decision of the Tax Court, issued only a few weeks after the decision of the Circuit Court of Appeals in the *Paymer* case, to insist upon treating operating losses as those of the corporation seems quite consistent.

In *Loula Mae Harrison*<sup>24</sup> a dormant corporation had been acquired by the taxpayer in order to increase borrowing capacity through involved arrangements. Because of this clear business purpose, the Tax Court insisted upon gains being taxed to the corporation rather than the shareholder.

The reasoning of the Tax Court seems less clear in the case of *L. B. Whitfield*.<sup>25</sup> There some of Mr. Whitfield's real estate was located in Florida, and in order to avoid the need for ancillary probate proceedings at Mr. Whitfield's death, his attorneys had him form a Florida corporation, which took title to the realty. Pursuant to an arrangement with creditors, the rents received were turned over to another corporation controlled by Whitfield, just as he had similarly turned over rent monies to the same payee prior to the formation of the Florida corporation. Although new leases were negotiated by the Florida corporation and it subsequently sold some of the real estate at Whitfield's direction, it had no other assets, was never listed in any directory, and had no officers or employees. Because of the negotiation of leases and sales of real estate, it was held to have carried on a business, so that it could not be disregarded as a separate taxpayer. This almost seems a return to the strict rule of the *Paymer* case, rather than the liberalized rule of the *Wilwerth* case. While the distinction may be that Mr. Wilwerth did not actually engage in business activities, his corporation seems to have been formed for a business purpose, namely, to protect him against liability in connection with turning his operations over to a new manager.

At this point some consideration shall be given to the Circuit Court of Appeals decisions in which the taxpayer has been unsuccessful when attempting to have the corporate entity disregarded. Notably most of these cases arose in the Second Circuit, possibly because the *Paymer* case was decided there, and because the taxpayer's position was also sustained by the court in the *Jackson* case.

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<sup>24</sup> 6 CCH Tax Ct. Mem. 782 (1947), *aff'd*, on a different issue, 173 F.2d 736 (5th Cir. 1949).

<sup>25</sup> 14 T.C. 776 (1950), *aff'd*, 192 F.2d 494 (5th Cir. 1951).

In any event, five of the ten cases decided by the Circuit Court of Appeals are found in the Second Circuit.

In *Sun-Herald Corp. v. Duggan*<sup>26</sup> the facts differed from those of previously considered cases in that the corporation in question had been actively engaged in business prior to the death of its controlling shareholder. His will directed that all the assets of the corporation be transferred to its tax-exempt successor. Through inadvertence certain debentures were not transferred. The litigated question was whether or not the transferor corporation should be taxed on the income of the assets retained inadvertently where, in fact, such income was turned over to the successor tax-exempt organization promptly on receipt, and where there was language in the instruments affecting the assets, indicating an intent to transfer all assets of the corporation. The court refused to disregard the existence of the transferee.

While it might be possible to treat this case as unimportant in view of the factual distinction, the temptation to quote the language of Judge Learned Hand is too great to resist:

The law of corporations allows the fabrication of such elaborately involuted jural persons as Munsey seems to have thought important in his affairs; and out of them authentic rights and duties will emerge. Although there are occasions when courts will brush them aside, and decide controversies as though only the human factors had been concerned, when there is no such occasion, the rights and duties that result must be respected and enforced like others. There was no reason which forbade the persons in charge of these transactions to treat the notes as property of the plaintiffs, and not only are we justified in taking them at their word, but we have no alternative. It is idle to ask us to look "realistically" at what they did; that is a word always indicating either an inability to discover, or unwillingness to tell, the determining factors, we study always to eschew it. It is true that these persons had it easily in their hands to exempt this money from taxation, and it is strange indeed that they did not use their power; but use it they did not; on the contrary they gave the most positive evidence that they did not mean to take those steps which alone would exempt it. We cannot now unravel the web they then wove, glad as we might be to do so.<sup>27</sup>

In *National Investor Corp. v. Hoey*<sup>28</sup> the case in question involved a parent corporation wishing to merge with several subsidiaries. The interested parties transferred the stock of the subsidiaries to another corporation which had neither assets nor liabilities. Dur-

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<sup>26</sup> 160 F.2d 475 (2d Cir. 1947).

