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THE FUNCTION OF THE ENTITY IN FEDERAL INCOME TAXATION: RECENT DEVELOPMENTS

By WILLIAM H. HARRAR*

THE concepts of trust and corporate entity have had a long life in federal income taxation and have been especially useful as weapons to the Treasury in its perennial pursuit¹ of taxpayers engaged in the enjoyment of their right² to decrease their taxes. These weapons are double-barrelled. The court may be asked to hold that the separate legal existence of a corporation as against its stockholders be upheld and affirmed, as, for instance, where a taxpayer has been paying the bills of the corporation of which he is president and wants to deduct the payments from his own income,³ or on the other hand, it may be urged inexorably to pierce the corporate veil and to rule that the corporation and its members, or the trust and its creator, are as One, as for example, where a grantor of a trust has sought to rid himself of fiscal burdens on the yield of his property by deeding a portion of it over to a trustee for the benefit of his wife.⁴

Last term, the Supreme Court of the United States upheld the government in brushing aside the shrouding veils of two corporations and a trust.⁵ The decisions are worthy of careful

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¹For an interesting recent exposition of the progress of the engagement, see Ray, *The Income Tax on Short Term and Revocable Trusts*, (1940) 53 *Harv. L. Rev.* 1322.

²*Gregory v. Helvering*, (1935) 293 U. S. 465, 55 *Sup. Ct.* 266, 79 L. Ed. 596; *Bullen v. Wisconsin*, (1916) 240 U. S. 625, 36 *Sup. Ct.* 473, 60 L. Ed. 830. This right is a chameleon, becoming transformed into a "wrong" when the taxpayer "gets on the wrong side of the line" and "evades," rather than "avoids" taxes. See Angell, *Tax Evasion and Tax Avoidance*, (1938) 38 *Col. L. Rev.* 80.

³*Archibald R. Watson*, (1940) 42 *B. T. A.* 52.

⁴*DuPont v. Commissioner*, (1933) 289 U. S. 685, 53 *Sup. Ct.* 766, 77 L. Ed. 1447. Disregard of the trust entity in these circumstances is popularly called the "no-trust" doctrine.

⁵*Griffiths v. Commissioner*, (1939) 308 U. S. 355, 60 *Sup. Ct.* 277, 84 L. Ed. 238; *Higgins v. Smith*, (1940) 308 U. S. 473, 60 *Sup. Ct.* 355, 84 L. Ed. 321; *Helvering v. Clifford, Jr.*, (1940) 309 U. S. 331, 60 *Sup. Ct.* 554, 84 L. Ed. 504.

study, especially as they are now being cited in briefs for everything under the sun and will doubtless result in a flood of explanatory decisions, conflicts of circuits and legal heart-searching similar to that which attended upon *Eisner v. Macomber* and *Gregory v. Helvering*.⁶

The first case was *Griffiths v. Commissioner*.⁷ Griffiths, defrauded on the purchase of certain stock, settled his claim against the seller by conveying the shares to a corporation created ad hoc and wholly under Griffiths' control and causing the corporation to transfer the stock back to the seller for \$100,000. The corporation upon receipt of that sum was to pay it over in installments to Griffiths for forty years. The commissioner taxed Griffiths on the entire amount of the settlement in the year in which it was made, and the Supreme Court, per Mr. Justice Frankfurter, upheld his action. The rationale of the decision lies in this sentence:

"We cannot too often reiterate that 'taxation is not so much concerned with the refinements of title as it is with actual command over the property taxed—the actual benefit for which the tax is paid.' . . . And it makes no difference that such 'command' may be exercised through specific retention of legal title or the creation of a new equitable but controlled interest, or the maintenance of effective benefit through the interposition of a subservient agency."

