

Washington University Law Review

Volume 1976 | Issue 3

January 1976

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Recommended Citation

Steven J. Stogel and David L. Jones, *Straw and Nominee Corporations in Real Estate Tax Shelter Transactions*, 1976 WASH. U. L. Q. 403 (1976).

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STRAW AND NOMINEE CORPORATIONS IN REAL ESTATE TAX SHELTER TRANSACTIONS

STEVEN J. STOGEL* AND DAVID L. JONES**

I. INTRODUCTION

During 1976, Congress placed some severe restrictions on tax shelter investments.¹ In addition, even before Congress acted, the Internal Revenue Service (IRS) initiated its own attack on tax shelters. One IRS tactic to frustrate the objectives of tax shelter investments is to shift the incidence of taxation from one entity to another. This Article focuses primarily on one phase² of the IRS attacks on real estate tax shelters.³

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The authors wish to thank Ronald J. Raben, Esq., for his assistance in the preparation of this article.

1. See Tax Reform Act of 1976, Pub. L. No. 94-455, §§ 201-14, 90 Stat. 1525 (1976).

2. See generally 22 U.S. NEWS & WORLD REP., Nov. 29, 1976, at 35, in which IRS Commissioner Donald C. Alexander indicated the unyielding stance the IRS has adopted against tax shelters. Alexander stated that the IRS is presently challenging \$300 million in tax sheltered investments in over 300 court cases.

The Internal Revenue Service has asserted that a limited partnership with sufficient corporate characteristics should be taxed as an "association" within the meaning of I.R.C. § 7701 and the corresponding regulations. This approach would deny the partners a deduction for their distributive losses and shift the losses to the corporation, which probably would not be in a position to use them. To date, the Commissioner has been unsuccessful in this approach. See, e.g., *Zuckman v. United States*, 524 F.2d 729 (Ct. Cl. 1975); *Larson v. Commissioner*, 66 T.C. 159 No. 1 (April 27, 1976). For a thorough discussion of the above approach, see Mendenhall & Ferguson, *What Risks Now for Partnership Treatment of Shelters? Lessons of Larson, Zuckman*, 45 J. TAX. 66 (1976).

The IRS has not given up the fight, however. On January 5, 1977, the IRS released proposed regulations which, if adopted, would have radically altered the § 7701 tests to determine whether an entity qualifies as a partnership or a corporation. See 42 Fed. Reg. 1038 (1977). The proposed regulations were ordered withdrawn by Secretary of the Treasury William Simon on the same date. See [1977] 6 FED. TAXES (P-H) ¶ 60,049. As this Article goes to press, it is unknown whether these regulations will ever be proposed for public comment and possible adoption.

3. Many other business ventures have been used as tax sheltered investments, such

In the normal course of the development of a real estate project, a taxpayer, whether an individual or partnership ("real taxpayer"),⁴ acquires land, engages engineers and architects, obtains interim and permanent financing, secures appropriate zoning and building permits, lets construction contracts, and builds the project. Occasionally, however, the real taxpayer uses a straw corporation to transact one or more of the project's developmental phases. A "straw" corporation is a corporate entity created to hold record legal title for the beneficial owner of the real estate. The real taxpayer may use a straw corporation in order to limit his personal liability,⁵ avoid restrictive usury laws⁶ or government regulations,⁷ or simply because of personal convenience,⁸ inadvertence, or ignorance. In such a situation the straw corporation might, for example, acquire and hold title to the real estate or obtain a loan in its name. Although the straw corporation participates in developing the project, the real taxpayer treats himself as sole owner of the project

as cattle feeding, cattle breeding, various agricultural crops, thoroughbred horseracing, oil and gas drilling, equipment leases, motion picture production, and professional sports franchises. The Tax Reform Act of 1976 limits the taxpayer's deduction to the amount he has "at risk" in activities such as motion picture production and distribution, farming, leasing of section 1245 property, and exploration of oil and gas resources, but the "at risk" limitation does not apply to real estate ventures. Tax Reform Act of 1976, Pub. L. No. 94-455, § 204(c), 90 Stat. 1531 (1976) (to be codified in 26 U.S.C. § 465(c)).

Recent commentaries on this subject include Baker & Rothman, *Straw Corporations: New Cases Shed Light on Tax Recognition Criteria*, 45 J. TAX. 84 (1976); Baker & Rothman, *Nominee and Agency Corporations: Grasping for Straws*, 33 N.Y.U. INST. ON FED. TAX. 1255 (1975); Bertane, *Tax Problems of the Straw Corporation*, 20 VILL. L. REV. 735 (1975); Hoffman, *Straw or nominee corps. must be as passive as possible to protect investors deductions*, 5 TAX. FOR LAW. 10 (1976); Wright, *Owning Real Estate Through Shams and Nominees*, 6 REAL ESTATE REV. 53 (1976). Two excellent older articles are Kronovet, *Straw Corporations: When Will They Be Recognized; What Can and Should Be Done*, 39 J. TAX. 54 (1973), and Kurtz & Kopp, *Taxability of Straw Corporations in Real Estate Transactions*, 22 TAX LAW. 647 (1969).

4. Throughout this article, the term "real taxpayer" is used synonymously with the term "real party in interest." The authors recognize that the phrase "real taxpayer" reveals their protaxpayer attitude. Considering the tax consequences of tax shelters, however, it is invariably the individual in a high income tax bracket who actively seeks the losses, not the entity through which the investment may have been made or held. In many other areas of income taxation, the general rule is that the substance of the transaction, not its form, is controlling. See note 87 *infra* and accompanying text.

5. See, e.g., *Stillman v. Commissioner*, 60 T.C. 897 (1973); H. HENN, *LAW OF CORPORATIONS* § 73 (2d ed. 1970).

6. See, e.g., *Rogers v. Commissioner*, 34 T.C.M. (CCH) 1254 (1975); *Bolger v. Commissioner*, 59 T.C. 760 (1973).

7. See, e.g., *Elot H. Rafferty Farms, Inc. v. United States*, 511 F.2d 1234 (8th Cir. 1975); *Waterman v. Commissioner*, 34 T.C.M. (CCH) 910 (1975).

8. See, e.g., *Moline Properties, Inc. v. Commissioner*, 319 U.S. 436 (1943); *Salmon v. Commissioner*, 126 F.2d 203 (2d Cir. 1942).

for federal income tax purposes. He reports the gains and losses realized from the project, claims deductions for interest, taxes, and depreciation, and capitalizes other expenditures that increase his basis in the project.⁹ After completing the project, he liquidates the straw corporation and transfers title to the project to himself, if the corporation held record legal title to the real estate.