<sup>27</sup> *Id.* at 478.

<sup>28</sup> 144 F.2d 466 (2d Cir. 1944).

ing the time that the plan of merger was being worked out and submitted to shareholders of the parent corporation, the new owner of the subsidiaries engaged in no activity except to receive and hold the stock of the subsidiaries. When the corporation's consolidation plan was rejected by the parent corporation's shareholders, the new company was liquidated. The Court of Appeals held that the corporate entity of the new company which temporarily held the stock of the subsidiaries could not be disregarded because the use of the holding company as a means of achieving consolidation and holding title to the securities "was a 'business' activity." This was the same Court of Appeals for the Second Circuit which, in the later *Jackson* case, found that there was no such business purpose or activity. There the taxpayer's purpose was to protect the interest of Mrs. Jackson (taxpayer-wife) from creditors of taxpayer-husband as to any increment in value occurring after the transfer to the corporation. Apparently, the corporation continued to hold the stock of the subsidiary after the transfer.

*Given v. Commissioner*<sup>29</sup> is of little interest. The corporation in question had owned and disposed of other properties before the period involved in litigation. Substantially all of the stock was owned by Given. He and three other individuals agreed to buy a building, title to which was taken in the name of the corporation. The corporation paid a portion of the purchase price from funds deposited in its bank account by the interested individuals. A corporate note secured the balance of the price. Some of Given's stock was then redistributed among the other interested persons. About a year later Given and another individual bought out the balance of the shareholders. Operating expenditures were made from the corporation's funds with the necessary amounts being contributed by the shareholders from time to time. All payments in relation to the building, except the purchase of the interest of shareholders, were made by corporate check, and all leases were executed in the corporation's name. Accordingly, the refusal of the court to disregard the corporate entity is easily understood.

In *Skarda v. Commissioner*<sup>30</sup> it was the Appellate Court for the Tenth Circuit which insisted upon recognizing the existence of a corporation that had actually operated a newspaper, filed necessary information returns, and maintained bank accounts, even though there had never been meetings of shareholders or directors, no by-laws had been adopted, and no shares of stock had ever been issued. The court stated:

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<sup>29</sup> 238 F.2d 579 (8th Cir. 1956).

<sup>30</sup> 250 F.2d 429 (10th Cir. 1957).

For tax purposes, where the purpose for the creation of the corporation is a business one or the creation is followed by business activity, the corporate entity will not be disregarded.<sup>81</sup>

The court also stated:

Where the purpose for creating the corporation is to gain an advantage under the law of the state of incorporation, *relieve the stockholders from personal liability for debts created by the corporation*, or serve the creator's personal convenience, so long as that purpose is the equivalent of a business activity, or is followed by the carrying on of business by the corporation, the corporation remains a separate taxable entity. Where the taxpayer, for business purpose of his own, adopts the corporate advantage to do business requires acceptance of the tax disadvantages.<sup>82</sup>

The Court of Appeals for the Ninth Circuit was confronted with the problem in *O'Neill v. Commissioner*.<sup>83</sup> There the taxpayer-shareholder contended that advances which he had made to his corporation should be treated as business losses because, in effect, the losses were incurred in the operation of his own business. The Tax Court had held that these were capital advances and had refused to disregard the corporate entity. In affirming this position the Appellate Court recognized that the corporate structure might be disregarded where the purpose of its creation was not a business purpose and was not followed by business activity, but went on to say:

On the other hand, where the corporation is created for a business activity or the creation is followed by business activity, the corporation must be recognized as a separate entity.<sup>84</sup>

We find ourselves back in the Second Circuit in *Ralph Wattlely v. Commissioner*,<sup>85</sup> where the taxpayer was a licensed real estate broker who became sole shareholder of a corporation authorized to conduct a real estate brokerage business. Other brokers also purported to act for the corporation from time to time, and received compensation by way of a percentage of each commission earned. While the corporation never paid any income tax, returns were filed in its name, and the taxpayer's individual returns showed no income from the corporation during those years. The court refused to disregard the corporate entity for the purpose of treating any commission received as belonging to the taxpayer, rather than to the corporation, and declined to allow him the income-splitting benefits of the Internal Revenue Code for services performed as the cor-

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<sup>81</sup> *Id.* at 433-4.