In other words, the existence of Griffiths' carefully constructed corporation was given no tax effect. What happened was "a simple sale from Griffiths to Lay and the passage of money from Lay to Griffiths. That was the crux of the business to Griffiths, and that is the crux of the business to us."⁸

Shortly thereafter the Court decided what is fast becoming

⁶*Eisner v. Macomber*, (1920) 252 U. S. 189, 40 Sup. Ct. 189, 64 L. Ed. 521; *Gregory v. Helvering*, (1935) 293 U. S. 465, 55 Sup. Ct. 266, 79 L. Ed. 596. As of September 1, 1940, the *Macomber* Case had been cited 293 times by the federal district courts, court of claims and circuit courts of appeals, according to Shepard's Citations. The Prentice-Hall Citorator, which comprehends not only the federal courts but also the board of tax appeals, showed approximately 675 citations of this case. The *Gregory* Case, more recently decided, is holding its own, Shepard listing 84 citations and Prentice-Hall approximately 200. An old legend has it that a tax judge once told his new law secretary: "There are just three rules in this office. Investigate the facts closely, find them fairly, and don't cite the *Macomber* Case."

⁷(1939) 308 U. S. 355, 60 Sup. Ct. 277, 84 L. Ed. 238.

⁸The Griffiths decision is scarcely surprising, although one may question whether and how far certain of the aspects of title are merely "refinements." For a recent case following this one, see *Paul Plunkett & Co.*, (1940) 42 B. T. A. 464.

a tax cause célèbre,⁹ *Higgins v. Smith*.¹⁰ Smith had organized the Innisfail Corporation in 1926 under the laws of New Jersey. He owned all of its stock, his subordinates were its officers and directors, and its transactions, carried on under his direction, were "restricted largely" to buying securities from, or selling them to, him. In 1932, he owed Innisfail \$70,000, and in partial payment thereof, he sold the corporation some stock at market, which had cost him considerably more than market. He was mindful of tax consequences¹¹ in so doing, and sought to deduct his resulting loss in his return for 1932, under sec. 23 (e) of the Revenue Act of 1932.¹²

His loss fell under sec. 23 (e) (2), that is, it would have to be shown to have been incurred in a transaction entered into for profit, since he was not in the business of buying and selling securities.¹³ It would further have to be shown that the loss was sustained in a closed transaction, that is, by a completed, bona fide sale.¹⁴ Previous to the time at which *Higgins v. Smith* arose

⁹Rendition of the opinion in *Higgins v. Smith* led the board of tax appeals, upon motion of the commissioner, to vacate its decision in *John Thomas Smith*, (1939) 40 B. T. A. 387, which had allowed Smith to deduct losses on sales to his wholly owned corporation in 1929, and to enter an order disallowing those losses. *John Thomas Smith*, (1940) 42 B. T. A. 505. Smith's application to the circuit court of appeals, second circuit, for writs of prohibition and mandamus to restrain the board from taking action on the commissioner's motion for reconsideration had previously been denied. In the Matter of the Application of *Smith*, (C.C.A., 2nd Cir. April 24, 1940, (1940) PH Par. 62757). The court held that the board's error in vacating its prior decision, if it were an error, could be questioned by the usual petition for review, and that the court's jurisdiction to grant writs of prohibition or mandamus was "limited to the protection of our own appellate jurisdiction."

¹⁰(1940) 308 U. S. 473, 60 Sup. Ct. 355, 84 L. Ed. 321.

¹¹Awareness of tax consequences does not damn a taxpayer, but it wakes up the watchdog. *Gregory v. Helvering*, (1935) 293 U. S. 465, 55 Sup. Ct. 266, 79 L. Ed. 596; *Jones v. Helvering*, (1934) 63 App. D. C. 204, 71 F. (2d) 214; *Rands, Inc.*, (1936) 34 B. T. A. 1094, appeal dismissed, (C.C.A. 6th Cir. 1939) 101 F. (2d) 1018; *Pacific Grape Products Co.*, (1940) 42 B. T. A. 914.

¹²In computing net income there shall be allowed as deductions:

"(e) Losses by Individuals.—Subject to the limitations provided in subsection (r) of this section, in the case of an individual, losses sustained during the taxable year and not compensated for by insurance or otherwise—

"(1) if incurred in trade or business; or

"(2) if incurred in any transaction entered into for profit, though not connected with the trade or business. . . ."