In essence, the IRS's position is that the straw corporation, because of its active role in developing the project, is the actual taxpayer and should report any income and gains and deduct any expenses and losses realized from the project. Acceptance of the IRS's position shifts several tax consequences of the project from the real taxpayer to the straw corporation. First, attributing expenses and losses to the straw corporation increases the real taxpayer's taxable income dollar for dollar in the amount of the losses reallocated to the straw corporation. This results in a larger income tax for the real taxpayer,¹⁰ and shifts any losses to the straw corporation, which typically cannot use them as effectively as the real taxpayer. Second, if the IRS treats the straw corporation as the actual taxpayer, it may also treat any distributions from the straw corporation to the real taxpayer as dividend income, return of capital, or gain from the sale or exchange of property.¹¹ In addition, the real taxpayer may be forced to recognize any gain he realizes upon dissolution or liquidation of the straw corporation.¹² Finally, the real taxpayer

9. Organizational and development costs, engineering and architectural expenses, and other capital expenditures are added to the basis of the capital asset with respect to which they are incurred. These expenses cannot be deducted as "ordinary and necessary," either as business expenses under I.R.C. § 162, or as expenses of "management, conservation, or maintenance" under I.R.C. § 212.

10. Since most investors in tax shelters are high tax bracketed taxpayers, the resulting tax to the real taxpayer is usually fifty percent or more of the dollars shifted from the real taxpayer to the straw corporation. The Internal Revenue Service, pursuant to I.R.C. § 6601, also adds an interest charge to the amount of the determined tax deficiency. In addition, the IRS may seek to impose penalties on the corporation for failure to file its tax returns and pay the tax. *See, e.g.,* *Paymer v. Commissioner*, 150 F.2d 334 (2d Cir. 1945).

11. I.R.C. §§ 301, 312, 316. *See, e.g.,* *Collins v. United States*, 386 F. Supp. 17 (S.D. Ga. 1974), *aff'd per curiam*, 514 F.2d 1282 (5th Cir. 1975). For a thorough discussion of whether distributions from a corporation should be treated as dividends, returns of capital, or gains from sale or exchange of property, see BITTKER & EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* ch. 7 (3d ed. 1966).

12. *See generally* I.R.C. § 302 (redemptions) and I.R.C. § 331 (partial and complete liquidations). In the case of certain liquidations, if the shareholders make an election under I.R.C. § 333, the gain may not be recognized. *See* I.R.C. § 333. A

may lose the advantage of the investment tax credit¹⁵ and accelerated depreciation methods.¹⁴

This Article will explore the history and legal foundation of the IRS's present position, outline alternative arguments that can be raised by a real taxpayer involved in an IRS audit, and suggest possible tax planning considerations.

II. DISREGARD OF THE STRAW CORPORATION

Historically, the real taxpayer has argued that he should be treated as sole owner of the project for tax purposes and that the IRS should disregard¹⁶ the straw corporation because the corporation's activities were minimal. Under the principle enunciated by the Supreme Court in *Moline Properties, Inc. v. Commissioner*,¹⁶ however, courts normally do not disregard corporate entities because "[t]he doctrine of corporate entity fills a useful purpose in business life."¹⁷

Thompson, the real taxpayer in *Moline*, organized Moline Properties, Inc. in 1928 as a security device in connection with his Florida real estate. The mortgagee of his real estate suggested that Thompson transfer all his real property to the corporation, which would assume the outstanding mortgages on the property. Thompson therefore transferred the property to Moline Properties, Inc. in exchange for all of its stock, and then transferred the stock to a voting trustee appointed

straw corporation would not want to so elect because to do so would be inconsistent with the straw corporation's position that it is a mere conduit for the real taxpayer. Several options are available to the shareholders when distributing the assets of the straw corporation. At the time the straw corporation is challenged, however, the assets usually have been distributed to the real taxpayer and those options are already foreclosed.

It should also be noted that when appreciated property is transferred to a corporation for any purpose, the appreciation is not recognized at the time of the transfer to the corporation, but may be recognized when the corporation subsequently transfers the property, I.R.C. § 311(d).

13. When the real taxpayer reacquires the real property, he may not be considered "first user" of the property and therefore may be precluded from claiming the investment tax credit. I.R.C. § 48(b). See also I.R.C. § 48(c) and Treas. Reg. § 1.48-3 (1964), relating to whether limited investment credit is available for "Section 38 property."

14. See, e.g., I.R.C. §§ 167(j), (k). See generally 4 J. MERTENS, LAW OF FEDERAL INCOME TAXATION § 23 (1973).

15. The term "disregarded" in this article is synonymous with the word "ignored." A corporation which is not disregarded is a separate entity and will be recognized as such for federal income tax purposes.

16. 319 U.S. 436 (1943).

17. *Id.* at 438.

by his mortgagee and other creditors. From 1928 to 1933, Moline Properties assumed certain of Thompson's obligations, instituted a lawsuit to remove restrictions on its real property, and defended several condemnation proceedings. Thompson paid all expenses incurred by Moline Properties in connection with the lawsuits and condemnation proceedings. In 1933, after Thompson caused the mortgages to be satisfied, the trustee transferred the stock of Moline Properties to Thompson. The corporation continued to exist, and in 1934 it leased one of its lots and initiated a sales program to sell its real property. On its 1934 and 1935 corporate income tax returns, Moline Properties reported a loss and a gain, respectively, from the sale and operation of its real estate. By 1936, the corporation had sold all the real estate, and had substantial gains on the sales made in 1936. During its existence, the corporation kept no books, maintained no bank accounts, and owned no assets other than the real property described above.¹⁸

Upon the advice of his accountant, Thompson filed a claim in 1936 for a refund of income taxes paid by the corporation in 1935, asserting that Moline Properties should be disregarded for tax purposes and the gain on the sales of property taxed to him personally. Thompson also treated the substantial gain from the 1936 real estate sales as his personal gain. The Commissioner argued that Moline Properties was a separate taxable entity that should be taxed on the gain from the sales, and that Thompson had received dividends when Moline Properties distributed money and property to him. The Supreme Court accepted the Commissioner's position and refused to disregard the corporation for tax purposes. The Court found that Moline Properties gave Thompson special advantages,¹⁹ and was not his alter ego. The Court reasoned:

Whether the purpose be to gain an advantage under the laws 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

18. *Id.* at 437-38.