<sup>82</sup> *Id.* at 434. (Emphasis added.)

<sup>83</sup> 271 F.2d 44 (9th Cir. 1959).

<sup>84</sup> *Id.* at 49.

<sup>85</sup> 275 F.2d 462 (2d Cir. 1959), *aff'd*, 298 F.2d 791 (2d Cir. 1962).

poration's agent. The services involved negotiating a lease over a period when negotiations were being conducted in the name of the corporation and on its letterhead. However, the court did recognize taxpayer's right to terminate his relationship with the corporation, and thereafter he was entitled to prorate commissions received as an individual broker, not over the entire period but over the period from termination of the relationship with the corporation.

Again, it was the Second Circuit which denied relief in *Commissioner v. State-Adams Corporation*.<sup>36</sup> A Mrs. Whitehouse was sole trustee and sole income beneficiary of a trust of certain real property located in Chicago. It appeared that at her death the property would be distributed to her descendants per stirpes, that two of the recipients would be aliens prohibited by Illinois law from owning real estate for more than a limited time, and that part of the ownership would become vested in minor beneficiaries.

Accordingly, when Mrs. Whitehouse was 81 years of age, taxpayer corporation was formed under Illinois law, and the real estate in question was transferred to it in exchange for all of its stock. At that time, the realty was rented to a department store for stipulated rentals through the year 1994, and the lease was transferred to it in exchange for its promissory note payable to Mrs. Whitehouse as trustee. The interest on the note was equivalent to the amount of rent received from the department store. At the time the corporation was formed Mrs. Whitehouse was advised by her attorney that the new arrangement would not affect "the present crediting to her account" with a sum equal to the total rent of the property. After incorporation, rent checks were made payable by the tenant to the corporation, which in turn transmitted them to Mrs. Whitehouse's account as trustee. After the death of Mrs. Whitehouse the rental payments received by the corporation continued to be transferred to Mrs. Whitehouse's bank, but instead of being delivered to her, they were delivered directly to the shareholders, who succeeded to the shares on termination of the trust. The lease was a "net lease" under which all of the usual duties of ownership and management were on the tenant. In denying the corporation's contention that the corporation should be disregarded under the rule of the *Paymer* case, the court pointed out that the stockholder here intended to make the corporation the true owner, and that the directors and officers could have exercised control without the consent of the shareholder. In footnote 2 of the case, the court points out that:

When Congress has desired to give taxpayers the benefit of using the corporate form without paying a corporate income tax, it has known

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<sup>36</sup> 283 F.2d 395 (2d Cir. 1960), *cert. denied*, 365 U.S. 844.

how to do so specifically and directly. Compare the election as to taxable status given 'Certain small business corporations' by I.R.C. 1954, Subchapter S, §§ 1371-77. . . .<sup>37</sup>

In *Hagist Ranch Inc. v. Commissioner*<sup>38</sup> the Court of Appeals for the Seventh Circuit held that the fact that a corporation was formed for the convenience of its shareholders was a factor in recognizing the corporate ownership, where the corporation was formed to take over, operate and liquidate certain assets of a bankrupt, and distribute proceeds to creditors, there having been considerable operating activity involved.

In *Greer v. Commissioner*<sup>39</sup> the Court of Appeals for the Fifth Circuit faced the question of whether or not the corporation in question was an agent of the joint venture made up of three individuals so that they might deduct losses from its activities, or whether recognition had to be given to the corporation as a taxpayer. This, of course, presents a different problem from the cases previously considered, where the issue was whether or not the corporation was a "dummy." Nevertheless, the court was asked to analyze similar facts, since there were none of the usual evidences of a principal and agent relationship. The court held that since the taxpayers had not shown that in fact the corporation was merely their agent, they had not sustained the burden placed up them, and said:

Whether the corporation operates in the name and for the account of the principal, binds the principal by its actions, transmits money received to the principal, and where the receipt of income is attributable to the services of the employees of the principal and to assets belonging to the principal are some of the relevant considerations in determining whether a true agency exists. If the corporation is a true agent, its relation to its principal must not be dependent upon the fact that it is owned by the principal, if such is the case. Its business purpose must be the carrying on of the normal duties of an agent.<sup>40</sup>