¹³For a collection of cases involving the latter type of loss, see *Marjorie Fleming Lloyd-Smith*, (1939) 40 B. T. A. 214 (on appeal, C.C.A. 2nd Cir.). See *John Thomas Smith*, (1939) 40 B. T. A. 387 for details of Smith's occupation.

¹⁴See *Paul & Mertens, The Law of Federal Income Taxation* (1934) sec. 26.54; *Mertens, The Law of Federal Income Taxation, 1939 Supplement*, sec. 26.54, for a collection of the legion of cases enunciating this rule.

for decision, sales between a stockholder and a corporation were generally held to constitute closed transactions, losses thereon being subject to disallowance only where lack of bona fides was shown or where an agreement existed for reacquisition of the thing sold.¹⁵ Lack of bona fides, of course, could serve as a reason for disregarding the separateness of the entity of the corporation from Smith, its sole stockholder,¹⁶ and it is here that the concept of entity comes into our discussion.

The "General Rule" and the "Exception" concerning corporate entity in federal income taxation are simply and briefly phrased. Ordinarily, the distinction between the corporation and its stockholders will be upheld—the corporate veil is a shield.¹⁷ But where to sustain the corporate entity "would present an obstacle to the due protection or enforcement of public or private right,"¹⁸ the corporate entity will be disregarded—the veil becomes a thing of gossamer, easily slashed by the perceptive sword of the tax tribunal.¹⁹

¹⁵*Helvering v. Johnson*, (C.C.A. 8th Cir. 1939) 104 F. (2d) 140, affirmed by an equally divided Court, (1940) 308 U. S. 523, 60 Sup. Ct. 293, 84 L. Ed. 247; *Shoenberg v. Commissioner*, (C.C.A. 8th Cir. 1935) 77 F. (2d) 446, cert. denied (1936) 296 U. S. 586, 56 Sup. Ct. 101, 80 L. Ed. 414; *Commissioner v. Riggs*, (C.C.A. 3rd Cir. 1935) 78 F. (2d) 1004, cert. denied, (1936) 296 U. S. 637, 56 Sup. Ct. 171, 80 L. Ed. 453; *Commissioner v. Dyer*, (1935) 74 F. (2d) 685, cert. denied, (1936) 296 U. S. 586, 56 Sup. Ct. 97, 80 L. Ed. 414; *Shelden Land Company*, (1940) 42 B. T. A. 498, and cases therein cited.

¹⁶Disregard, of course, would mean that no "true" sale, no "identifiable event," no "closed transaction," took place in the eyes of the law, for if Smith "were" *Innisfail Corporation*, how could he be said to "sell" anything to himself, etc.?

¹⁷*Eisner v. Macomber*, (1920) 252 U. S. 189, 40 Sup. Ct. 189, 64 L. Ed. 521, [The author must herein beg his own pardon, but nevertheless Mr. Justice Pitney *did* hold that Mrs. Macomber had a life of her own, legally distinct from that of the Standard Oil Company of California]; *Klein v. Board of Tax Supervisors*, (1930) 282 U. S. 19, 51 Sup. Ct. 15, 75 L. Ed. 140 [Kentucky tax on stockholders of corporations, less than 75 per cent of the property of which was subject to the state's tax jurisdiction]; *Dalton v. Bowers*, (1932) 287 U. S. 404, 53 Sup. Ct. 205, 77 L. Ed. 389; *Burnet v. Clark*, (1932) 287 U. S. 410, 53 Sup. Ct. 207, 77 L. Ed. 397; *Burnet v. Commonwealth Improvement Co.*, (1932) 287 U. S. 415, 53 Sup. Ct. 198, 77 L. Ed. 399; *New Colonial Ice Co. v. Helvering*, (1934) 292 U. S. 435, 54 Sup. Ct. 788, 78 L. Ed. 1348.

¹⁸*New Colonial Ice Co. v. Helvering*, (1934) 292 U. S. 435, 54 Sup. Ct. 788, 78 L. Ed. 1348.