19. The taxpayer in *Moline* argued that Thompson's creditors coerced him to form the corporation. The Supreme Court concluded that this argument merely emphasized the taxpayer's separate and distinct existence, and also supported a finding that creation of the corporation conferred advantages on Thompson. Having accepted the advantages the corporation offered, Thompson was also forced to accept the tax disadvantages. See notes 34-36 *infra* and accompanying text for a discussion of the agency aspects of the *Moline* case.

carrying on of business by the corporation, the corporation remains a separate taxable entity.²⁰

A literal reading of *Moline* suggests a disjunctive test for determining whether a corporation's existence will be disregarded. Under this test, a corporation is a separate taxable entity if its purpose is: (1) a business purpose which "is the equivalent of business activity;" or (2) a business purpose which "is followed by the carrying on of business."²¹ Over the years, this test has been abbreviated to (1) business purpose or (2) business activity.²²

In nearly all post-*Moline* cases in which the issue was raised,²³ the straw corporations had engaged in substantial business activity,²⁴ and

20. 319 U.S. at 438-39.

21. *Moline Properties, Inc. v. Commissioner*, 319 U.S. 436, 439 (1943).

22. *Rogers v. Commissioner*, 34 T.C.M. (CCH) 1254, 1256 (1975).

23. Prior to *Moline* courts struggled with the question of when to disregard a corporation for federal income tax purposes, but did not develop a uniform principle of law. For cases prior to 1943 holding that the corporation was a distinct and separate entity, see, e.g., *New Colonial Co. v. Helvering*, 292 U.S. 435 (1934) (purchasing corporation not disregarded and could not deduct the net loss carryovers of the purchased corporation); and *Burnet v. Commonwealth Improvement Co.*, 287 U.S. 415 (1932) (corporation which had sold stock to an estate and had filed corporate income tax returns on its business transactions not disregarded).

For cases prior to 1943 holding that a corporation would be disregarded, see, e.g., *Southern Pac. Co. v. Lowe*, 247 U.S. 330 (1918) (corporate tax status ignored where another corporation owned all the taxpayer corporation's outstanding shares, property, and funds, and dominated its affairs and operations); *United States v. Brager Bldg. & Land Corp.*, 124 F.2d 349 (4th Cir. 1941) (corporate tax status ignored where corporation held title to real estate for a partnership); *Inland Dev. Co. v. Commissioner*, 120 F.2d 986 (10th Cir. 1941) (corporate tax status ignored where corporation's only activity was holding of a lease to oil producing property); *North Jersey Title Ins. Co. v. Commissioner*, 84 F.2d 898 (3d Cir. 1936) (corporate tax status ignored where corporation was formed merely to protect another corporation from publicity and was operated as a division of that corporation); *112 West 59th Street Corp. v. Helvering*, 68 F.2d 397 (D.C. Cir. 1933) (corporate tax status ignored where corporation held title to property merely to facilitate resale during actual owner's absence); *Carling Holding Co. v. Commissioner*, 41 B.T.A. 493 (1940) (corporate tax status ignored where corporation was formed to hold title to real estate during foreclosure); *Mayer v. Commissioner*, 36 B.T.A. 117 (1937) (corporate tax status disregarded where corporation held title to real estate for a partnership).

24. See, e.g., *Strong v. Commissioner*, 66 T.C. 12 No. 1 (April 5, 1976). The straw corporation held record title to the assets, granted easements, obtained an insurance policy on the building, named itself as the insured, and negotiated loans.

See also *Elot H. Rafferty Farms, Inc. v. United States*, 511 F.2d 1234 (8th Cir. 1975) (straw corporation held record title to assets, defended a law suit, maintained its own books and records, managed property, collected rent, negotiated loans, executed leases in its own name, and held itself out to the public as a separate entity); *Taylor v. Com-*

the courts refused to disregard them for tax purposes;²⁵ in only four cases were the straw corporations' activities so insubstantial that they could be disregarded.²⁶ Thus, despite occasional success by the real taxpayer, the courts have been quite reluctant to disregard straw corporations. The following four cases, decided recently by the Tax Court, demonstrate that courts will almost invariably recognize straw corporations for tax purposes.

In *Preferred Properties, Inc. v. Commissioner*,²⁷ the real taxpayer, Mr. Kline, owned all the stock of the straw corporation, Preferred Properties, Inc. The corporation held title to real estate, borrowed money,

missioner, 445 F.2d 455 (1st Cir. 1971) (straw corporation held record title to assets, established corporate checking account, executed deed and mortgage, collected receipts, negotiated and made loans, and held itself out to the public as a separate entity); *Thomlinson v. Miles*, 316 F.2d 710 (5th Cir. 1963) (straw corporation held record title to assets, established corporate checking account, sold timber in its own name, negotiated sales of land, paid taxes, received purchase money security deed and release of the security deeds); *Harrison Property Mgmt. Co. v. United States*, 475 F.2d 623 (Ct. Cl. 1973), *cert. denied*, 414 U.S. 1130 (1974) (straw corporation held record title to assets, established a corporate checking account, joined with individuals in law suits, maintained corporate books and records, collected rent, executed leases, and held corporate meetings).