The court specifically noted that the doctrine of *Lucas v. Earl*,<sup>41</sup> that assignment of the fruit without the tree is not effective for shifting income, does not mean that income will be taxed to the owner of property when in fact it is the income of the operations of a taxpayer other than the owner. This is, of course, merely a restatement of the doctrines applied by the Tax Court in several of the cases where the taxpayer was successful in having the corporate entity disregarded, as for example, the *Roberts* and *Czivzler* cases. It is interesting mainly because of the reference to *Lucas v.*

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<sup>37</sup> *Id.* at 399.

<sup>38</sup> 295 F.2d 351 (7th Cir. 1961).

<sup>39</sup> 334 F.2d 20 (5th Cir. 1964), *affirming*, 21 CCH Tax Ct. Mem. 998 (1962).

<sup>40</sup> *Id.* at 23-24.

<sup>41</sup> 281 U.S. 111 (1930).

*Earl* and its refusal of taxpayer's suggestion that the doctrine of that case be applied inversely.

Like the *Greer* case, *Worth Steamship Corporation*<sup>42</sup> involved the question of whether or not the taxpayer corporation operated as an owner or as an agent for individuals. The Tax Court held that although title to a ship was in the corporation, it was clear from a pertinent agreement that the corporation held title for the benefit of the individuals, and operated the ship as manager for the individuals, turning over all profits to the individuals and being paid a fixed amount as compensation. Although the taxpayers were successful in establishing the agency arrangement in this instance, the case was not discussed with the other Tax Court decisions favoring the taxpayers since it turned on the agency question rather than on a determination as to whether or not the corporate existence should be ignored as being a mere sham.

#### ACQUISITION OF CORPORATION TO ACQUIRE ITS ASSETS

In addition to the foregoing cases where the courts were asked to disregard the corporate entity because it was a mere sham and because there was no business purpose or activity, there has been another type of case where the corporate entity has been disregarded. This category involves the acquisition of a corporation with the intent to liquidate it promptly in order to acquire the assets of that corporation. In other words, the buyer is not interested in the corporation except for the purpose of acquiring its assets. Considerably less space will be devoted to a discussion of this doctrine, since the guidelines are better settled than those affecting the previously discussed cases, and to some extent have been made obsolete by legislative action. Nevertheless, some mention must be made of the situation since it properly falls within the scope of this paper, as an instance where the corporate entity is disregarded for the benefit of the taxpayer.

The leading case involved determination of the cost basis of the underlying assets acquired through purchase of the stock of the owner corporation, and liquidation of that corporation. In *Kimbell-Diamond Milling Co.*<sup>43</sup> the Commissioner unsuccessfully sought to have the procedure taxed as a "single transaction" so as to deny to the purchasing corporation the right to carry over a basis in excess of what it had paid for the stock of the liquidated corporation. The

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<sup>42</sup> 7 T.C. 654 (1946).

<sup>43</sup> 14 T.C. 74 (1950), *aff'd*, 187 F.2d 718 (5th Cir. 1951), *cert. denied*, 342 U.S. 827 (1951).



same principle was applied in *Montana-Dakota Utilities Co.*<sup>44</sup> and *Kanawha Gas and Utilities Co. v. Commissioner*<sup>45</sup> to give the acquiring corporation the benefit of its cost, where that exceeded the cost basis of the underlying assets to the original owner whose stock it acquired. In both of these cases the surviving corporation wished to acquire the assets of the predecessor corporate owner, and in order to do so acquired the outstanding stock (or the outstanding stock and other securities in addition to assuming the liabilities) of the predecessor. In each, the cost of thus acquiring the corporation was more than the cost basis of the underlying assets to the corporation. The Commissioner contended that the cost basis of the assets to the purchaser should be restricted to the cost basis of those assets in the hands of the prior owner. In each instance he was unsuccessful, the courts holding that the various steps by which the control of the subsidiary corporation was obtained and the subsidiary liquidated constituted the purchase of the underlying assets by the surviving corporation. In each instance the *Kimbell-Diamond Milling Co.* case was cited, and the surviving corporation was permitted to use its overall cost of acquiring the assets through the acquisition and liquidation of the predecessor corporation as the cost basis for the assets.