¹⁹*United States v. Lehigh Valley R. Co.*, (1911) 220 U. S. 257, 31 Sup. Ct. 387, 55 L. Ed. 458; *Southern Pacific Co. v. Lowe*, (1918) 247 U. S. 330, 38 Sup. Ct. 540, 62 L. Ed. 1142; *Chicago, Milwaukee & St. Paul Ry. Co. v. Minneapolis Civic & Commerce Ass'n*, (1918) 247 U. S. 490, 38 Sup. Ct. 553, 62 L. Ed. 1229 [not a tax case]; *Gulf Oil Corporation v. Lewellyn*, (1918) 248 U. S. 71, 39 Sup. Ct. 35, 63 L. Ed. 133. There is naturally a multitude of lower-court and board decisions on corporate entity, some of which will be discussed below. But this and note 17 give the clear-cut rule and the exception well enough.

In this state of the law, the decision of *Higgins v. Smith* came as a surprise. The district court for the southern district of New York had given a charge to the jury which, not having been published, had passed generally unnoticed. The jury had been directed to consider whether the sales by Smith to his corporation were transfers "out of Mr. Smith and into something that existed separate and apart from him," or whether there had been "a transfer by Mr. Smith's left hand, being his individual hand, into his right hand, being his corporate hand, so that in truth and fact there was no transfer at all." The jury found that Smith had, in fact, been playing catch with himself. On appeal, the judgment was reversed and the case remanded. The second circuit, per Chase, J., adhered to the general rule we have above described and in addition relied on certain other circuit decisions.²⁰

In writing for the majority and in reversing the court below, Mr. Justice Reed was forthright and clear. He found the domination and control exercised by Smith over Innisfail Corporation to be "so obvious . . . as to require a peremptory instruction that no loss in the statutory sense could occur upon a sale by a taxpayer to such an entity." *Burnet v. Commonwealth Improvement Co.*²¹ did not aid Smith in any sense, for if a taxpayer incorporates his affairs "he must accept the tax disadvantages."²²

The following language was destined to be cited in innumerable briefs subsequently filed on behalf of the Commissioner of Internal Revenue:

" . . . the government may not be required to acquiesce in the taxpayer's election of that form for doing business which is most advantageous to him. The government may look at actualities and upon determination that the form employed for doing business or carrying out the challenged tax event is unreal or a sham may sustain or disregard the effect of the fiction as best serve the purposes of the tax statute. To hold otherwise would permit the schemes of taxpayers to supersede legislation in the

²⁰Particularly on *Jones v. Helvering*, (1934) 63 App. D. C. 204, 71 F. (2d) 214; *Commissioner v. Eldridge*, (C.C.A. 9th Cir. 1935) 79 F. (2d) 629; *Commissioner v. McCreery*, 83 F. (2d) 817, (C.C.A. 9th Cir. 1936) and *Foster v. Commissioner* (C.C.A. 2d Cir. 1938) 96 F. (2d) 130. The Supreme Court in the course of its opinion did not expressly overrule any of these. It would thus appear that only history will show whether they are no longer good law. See Mr. Justice Roberts' dissent at 308 U. S. 480.

²¹(1932) 287 U. S. 415, 53 Sup. Ct. 198, 77 L. Ed. 399.

²²In the *Commonwealth Improvement Co.* Case, the taxpayer corporation, by filing separate returns, had enabled the estate of its sole stockholder to enjoy tax advantages in years prior to the taxable year there under consideration. An appeal for disregard of corporate entity was denied, the facts controlling the situation to a marked degree.

determination of the time and manner of taxation. It is command of income and its benefits which marks the real owner of property."²³

At first seeming, this is verbiage of bitter import to the man in the barrel. A hasty reading leaves the impression that the Treasury may play fast and loose with legal entities, whenever its adding machines and comptometers tell it that the revenues will thereby wax greater. But it is here that study must begin, and here that the purpose of this paper will be discharged.