25. *See, e.g.*, *Elot H. Rafferty Farms, Inc. v. United States*, 511 F.2d 1234 (8th Cir. 1975); *Taylor v. Commissioner*, 445 F.2d 455 (1st Cir. 1971); *Britt v. United States*, 431 F.2d 227 (5th Cir. 1970); *Greer v. Commissioner*, 334 F.2d 20 (5th Cir. 1964); *Thomlinson v. Miles*, 316 F.2d 710 (5th Cir. 1963); *Hagist Ranch, Inc. v. Commissioner*, 295 F.2d 351 (7th Cir. 1961); *Commissioner v. State-Adams Corp.*, 283 F.2d 395 (2d Cir. 1960); *Collins v. United States*, 386 F. Supp. 17 (S.D. Ga. 1974), *aff'd per curiam*, 514 F.2d 1282 (5th Cir. 1975); *Harrison Property Mgmt. Co. v. United States*, 475 F.2d 623 (Ct. Cl. 1973), *cert. denied*, 414 U.S. 1130 (1974); *Carver v. United States*, 412 F.2d 233 (Ct. Cl. 1969); *Strong v. Commissioner*, 66 T.C. 12 No. 1 (April 5, 1976); *Simpson v. Commissioner*, 35 T.C.M. (CCH) 710 (1976); *Preferred Properties, Inc. v. Commissioner*, 35 T.C.M. (CCH) 68 (1976); *Rogers v. Commissioner*, 34 T.C.M. (CCH) 1254 (1975); *Stillman v. Commissioner*, 60 T.C. 897 (1973); *Bolger v. Commissioner*, 59 T.C. 760 (1973); *Bass v. Commissioner*, 50 T.C. 595 (1968); *Weigman v. Commissioner*, 47 T.C. 596 (1967); *Siegel v. Commissioner*, 45 T.C. 566 (1966); *Sas-Jaworsky v. Commissioner*, 24 T.C.M. (CCH) 630 (1965), *aff'd per curiam*, 379 F.2d 337 (5th Cir. 1967); *Rothafel v. Commissioner*, 24 T.C.M. (CCH) 1524 (1965); *Pollack v. Commissioner*, 23 T.C.M. (CCH) 433 (1964); *Pickus v. Commissioner*, 22 T.C.M. (CCH) 1791 (1963); *Barker v. Commissioner*, 22 T.C.M. (CCH) 1649 (1963); *Nutt v. Commissioner*, 39 T.C. 231 (1962); *Estate of Lichstein v. Commissioner*, 21 T.C.M. (CCH) 1335 (1962); *Caswal Corp. v. Commissioner*, 19 T.C.M. (CCH) 757 (1960); *K-C Land Co. v. Commissioner*, 19 T.C.M. (CCH) 183 (1960).

26. *See, e.g.*, *Noonan v. Commissioner*, 451 F.2d 992 (9th Cir. 1971); *Paymer v. Commissioner*, 150 F.2d 334 (2d Cir. 1945); *Steinmetz v. Commissioner*, 32 T.C.M. (CCH) 969 (1973); *Davis v. Commissioner*, 29 T.C.M. (CCH) 749 (1970).

27. 35 T.C.M. (CCH) 68 (1976).

executed mortgages, and defended a lawsuit. In a memorandum opinion, the Tax Court summarily concluded that Preferred Properties, Inc., was a real entity that would not be disregarded for tax purposes.

The real taxpayer in *Strong v. Commissioner*²⁸ used the straw corporation, Heritage Village Apartments Co., to avoid New York's usury law limitations. The corporation's articles of incorporation stated broad corporate purposes. During its existence, the corporation executed numerous mortgages and financing documents. Certain internal documents of the real taxpayer, a partnership, recognized the use of a straw corporation. The straw corporation filed its tax return on a basis consistent with the partnership's; the corporation did not report any income or claim any losses. The Tax Court held that the straw corporation would not be disregarded in those circumstances.

In *Bolger v. Commissioner*,²⁹ the corporation in the space of one day acquired a piece of real estate in its name; made a lease with a solvent lessee; sold for the price of the purchased property its own interest-bearing negotiable corporate note to an institutional lender who agreed to collect the rent and simultaneously reduce the mortgage note; and conveyed the property to its shareholders for \$1.00. The transaction was designed to avoid state usury law restrictions, limit certain individuals' personal liability, and facilitate multiple-lender financing. The individual shareholders, who were the real taxpayers, argued that the corporation should be disregarded for tax purposes. The Tax Court, in an opinion considered by the full court, concluded that the corporation's

28. 66 T.C. 12 No. 1 (April 5, 1976). By a letter dated August 1976, the authors have been advised that this case is being appealed to the Second Circuit Court of Appeals.

Unfortunately, the terminology used by the Tax Court in *Strong* is somewhat different than the terminology used in this article. The *Strong* Court used the word "nominee" to describe what this article refers to as a "straw" corporation.

A careful reading of the opinion in *Strong* and the briefs submitted to the Tax Court reveal that the taxpayer did not advance an agency argument. Although some favorable indices of agency were present, the taxpayer's sole argument was that the corporation should be disregarded.

Another significant fact in *Strong* is that the real taxpayers, partners of a partnership, individually owned the straw corporation. Thus, even if an agency argument had been advanced, the real taxpayer probably could not have demonstrated that the principal-agent relationship was independent of the principal's controlling stock interest in the purported corporate agent. See notes 65 & 66 *infra* and accompanying text.

29. 59 T.C. 760 (1973). The ultimate result in *Bolger* was favorable to the taxpayer, but was based upon a theory other than disregard of the straw corporation. For a comprehensive discussion of the case, see Lurie, *Bolger's Building: The Tax Shelter That Wore No Clothes*, 28 TAX LAW REV. 355 (1973).

activities were sufficient to constitute "business activities followed by a valid business purpose," and that the corporation could not be disregarded. The court reached this result notwithstanding the fact that all the corporation's activities occurred on one day, whereas in previous cases the corporate activities extended over a period of time.

The real taxpayer in *Rogers v. Commissioner*³⁰ created a straw corporation, Armadillo Investment Co., to obtain a loan at an interest rate which would have been usurious under Missouri law if made to an individual.³¹ In connection with obtaining the loans, Armadillo renegotiated renewal loans, loaned money to another corporation, maintained bank accounts, and filed the required state corporate informational reports. The Tax Court, in a memorandum opinion, concluded that these activities warranted recognition of the corporation as a separate taxpayer, despite the corporation's minimal activities. Most corporations file state informational returns of some kind,³² and Armadillo's only other activities consisted of obtaining loans and maintaining a bank account to facilitate the loans.

The *Rogers* holding that the quantum of corporate activity is not controlling, and the *Bolger* conclusion regarding activities confined to a single day, indicate that one substantial business transaction is sufficient to cause a straw corporation to be recognized as a separate taxpayer for federal income tax purposes.

III. NOMINEE CORPORATIONS

Because courts invariably recognize straw corporations for federal income tax purposes, the real taxpayer who desires or needs to use a

30. 34 T.C.M. (CCH) 254 (1975).

31. Missouri law, MO. REV. STAT. § 408.030 (1969), provided that the maximum interest rate chargeable to an individual was eight percent per annum. On January 1, 1975, the limit was raised to ten percent. Even before the new provision became effective, however, corporations were not subject to maximum interest rates in their borrowings, and corporate vehicles for borrowing money were used extensively in Missouri, particularly during the high interest periods of 1973 and 1974. See notes 92-94 *infra* and accompanying text for discussion of the effect of repeal and amendment of usury law limitations.