An analogous doctrine was involved in *Commissioner v. Ashland Oil & Refining Co.*,<sup>46</sup> and *H. B. Snively*.<sup>47</sup> In these cases, again, the purchaser acquired the stock of the prior corporate owner of the desired assets, and then liquidated that corporation in order to acquire the underlying assets. In each instance the value of the assets received on liquidation exceeded the cost to the surviving taxpayer of acquisition of the controlled corporation. Both courts held that no liquidation gain resulted under the circumstances, since in fact there was a purchase of underlying assets.

Incidentally, in the *Snively* case, the court also decided that the rule relieving the purchaser-taxpayer from realization of gain on liquidation of the acquired corporation did not relieve that corporation from liability for income received between the time that it was acquired by the purchase and the time that it was liquidated.

The converse of the *Snively* and *Ashland* cases is found in *Ruth M. Cullen*<sup>48</sup> where one of several shareholders of a corporation bought out the others in order to liquidate the corporation and operate the business as a sole proprietorship. The cost to him of the

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<sup>44</sup> 25 T.C. 408 (1955).

<sup>45</sup> 214 F.2d 685 (5th Cir. 1954).

<sup>46</sup> 99 F.2d 588 (6th Cir. 1938), *cert. denied*, 306 U.S. 661.

<sup>47</sup> 19 T.C. 850 (1953).

<sup>48</sup> 14 T.C. 368 (1950).

stock acquired exceeded the value of the liquidating distribution, but the court denied taxpayer the right to a deductible loss because he "had neither more nor less than he had paid for."

It is to be noted that the so-called *Kimbell-Diamond* rule, as applied to corporate surviving taxpayers, has now been incorporated by the 1954 Internal Revenue Code in Section 334(b)(2). However, this section does not apply to individuals acquiring corporate stock in order to reach underlying assets, and as to them the theories of the courts, in going through form to substance, still apply. In *Estate of Suter*,<sup>49</sup> the individuals had first attempted to buy the underlying assets from the old corporation, but had been forced to buy the stock of the corporation instead. As planned, the old corporation was dissolved, and its assets distributed to the individuals. The individuals then transferred the assets to a new corporation, completely controlled by them, with this new corporation assuming the liabilities for the purchase price of the stock. The Tax Court held that the series of steps constituted a single transaction, that is, the purchase by the new corporation of the assets of the old. The basis of the assets in the hands of the new corporation would therefore be the purchase price of the stock of the old corporation. It further held that the individual shareholders did not receive a dividend when the new corporation assumed liability for the purchase price of the stock.

#### CRITIQUE

Perhaps the cases last mentioned, in which the stock of a corporation is acquired only for the purpose of liquidating it and reaching its underlying assets, are not true cases of "disregard of the corporate entity." However they are examples of proceeding through form to substance, and the net effect is to disregard the existence of the predecessor corporate owner insofar as liquidation is concerned, so as to recognize that the surviving taxpayer in fact merely acquired the underlying assets desired.

The more interesting questions arise in the case where the courts have been asked to disregard the corporate entity because it was in fact a sham, and because the corporation had neither business purpose nor activity. The rule does not seem to fit within generally accepted tax principles. As previously noted, a commonly accepted principle is that the taxpayer, having had the choice of whether or not to do business in corporate form, must be held

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<sup>49</sup> 29 T.C. 244 (1947).

responsible for his election to adopt that form.<sup>50</sup> Any exceptions to this rule would be expected to involve instances where application of the rule would work an undue hardship on the taxpayer because of circumstances beyond his control, so that he should be granted relief to prevent an unfair result. This reasoning would support only a few of the cases where the taxpayer was successful.<sup>51</sup> Perhaps on this theory the decision of the Court of Appeals of the Second Circuit in the *Sun-Herald* case might have been decided differently, since it appears that the parties in control of the situation were guilty, at worst, of inadvertence.