The first thing to be noted is in the above-quoted paragraph: "Upon determination that the form employed for doing business or carrying out the challenged tax event is *unreal* or a *sham*."²⁴ The primary effect of this is to cast upon the taxpayer the burden of proving the reality and the practical business necessity of the scheme by which he has ordered his affairs. He has always had the burden of proving his freedom from tax liability anyway,²⁵ and he cannot justly complain at having to obey this behest once again. Over-ingenuous schemes for reducing taxes have, moreover, throughout the history of the Revenue Acts, earned the disapproval and even the lash of courts.²⁶ Hence, no taxpayer should feel aggrieved at having to demonstrate the fiscal purity of his conduct. Nor, per contra, may the Treasury arbitrarily rule, and be upheld in ruling, that the United States

²³Lucas v. Earl, (1930) 281 U. S. 111, 50 Sup. Ct. 241, 74 L. Ed. 731; Corliss v. Bowers, (1930) 281 U. S. 376, 50 Sup. Ct. 336, 74 L. Ed. 916; Griffiths v. Commissioner, (1939) 308 U. S. 355, 60 Sup. Ct. 277, 84 L. Ed. 238. Refinements of title are not always as scorned as this. See cases below, notes 28 and 36; Senior v. Braden, (1935) 295 U. S. 422, 55 Sup. Ct. 800, 79 L. Ed. 1520.

²⁴Italics added.

²⁵Board of Tax Appeals, Rules of Practice, (15th ed. 1940) Rule 32; Wisconsin Butter & Cheese Co., (1928) 10 B. T. A. 852; American Felt Co., (1929) 18 B. T. A. 504; affirmed on other grounds sub. nom. American Felt Co. v. Burnet, (1932) 61 App. D. C. 125, 58 F. (2d) 530. In suits for refund in the United States district courts, the plaintiff-taxpayer, as is well-known, carries the burden of proving his case. See 9 Wigmore, Evidence (1940) secs. 2485, 2486. The burden of proof is cast upon the government in certain instances, such as fraud (Internal Revenue Code sec. 1112), or where the government has pleaded new matter in its answer, (John O. Fowler, (1939) 40 B.T.A. 1292 (on appeal, C.C.A. 2nd Cir.)

²⁶Gregory v. Helvering, (1935) 293 U. S. 465, 55 Sup. Ct. 266, 79 L. Ed. 596, and Helvering v. Mitchell, (1938) 303 U. S. 391, 58 Sup. Ct. 630, 82 L. Ed. 917, come most readily to mind as examples. There was no fraud involved in Higgins v. Smith, and that taxpayer has been absolved thereof in respect of similar transactions for other years in John Thomas Smith, (1940) 42 B. T. A. 505 and (1939) 40 B. T. A. 387. See note 9. The real surprise in Higgins v. Smith is its holding that sales between an individual and the corporation of which he owns all the capital stock are, as a matter of law, sham and unreal.

Steel Corporation is sham and unreal or that sales of stock between it and one of its small stockholders are without tax consequences.

The second point for emphasis lies in other portions of the opinion and serves to indicate the scope of the fiction of corporate entity.

"It is clear," said Mr. Justice Reed, "an actual corporation existed. . . . But the existence of an actual corporation is only one incident necessary to complete an actual sale to it under the revenue act. Title, we shall assume, passed to Innisfail but the taxpayer retained the control."

In other words, a "disregard of corporate entity" in tax law here goes no further than to disallow the particular tax consequence of a deductible loss. The title to the stock, lumping the title concept for the moment, passed to the corporation. The latter alone could vote it, sell it, pledge it, or receive the dividends thereon. When the Court holds "there is not enough of substance in such a sale finally to determine a loss," it means that the loss does not constitute an item deductible from gross income for tax purposes, but it does not mean "there was no sale" or "there was no corporation." The fiction is tailored to fit the facts, not to annihilate them.²⁷

²⁷To uphold or to disregard corporate entity is to employ a fiction. The most pertinent observation in this regard is that of Mr. Justice Holmes in *Klein v. Board of Tax Supervisors*, (1930) 282 U. S. 19, 51 Sup. Ct. 15, 75 L. Ed. 140: "But it leads nowhere to call a corporation a fiction. If it is a fiction it is a fiction created by law with intent that it should be acted on as if true. The corporation is a person and its ownership is a non-conductor that makes it impossible to attribute an interest in its property to its members." The same judge, in *Gulf Oil Corporation v. Lewellyn*, (1918) 248 U. S. 71, 39 Sup. Ct. 35, 63 L. Ed. 133, declared that the existence of a holding company apart from its subsidiary corporation was only "bookkeeping" and held that the former was not taxably in receipt of a dividend from the latter.