32. In Missouri, for instance, a corporation must annually file a franchise tax return, MO. ANN. STAT. § 147.010 (Vernon Supp. 1976), and an annual registration form, MO. ANN. STAT. § 351.120 (Vernon Supp. 1976), to maintain its corporate standing. Also, federal law requires a corporation to file an income tax return. I.R.C. § 6012(a) (2). The suggestion that any corporation that files tax returns to comply with state and federal law must be recognized for tax purposes places far too much emphasis on the form, and ignores the substance, of the transaction.

corporation to develop a real estate project or similar tax sheltered investment should consider a different approach. An alternative that may preserve the desired tax consequences is a nominee corporation. A nominee corporation differs from a straw corporation in that the former is conceded to be a recognized entity for federal income tax purposes, but is characterized as an *agent* of the real taxpayer.³³

A. *National Carbide*

Thompson, the sole shareholder in *Moline*,³⁴ also argued that Moline Properties, Inc. should be disregarded for tax purposes because the corporation was his identity in a different form, or was his agent.³⁵ The Supreme Court rejected this argument, however, observing that "there was no actual contract of agency, nor the usual incidents of an agency relationship."³⁶

The Court elaborated on this corporate agency concept in *National Carbide Corp. v. Commissioner*.³⁷ In *National Carbide*, three wholly-owned subsidiaries of Air Reduction Corporation ("Airco") argued that they were agents of Airco, and that the court should determine income and excess profits taxes on that basis. Each subsidiary performed major aspects of Airco's business and operated strictly in accordance with a master contract with Airco. The contract provided that the subsidiaries were employed as agents to produce and sell certain products. The parent was to furnish capital, management, and officers for the subsidiaries. The contract required each subsidiary to turn over to Airco all profits in excess of six percent of the capital stock. The subsidiaries held title to all assets, and the subsidiaries' books reflected all capital advanced to them by Airco as accounts payable without interest. The officers of the subsidiaries and the parent were identical, and the

33. In *Schuh Trading Co. v. Commissioner*, 95 F.2d 404, 411 (7th Cir. 1938), the court stated:

The word nominee ordinarily indicates one designated to act for another as his representative in a rather limited sense. It is used sometimes to signify an agent or trustee. It has no connotation, however, other than that of acting for another, in representation of another

For this reason, the word "nominee" is clearly appropriate to describe the context in which a "nominee" corporation operates.

34. *Moline Properties, Inc. v. Commissioner*, 319 U.S. 436 (1943). See notes 16-20 *supra* and accompanying text.

35. *Id.* at 440.

36. *Id.*

37. 336 U.S. 422 (1949).

subsidiaries' directors merely ratified the actions of Airco's officers and directors.

The Commissioner argued that all income was taxable to the subsidiaries, whereas the taxpayers took the position that the income in excess of six percent was Airco's. The Commissioner and the taxpayers agreed that *Moline*, which had been decided six years earlier, required taxation of a corporate entity engaged in business activity, unless the corporation acted only as agent of its owner. The taxpayers, however, argued that a corporate agency exists and that the corporate entity may be disregarded for tax purposes when there is complete identity of stock ownership and control between the subsidiary and parent corporations.³⁸ The Tax Court agreed with the taxpayers.

Reversing the Tax Court's judgment, the Supreme Court held that identity of ownership and control of two corporations does not establish an agency relationship.³⁹ Emphasizing this point, the Court noted that Airco's control of the subsidiaries was no different from Thompson's control of *Moline Properties*; in both cases, control was achieved through stock ownership.

Nevertheless, the Court stated that it was "necessary to go farther" and to consider the corporate agency issue *distinct from* the identity issue.⁴⁰ Addressing the agency argument presented by the taxpayers, the Court reasoned:

[T]he contracts between Airco and petitioners by which the latter agreed to pay all profits above a nominal return to the former, [do not] on that account, become "agency" contracts within the meaning of our decisions. . . . Our decisions requir[e] that income be taxed to those who earn it, despite anticipatory agreements designed to prevent vesting of the income in the earners Of course one of the duties of a collection agent is to transmit the money he receives to his principal according to their agreement. But the fact that petitioners were required by contract to turn over the money received by them to Airco, after deducting expenses and nominal profits, is no sure indication that they were mere collection agents. Such an agreement is entirely consistent with the corporation-sole stockholder relationship whether or not any agency exists, and with other relationships as well.

38. 336 U.S. at 427.

39. *Id.* at 427-30. The Court stated, "ownership of a corporation and the control incident thereto have no different tax consequences when clothed in the garb of an agency rather than worn as a removable corporate veil." *Id.* at 430.

40. *Id.* at 430.

What we have said does not foreclose a true corporate agent or trustee from handling the property and income of its owner-principal without being taxable therefor. 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 whether receipt of income is attributable to the services of 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 relations with 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.*⁴¹

The Supreme Court concluded that Airco could not escape the adverse tax consequences inherent in the structure of the transaction,⁴² stating, "When we referred to the 'usual incidents of an agency relationship' in the *Moline Properties Case*, we meant just that—not the identity of ownership and control disclosed by the facts of this case."⁴³ Thus, a corporation wholly owned by the real taxpayer must be a *true corporate agent* of the taxpayer in order to shift the incidence of taxation from itself to the real taxpayer.

Several cases subsequent to *Moline* and *National Carbide* presented the sole question whether the corporation should be disregarded for federal income tax purposes;⁴⁴ these cases are irrelevant to determining whether a corporation is a true corporate agent (*i.e.*, a nominee corporation). In several other post-*Moline* and *National Carbide* cases, the taxpayers argued that the corporation should either be disregarded or characterized as a true corporate agent.⁴⁵ In each case, however, the court rejected both arguments,⁴⁶ holding that the corporation had en-

41. *Id.* at 435-37 (emphasis added).

42. The Court found that the taxpayers' agency argument in *National Carbide* contained a fatal fallacy, *i.e.*, Airco had attempted to *avoid* the burdens of principalship in establishing this very arrangement. *Id.* at 438 n.21.

43. *Id.* at 439.

44. *See* cases cited note 25 *supra*.

45. *See, e.g.*, *Elot H. Rafferty Farms, Inc. v. United States*, 511 F.2d 1234 (8th Cir. 1975); *Collins v. United States*, 386 F. Supp. 17 (S.D. Ga. 1974), *aff'd per curiam*, 514 F.2d 1282 (5th Cir. 1975); *Preferred Properties, Inc. v. Commissioner*, 35 T.C.M. (CCH) 68 (1976); *Rogers v. Commissioner*, 34 T.C.M. (CCH) 1254 (1975).