In any event, if the taxpayers were to be relieved of the burdens of the corporate existence only in such hardship cases, we would not find the peculiar results of the decisions reviewed, which deny relief to taxpayers because of the business purpose of a corporation in some cases, while other cases, which pay lip service to the same doctrine, proceed to ignore the corporate entity when the corporation was formed either to conceal assets from creditors or to protect an individual from civil liability or to transfer assets from the taxpayer to another to defeat creditors.<sup>52</sup> To deny relief where the corporation executes leases and transfers title to property because title is held in the name of the corporation, but no other business activity occurs,<sup>53</sup> or where the corporation merely holds title to stock temporarily while a merger is negotiated,<sup>54</sup> and then to allow relief where the corporation is deliberately formed to protect the taxpayer against any liability which might be incurred by his employee in operating his business<sup>55</sup> seems to place an undue emphasis on the question of whether or not unimportant activities are undertaken in the name of the corporation, and not enough emphasis on the purpose for which the corporation is formed or used.

It is submitted, however, that a review of the decisions of the Courts of Appeal, both for and against the taxpayer, seems to indicate a tendency towards renunciation of the rule, or at least a ten-

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<sup>50</sup> *United States v. Morris & Essex R.R. Co.*, 135 F.2d 711 (2d Cir. 1943); *Moline Properties Inc. v. Commissioner*, 319 U.S. 436 (1943); *Skarda v. Commissioner*, 250 F.2d 429 (10th Cir. 1957).

<sup>51</sup> See, e.g., *Paul C. F. Vietzke*, 37 T.C. 504 (1961). In addition, perhaps the decision in *John A. Mulligan*, 16 T.C. 1489 (1951), might be included on the basis that the taxpayers were acting pursuant to instructions of the Surrogate's Court.

<sup>52</sup> *Paymer v. Commissioner*, 150 F.2d 334 (2d Cir. 1945); *Raymep Realty Corp. Inc.*, 7 CCH Tax Ct. Mem. 262 (1948); *Thomas C. Wilwerth*, 14 CCH Tax Ct. Mem. 987 (1955); *Jackson v. Commissioner*, 233 F.2d 289 (2d Cir. 1956).

<sup>53</sup> *Paymer v. Commissioner*, 150 F.2d 334 (2d Cir. 1945); *Raymep Realty Corp. Inc.*, 7 CCH Tax Ct. Mem. 262 (1948); *L. B. Whitfield*, 14 T.C. 776 (1950).

<sup>54</sup> *National Investor's Corp. v. Hoey*, 144 F.2d 466 (2d Cir. 1944).

<sup>55</sup> *Thomas C. Wilwerth*, 14 CCH Tax Ct. Mem. 987 (1955).

dency to restrict its application, through factual interpretations.<sup>56</sup> There remain several doubts as to just which facts will be deemed to justify application of the rule in the taxpayer's favor, unless he wishes to conceal assets from his creditors, and even then, there may be a question as to whether or not he will be allowed to treat as individual deductions any taxes and similar items attributable to ownership of the property if title is in the corporation. In addition, there is always the possibility that the language of the Supreme Court in the *Moline* case, "Whether the purpose be to gain an advantage under the law of the state of incorporation *or to avoid or to comply with the demands of creditors . . .*"<sup>57</sup> will result in repudiation of the doctrine of the *Paymer* case where a corporation is formed to conceal assets from creditors.

Nevertheless, the "court-made" law established by the cases discussed here has been on the books for over thirty years.<sup>58</sup> Accordingly, the failure of Congress to legislate the doctrine out of existence seems to justify its continued recognition by the courts. It remains available for those who have the inclination, and the courage, to make use of it.

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<sup>56</sup> *Sun-Herald Corp. v. Duggan*, 160 F.2d 475 (2d Cir. 1947); *Investor's Corp. v. Hoey*, 144 F.2d 466 (2d Cir. 1944); *Commissioner v. State-Adams Corp.*, 283 F.2d 395 (2d Cir. 1960).

<sup>57</sup> 319 U.S. 436, at 438 (1943). (Emphasis added.) See also, *Skarda v. Commissioner*, 250 F.2d 429 (10th Cir. 1957).

<sup>58</sup> *112 West 59th Street Corp. v. Helvering*, 68 F.2d 397 (1933). Other cases can be found in *Moline Properties Inc. v. Commissioner*, 319 U.S. 436 n.1 (1943).