The handling of the fiction in two recent cases is interesting. In *Mead Corp. v. Commissioner*, (C.C.A. 3rd Cir. 1940) F. (2d) the court refused to sanction the commissioner's argument that the entity of the taxpayer corporation should be sustained but the entity of its sole stockholder, a family corporation, disregarded, for the purposes of sec. 104 of the Revenue Act of 1928. The inconsistency thus suggested was too much for the court. In *Lyon, Inc.*, (1940) 42 B. T. A. 1094, the taxpayer asked to have a "mere conduit corporation disregarded under the rule of *Gregory v. Helvering*, (1935) 293 U. S. 465, 55 Sup. Ct. 266, 79 L. Ed. 596 so that the conclusion might be reached that no tax-free reorganization had resulted. Citing *Higgins v. Smith*, (1940) 308 U. S. 473, 60 Sup. Ct. 355, 84 L. Ed. 321 the board replied: ". . . in the light of *Gregory v. Helvering*, and the record, the acquisition of Lyon's assets by petitioner through the Lyon Development Company as a mere conduit, may have been, as petitioner argues, a mere device—a disguise—a fiction—but the government is not

This limitation on the use of *Higgins v. Smith* as a precedent has already been recognized in a decision of the board of tax appeals. In *Otto Peterson*,²⁸ a corporation, all of whose stock was held by three individuals who were also its directors, increased its capital stock and issued the new shares to the wives and families of the existing stockholders at a price of \$10 per share, which was duly paid by the purchasers. The stock was worth considerably more than \$10 per share, and three days after its issuance a dividend of \$50 per share on all stock of record was declared and paid. Although the motives of the transaction were to reduce surtaxes on the corporation without unduly increasing the individual taxes of the shareholders, the board found that all formal requirements of an issuance and sale of stock had been complied with and refused to tax the three original stockholders in respect of the dividends declared on the shares of the new stockholders. The commissioner had relied on *Higgins v. Smith* and *Helvering v. Clifford* and had urged that no real transfer of the new stock had taken place. Though remarking that the transaction might have been heavily tainted with sham and unreality, the board held that "the transfer of title to that stock to those record owners was actual and absolute." The liability for income tax on the dividends on the new shares attached only to the new stockholders.²⁹

The last decision of the Supreme Court on entity was *Helvering v. Clifford, Jr.*³⁰ The import of this case for trust com-

compelled to so regard it in the special circumstances before us here. It may and here does continue to treat this fiction as real."

For the leading philosophical work on the use of fictions in all fields of thought, see Vaihinger, *The Philosophy of As-If*, (translated from the German original, *Die Philosophie des Als Ob*), (1924).

²⁸(1940) 42 B. T. A. 102 (Now on appeal to the C.C.A. 6th Cir.)

²⁹In *Archibald R. Watson*, (1940) 42 B. T. A. 52, the board further delimited the doctrine of *Higgins v. Smith* by holding that it did not disturb the exception to the general rule (see note 17) embodied in *North Jersey Title Insurance Co. v. Commissioner*, (C.C.A. 3rd Cir. 1936) 84 F. (2d) 898; *Moro Realty Holding Corp.*, (C.C.A. 2nd Cir. 1933) 65 F. (2d) 1013; *Carling Holding Co.*, (1940) 41 B. T. A. 493 and *Mark A. Mayer*, (1937) 36 B. T. A. 117; namely that where the corporation created by the taxpayer functions only to hold title to real estate and where the disregard by the taxpayer of its separate entity in his tax returns has been consistent, its entity will be disregarded and the individual taxpayer allowed to deduct taxes paid on the lands owned by it. In the same opinion, the board held that *Watson* could not deduct the expenses of two corporations he had created to publish two magazines, invoking *Burnet v. Commonwealth Improvement Co.*, (1932) 287 U. S. 415, 53 Sup. Ct. 198, 77 L. Ed. 399, because their entities must be held to be taxably separate from *Watson*. The crucial fact for the Board was that the two corporations had been created by the taxpayer to carry on a business.