46. The very fact that taxpayers' counsel were forced to argue both positions indicates the weakness of both positions. The "disregard" concept and the agency concept are mutually exclusive, and should never be advanced simultaneously. The taxpayer should advance the stronger of the two positions based on the facts of the particular case.

gaged in too many activities to be disregarded, and that the taxpayer had offered no proof that the purported agent was imbued with the usual incidents of agency or had in fact acted as an agent.⁴⁷

B. Test for Nominee Corporations

To demonstrate that a corporation is a true corporate agent when the principal owns a controlling stock interest in the nominee corporation, the nominee must prove both that (1) the usual incidents of an agency relationship exist; and (2) the corporation's relations with its principal are not dependent on the principal's ownership of a substantial part of the corporation.⁴⁸ Each component of this test must be analyzed and understood independently.

National Carbide presented the question whether the subsidiaries were "collection agents" of the parent, Aircor. The Supreme Court rejected the taxpayers' position, stating:

Of course one of the duties of a *collection agent* is to transmit the money he receives to his principal according to their agreement. But the fact that petitioners were required by contract to turn over the money received by them to Aircor, after deducting expenses and nominal profits, is no sure indication that they were *mere collection agents*.⁴⁹

It is critical to recognize that *National Carbide* dealt with only one type of agent—a collection agent. Footnote 17 of *National Carbide* refers to the *Restatement*⁵⁰ of Agency section 427,⁵¹ which appears

47. *Elot H. Rafferty Farms, Inc. v. United States*, 511 F.2d 1234, 1239 (8th Cir. 1975); *Collins v. United States*, 386 F. Supp. 17 (S.D. Ga. 1974), *aff'd per curiam*, 514 F.2d 1282 (5th Cir. 1975); *Simpson v. Commissioner*, 35 T.C.M. (CCH) 710, 716 (1976); *Preferred Properties, Inc. v. Commissioner*, 35 T.C.M. (CCH) 68, 70 (1976); *Rogers v. Commissioner*, 34 T.C.M. (CCH) 1254, 1258 (1975).

48. Rev. Rul. 31, 1975-1 C.B. 10, 13. The Ruling states that "[i]n any case in which a purported principal owns a controlling stock interest in its purported corporate agent, whether an agency relationship will be recognized for Federal income tax purposes is determined by reference to *more than* the presence of the usual incidents of an agency relationship." (emphasis added). This statement gives rise to the interesting negative inference that in a case in which a purported principal owns *less than* a controlling stock interest, reference should be made to *no more than* the presence of the usual incidents of an agency relationship. Thus, in a case in which a principal owns *less than* a controlling stock interest, establishing a true corporate agency may require only a demonstration of the "usual incidents of an agency relationship."

49. *National Carbide Corp. v. Commissioner*, 336 U.S. 422, 436 (1949) (emphasis added).

50. The RESTATEMENT OF AGENCY in effect in 1943 has been superceded by the RESTATEMENT (SECOND) OF AGENCY (1957).

51. RESTATEMENT OF AGENCY § 427 (1933) provides:

under the general heading "Duties and Liabilities of Particular Kinds of Agents." The Restatement mentions many kinds of agents—Agents in Charge of Lands or Chattels,⁵² Agents Holding a Title,⁵³ Agents to Buy or Sell,⁵⁴ Agents to Make Investments,⁵⁵ Agents to Make Collections,⁵⁶ Agents Who Have Made Collections⁵⁷—but only one kind of agency was involved in *National Carbide*. Only in the context of *collection* agents and the peculiar facts of *National Carbide* did the Supreme Court focus on "some of the relevant considerations"⁵⁸ to the existence of a true corporate agency. Those considerations included: (1) whether the corporation operates in the name and for the account of the principal,

§ 427 AGENTS WHO HAVE MADE COLLECTIONS

The duties of an agent who has received goods or money for the principal depend upon the agreement between them. Unless otherwise agreed, the agent has a duty to use care to keep them safely until they are remitted or delivered to the principal, and to deliver them to the principal upon his demand when the amount due him has been ascertained. The agent may also have a duty to use care to notify the principal of the collection, or to remit the goods or money to him within a reasonable time.

RESTATEMENT (SECOND) OF AGENCY § 427 (1957) provides:

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52. RESTATEMENT (SECOND) OF AGENCY § 422 (1957). This section could be directly applicable to a nominee corporation. The general rule of § 422 below is identical to that contained in the first *Restatement*:

§ 422 AGENTS IN CHARGE OF LAND OR CHATTELS

Unless otherwise agreed, an agent who has charge of land or chattels for his principal is subject to a duty to the principal to use reasonable care in their protection, to use them only in accordance with the directions of the principal and for his benefit, and to surrender them upon demand or upon the termination of the agency.

53. RESTATEMENT (SECOND) OF AGENCY § 423 (1957) provides:

§ 423 AGENTS HOLDING A TITLE

Unless otherwise agreed, an agent who holds the title to something for the principal is subject to a duty to the principal to use reasonable care in the protection of the title which he so holds, to act in accordance with the directions of the principal, to use it only for the principal's benefit, and to transfer it upon demand or upon the termination of the agency.

This provision is also applicable to the normal activities of a nominee corporation as described in this Article.

54. RESTATEMENT (SECOND) OF AGENCY § 424 (1957).

55. *Id.* § 425.

56. *Id.* § 426.

57. *See* note 51 *supra*.

58. *National Carbide Corp. v. Commissioner*, 336 U.S. 422, 437 (1949).

binds the principal by its actions, and transmits money received to the principal; and (2) whether receipt of income is attributable to the principal's employees and assets.⁵⁹ Most of these considerations appear in the comments of section 427 of the *Restatement*; the others derive from general rules of agency law. Since the Supreme Court specifically stated that these were only "some of the relevant considerations in determining whether a true agency exists," and since there are many different kinds of agency, it should be evident that the considerations stated in *National Carbide* do not control in every instance in determining whether a corporation is a true corporate agent. In cases involving corporate agents who are not collection agents, therefore, other considerations, such as those cited in other sections of the *Restatement of Agency*, should control. For instance, a nominee corporation in a real estate venture could be characterized according to the rules and comments under section 422 or section 423 of the *Restatement*.⁶⁰

In determining whether the "usual incidents" or "normal duties" of an agency relationship exist,⁶¹ therefore, the particular type of agency must be carefully scrutinized. The corporation's status as an agent should be determined on the basis of the entire law of agency, not just the few factors⁶² listed in *National Carbide*. Any other conclusion would completely misconstrue the facts and holding of *National Carbide*.