³⁰(1940) 309 U. S. 331, 60 Sup. Ct. 554, 84 L. Ed. 504.

panies and settlors cannot be overemphasized and has been well treated elsewhere.³¹ What we are here concerned with is what it adds to the doctrine of entity in taxation. Clifford declared himself trustee of certain securities owned by him for a period of five years. The net income arising from those assets was to be paid over to his wife. Upon termination, the trust corpus reverted to him and any accumulated income or the proceeds of the investment of such income went to his wife. Meanwhile Clifford, as trustee, retained a large number of powers³² to deal with the trust res—all short of a power to revoke. The holding of the Court, per Mr. Justice Douglas, is well-known. In brief it was that Clifford had remained the owner of the trustee securities, despite his transfer of them to himself as trustee, and that he must include all the income arising from the trust res in his personal return and pay a tax thereon.

Clifford "continued to be the owner for purposes of sec. 22 (a)" of the Revenue Act of 1934.³³

"In substance his control over the corpus was in all essential respects the same after the trust as before. . . . As a result of the terms of the trust and the intimacy of the familial relationship respondent retained the substance of full enjoyment of all the rights which previously he had in the property."

If he remained the owner of the trustee stock, it followed that he had to pay tax on the income arising therefrom.

To reach this conclusion, Mr. Justice Douglas had to disre-

³¹See Ray, (1940) 53 Harv. L. Rev. 1322; note, (1940) 53 Harv. L. Rev. 1050; note (1940) 38 Mich. L. Rev. 885.

³²These retained powers were: to vote the trustee stock; to sell, exchange, mortgage or pledge any of the securities comprising the corpus; to invest cash in the trust estate in loans, secured or unsecured; to collect all income; to compromise any claims held by him as trustee; and to hold any property in the trust estate in the names of others or in his own name. He provided that he should be excused from all losses except those occasioned by his wilful and deliberate breach of duties as trustee. The wife was placed under no restrictions as to the use of the income paid over to her by her husband-trustee, but he reserved the discretion to determine what amounts she should receive.

³³Sec. 22. Gross Income.

(a) *General Definition.*—"Gross income includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce or sales, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transactions of any business carried on for gain or profit, or gains and profits and income derived from any source whatsoever. . . ." This is the cornerstone of the Federal Income Tax, next in importance to the sixteenth amendment.

gard the separate entity of the trust.³⁴ Otherwise, the trust income would have to be held taxable to Clifford's wife or to himself in his capacity as trustee under the Internal Revenue Code, sections 161 and 162. But if we shift the facts a little, and assume a third-party or corporate trustee, we are prepared again to note a limitation to the scope of the *Clifford* doctrine similar to that of *Higgins v. Smith*, although the result as to the taxability of the grantor of such a trust remains the same.³⁵ That limitation is, that the legal title passes to the trustee and the beneficial title to the cestui, despite the reading out of the trust, taxably speaking. The trust does not go up in smoke as a legal device. It is of no help to the grantor in reducing his income taxes, but the idea of "no-trust" applies only for the purpose of determining the liability for the tax on the income arising from the trust res.

This limitation on the scope of the Supreme Court's doctrine of entity has likewise been recognized in a recent decision of the board of tax appeals. In *Minnie M. Fay Trusts*,³⁶ the issue before the board was the proper basis to be used by the trustees of inter vivos trusts for computing gain on the sale of a portion of the securities held as corpora. The grantor had created the trusts prior to his death, and had provided that the income should be paid to his wife and that the power to revoke should be lodged in a committee of three persons, the interests of two of whom were non-adverse to the grantor.³⁷ He had also retained a possibility of reverter,³⁸ and enough powers to render the application of sec. 22 (a) likely had that issue been before the board.³⁹ Section 113 (a)(3) of the Revenue Acts of 1934

³⁴This is one of the themes elaborated in Mr. Justice Roberts' dissent, which cites the states which recognize a trust for tax purposes and define the tax consequences of its creation. See also *Higgins v. White*, (C.C.A. 1st Cir. 1937) 93 F. (2d) 357.

³⁵*George H. Deuble*, (1940) 42 B. T. A. 277; *Herbert W. Hoover*, (1940) 42 B. T. A. 289; *Purdon Smith Whiteley*, (1940) 42 B. T. A. 316; *Frank G. Hoover*, (1940) 42 B. T. A. 786. These cases all follow the *Clifford* decision and hold that the respective taxpayers remained in substance the owners of the corpora of the trusts they created, by reason of their retained powers of control. All of the trustees were trust companies.

³⁶(1940) 42 B. T. A. 765.

³⁷This, of course would have made the grantor taxable on the income under sections 166 of the Revenue Acts of 1934 and 1936 (Internal Revenue Code, sec. 166).

³⁸This would have required the inclusion of the corpora of the trusts in the grantor's gross estate. *Helvering v. Hallock*, (1940) 309 U. S. 106, 60 Sup. Ct. 444, 84 L. Ed. 382.

³⁹The Board assumed the applicability of sec. 22 (a) *arguendo*.

and 1936, under which the case arose, provided that the basis should be the cost to the grantor. Section 113 (a)(5) of the same acts created an exception: if there was reserved to the grantor a power to revoke, the basis should be the fair market value of the trustee property at the date of his death. The respondent relied on the *Clifford Case* and argued that sec. 113 (a)(5) applied because it obviously referred to instances where real control was reserved by settlors.

The board, in holding sec. 113 (a)(5) inapplicable since a power to revoke had not been reserved to the grantor but only to a non-adverse interest, said this: "None of the above-mentioned income and estate tax principles⁴⁰ contradict the juristic transfer of title from the grantor to the trustees." Hence, the tax liabilities of the grantor or his testamentary estate were not germane to the issue, which was the cost basis to be employed by the inter vivos trustees. The basis, held the Board, was dictated by sec. 113 (a)(3).

It remains to be noted that the problem for taxpayers created by *Higgins v. Smith* has been removed, albeit unfavorably to them, by sec. 24 (a)(6) of the Revenue Act of 1934, as amended by sec. 301 of the Revenue Act of 1937.⁴¹ The provision in its present form disallows losses from sales or exchanges of property, directly or indirectly⁴² between (1) members of a family, (2) between an individual and a corporation if more than fifty per cent in value of its outstanding stock is owned by or for such individual (except in the case of liquidating distributions),⁴³ (3) between foreign or domestic personal holding companies (except liquidating distributions) if more than fifty percent of the stock of each is owned by or for the same individual, (4) between the grantor and the fiduciary of any trust, (5) between fiduciaries of trusts with a common grantor, and (6) between a fiduciary and a beneficiary of a trust. Careful definitions of "stock ownership," "family" and "constructive ownership" are appended.

⁴⁰See notes 36, 37 and 38.

⁴¹Internal Revenue Code, sec. 24 (b), now contains the statute, as amended.

⁴²The Board has construed this phrase in *Shelden Land Co.*, (1940) 42 B. T. A. 498 and declared it to be sufficiently ambiguous to permit of a resort to the legislative history of the section. Section 24 (a) (6) is also construed by way of dictum, in *Higgins v. Smith*, (1940) 308 U. S. 473, 60 Sup. Ct. 355, 84 L. Ed. 321. For the legislative history of these statutes, see Seidman, *Legislative History of Federal Income Tax Laws* (1938) 316, 317, 198, 199.

⁴³Liquidating distributions are governed by Internal Revenue Code, sec. 115.

But meanwhile, *Higgins v. Smith* and *Helvering v. Clifford* will continue as "all things to all men" until they are defined and limited by subsequent cases. It is the hope of the writer that he has indicated certain methods of analysis whereby these authorities may be more usefully applied and distinguished. It is one thing to have a leading case. It is another to have to distinguish it constantly, keep it in its proper channel, and have it disturb one's dreams.