The second component of the test for determining true corporate agency is whether the corporation's relationship with its principal depends upon its ownership by the principal.⁶³ The IRS has ruled that if the principal is sole owner or owns a controlling stock interest of the agent, the agent's activities and its relationship to the principal must be independent of the fact that it is owned by that principal. The IRS stated in Revenue Ruling 75-31:

If a corporation is a true agent, its relations with its principal must not be dependent upon the fact that it is owned in substantial part by the principal. *National Carbide Corporation v. Commissioner*, 336 U.S. 422 (1949). The significant criteria that must be examined are

59. *Id.*

60. See notes 52 & 53 *supra*.

61. See note 48 *supra* and accompanying text.

62. See note 59 *supra* and accompanying text.

63. See note 48 *supra*.

whether "the so-called 'agent' would have made the agreement if the so-called 'principals' were not its owners, and conversely whether the 'principals' would have undertaken the arrangement if the 'agent' were not their corporate creature." *Harrison Property Management Co., Inc. v. United States*, 475 F.2d 623, 627 (Ct. Cl. 1973), *cert. denied* 414 U.S. 1130, *reh. denied* 415 U.S. 952 (1974). Thus, for a true agency relationship to exist, it must be shown that the principal's control over the corporation's functions in an agent's capacity rests on a relationship independent of any control attributable to stock ownership.⁶⁴

Under the second component of the test, *Moline, National Carbide, Harrison*,⁶⁵ and *Stillman*⁶⁶ were all properly decided against the taxpayer, because in none of those cases was there a showing that the respective corporations acted for independent reasons.

In *Carver v. United States*,⁶⁷ on the other hand, the taxpayer partially fulfilled the second component of the agency test. In 1935, Carver, a lawyer, and his client, Pipkin, joined together to purchase eight hundred acres of real estate. Chase National Company, Inc., a corporation owned entirely by Carver, took title to the real estate, obtained a loan, and opened a bank account. Pipkin assumed responsibility for payment of the loan with funds contributed by himself and Carver. In 1955, Pipkin negotiated a sale of the land, and the sale proceeds were paid directly to Pipkin and Carver without going through Chase National.

The Commissioner argued that Chase National should be recognized as the actual taxpayer for federal income tax purposes. Carver took the position that Chase National was the corporate agent of Carver and Pipkin, and that the court should attribute the gain from the sale of

64. Rev. Rul. 31, 1975-1 C.B. 10, 13.

65. *Harrison Property Mgmt. Co. v. United States*, 475 F.2d 623 (Ct. Cl. 1973), *cert. denied*, 414 U.S. 1130 (1974).

66. *Stillman v. Commissioner*, 60 T.C. 897 (1973). It is interesting to note that in *Stillman* the principal (real taxpayer) was a general partnership consisting of four partners, and the purported corporate agent was owned by three of those four general partners. The partners' three-quarters interest in the corporate agent would probably fall within the concept of "substantial" ownership specified in Revenue Ruling 75-31, *supra* note 64. The Tax Court rejected the argument accepted by the Court of Claims in *Carver*, *see* notes 67 & 68 *infra* and accompanying text, that if the corporation acted as an agent for one nonowner general partner, it acted as an agent for all the partners. In *Stillman*, the Tax Court concluded that the nonowner partner was only a "passive" investor, not as "active" as Pipkin in the *Carver* case, and that the *Carver* logic was inapplicable.

67. 412 F.2d 233 (Ct. Cl. 1969).

the real estate to the real taxpayers. The Court of Claims held that the corporation had acted as a true corporate agent of Carver and Pipkin, even though it was owned entirely by Carver, a principal:

Chase National was either the agent of or trustee for Mr. Pipkin, who was admittedly not an owner or stockholder of Chase National. If that relationship was valid for Mr. Pipkin, it must have been equally valid, under all of the circumstances, for Mr. Carver.⁶⁸

Of all the cases in which the real taxpayer relied on a theory of true corporate agency, however, the taxpayer succeeded only in *Carver*, and even in *Carver* the success was only partial.⁶⁹ Thus, if the principal owns all or a controlling stock interest of the purported corporate agent, even if the relationship exhibits the "usual incidents of an agency relationship," the nominee corporation will probably be unable to prove that its activities were unrelated to the stock ownership of its principal (the real taxpayer).

The Tax Court has not explicitly held that it will always rule against the owner-principal on the agency issue. In the *Bolger*⁷⁰ case, however, the Tax Court stated that it could not find an agency relationship because creation of a true agency relationship would have been "self-defeating in that it would have seriously endangered, if not prevented, the achievement of those objectives which . . . gave rise to the use of the corporations, namely, the avoidance of restrictions under State laws."⁷¹ This "self-defeating" notion, if broadly applied to all cases presenting an agency argument, could effectively eliminate the use of nominee corporations and completely erode *National Carbide*. Subsequently, in the *Stillman* case,⁷² the Tax Court discussed six relevant facts that weighed against a finding that a corporation was a true corporate agent: (1) the intent to act as a nominee corporation developed only after the real taxpayer (principal) was unable to develop the property itself; (2) the corporate resolutions did not acknowledge an agency capacity; (3) the parties had not executed an agency agreement; (4) the nominee corporation engaged in substantial activity; (5) the real taxpayer paid no compensation to the nominee corporation; and (6)

68. *Id.* at 240.

69. The Court of Claims held that Chase National was not a true corporate agent when it acted exclusively for Carver for his personal investments. See notes 78-79 *infra* and accompanying text.

70. 59 T.C. 760 (1973).

71. *Id.* at 766.

72. *Stillman v. Commissioner*, 60 T.C. 897 (1973).

the nominee corporation did not act as an agent for other parties. Had these facts been favorably determined, the Tax Court presumably might have concluded that the corporation in *Stillman* was a true corporate agent, able to act on behalf of its owner-principal without shifting the incidence of taxation from the owner-principal to itself.

The IRS has issued Revenue Ruling 75-31,⁷³ which recognizes the existence of a true corporate agency under the following assumed facts: *X*, a limited partnership organized under the laws of New York, owned the project; *D*, a corporation, was managing general partner of and owned a 1% interest in *X*. *D* organized *H*, a limited-profit housing company, with nominal capital to receive a state loan for the project; *H* was also a general partner of *X*. Under New York law a state agency supervised the development and operation of the project, and the state approved *H*'s initial charter because the corporation served a public purpose. *H* held title to the property, filed a Form 56⁷⁴ annually, had no interest in the profits or losses of *X*, and received no compensation from *X*. The limited partners of *X* owned no stock in *H*.

The issue resolved by the Ruling was whether *X* would be treated as owner of the project for federal income tax purposes; *i.e.*, whether *H* held title to the property as agent for *X* or on its own behalf. Applying the two-pronged test stated above,⁷⁵ the Ruling mentioned that (1) *H*'s certificate of incorporation and *X*'s partnership papers, which specifically acknowledged that *H* held title to the project on behalf of *X*, and (2) noncontracting parties' knowledge of the existence of the agency relationship (*i.e.*, public record), revealed the usual incidents of an agency relationship. Applying the second component of the test, the Ruling concluded that *H*'s activities did not depend on *D*'s ownership of *H*; rather, under New York law *H*'s activities were controlled by a state agency and by the contractual and legal obligations *inter sese*.⁷⁶

73. Rev. Rul. 31, 1975-1 C.B. 10.

74. A Form 56, Notice of Fiduciary Relationship, must be filed because an agency relationship involves fiduciary duties. RESTATEMENT (SECOND) OF AGENCY § 1 (1957).

75. See note 48 *supra* and accompanying text.

76. Baker and Rothman believe that this conclusion may be based at least partially on the "peculiar nature of public housing financing transactions" and that the Ruling may therefore be "of limited assistance to the taxpayer outside the public housing area." Baker & Rothman, *Straw Corporations: New Cases Shed Light on Tax-Recognition Criteria*, 45 J. TAX. 84, 87 (1976). Until the real taxpayer prevails in a court case as in *Carver*, however, these Rulings represent the best current legal authority to validate a true corporate agency.

The Revenue Ruling is interesting because it presents a limited factual pattern in which, because of state law, control of the agent is vested in part in an entity other than its principal or its owner. The Ruling is also important because it contains the Internal Revenue Service's articulation of the test of true corporate agency, and its conclusion that *H* was in fact a corporate agent of *X*.

In some cases, therefore, it is possible for the nominee corporation to be recognized as a true corporate agent of the owner-principal. In *Carver*,⁷⁷ for example, the court held that Chase National acted as a true corporate agent in the Carver-Pipkin transaction, even though one of the real taxpayers owned 50% of Chase National's stock. Similarly, in Revenue Ruling 75-31, *D*, owner of all the stock of the title-holding corporation, *H*, was a 1% partner of *X*. By comparison, in *Stillman*, in which the real taxpayers failed to prove an agency relationship, three of the four principal parties owned all the stock of the purported corporate agent. The likelihood of a court recognizing a nominee corporation as a true corporate agent for income tax purposes in an owner-principal situation evidently increases as the extent of the principal's ownership of the corporate agent decreases.⁷⁸ The principal who owns a small or noncontrolling percentage of stock in the nominee corporation is more likely to satisfy the second component of the test: since he cannot control the actions of the nominee corporation through stock ownership, the nominee corporation's actions are much more likely to appear independent.

C. Non-Owner-Principal Situations

The tax treatment of a nominee corporation in which the principal owns no stock presents an interesting variation of the corporate agency argument. Significantly, all the cases discussed above involved principals who owned at least some portion of the agents. In this context, the *Carver* case is educational. In *Carver*, the alleged tax deficiencies arose out of transactions involving Carver alone or Carver and a client jointly (e.g., the Pipkin transaction). Significantly, the Commissioner did not assess deficiencies on the basis of transactions carried out in the nominee corporation's name for Carver's clients.⁷⁹ *Carver*,

77. *Carver v. United States*, 412 F.2d 233 (Ct. Cl. 1969).

78. See note 48 *supra*.

79. 412 F.2d at 234, 240.

therefore, suggests that a nominee corporation wholly owned by a non-principal need not meet the dual tests of true corporate agency established in *National Carbide* and its progeny and articulated by the IRS in Revenue Ruling 75-31.

Two approaches might be adopted to determine the real party in interest in cases in which the real taxpayer owns no stock in the nominee corporation. One such test can be inferred from Revenue Ruling 76-26.⁸⁰ Revenue Ruling 76-26 involved *X*, a limited partnership organized under the laws of New York to build and operate a low income housing project. *X* had three general corporate partners: *M*, the managing partner; *S*, the nominally-capitalized corporation holding title; and *P*, the sole shareholder of *S*. A state agency formed *S* for the purpose of securing a loan, and transferred all the shares of *S* to *P*, subject to a collateral pledge agreement and irrevocable proxy. Only the limited partners made equity contributions to *X*; no limited partner of *X* owned an interest in *S*, and the limited partners collectively owned a 97% interest in *X*'s profits, losses, income, gains, and credits. *M* owned a 3% interest in *X*, but neither *S* nor *P* held any interest in *X*. The Ruling did not disclose the ownership of *P*. Neither *X* nor any of the limited partners paid any compensation to *S*. Public declarations of record disclosed *S*'s capacity vis-a-vis *X* and that *S* would hold title to the property for *X*. *S* annually filed a Form 56.

The pertinent issues presented in the Ruling were whether *X* or *S* would be treated as owner of the project for federal income tax purposes, and whether *S* held title to the project as an agent on behalf of *X* or on its own behalf. Since *P* had no interest in the income, profits, gains, losses, or credits of *X*, *X* was not an owner-principal of *P* or *S*. Citing Revenue Ruling 75-31's two-step analysis "as applied to the instant case,"⁸¹ Revenue Ruling 76-26 stated that the test is "(1) whether evidence of [an] agency relationship exists between *S* and *X*, and if so, (2) whether the relationship results merely from the stockholder relationship between *S* and *P*."⁸² This test does not refer to the "usual incidents of an agency relationship" or "independence" factors specified in Revenue Ruling 75-31. Instead, Revenue Ruling 76-26 seems to set forth the less stringent standard of "evidence of an agency relationship;" apparently partnership papers and mutual acknowledgments

80. Rev. Rul. 76-26, 1976-4 I.R.B. 5.

81. *Id.*

82. *Id.*

might suffice without proof of the “usual incidents” of agency. Furthermore, the Ruling suggests a “merely from,” as opposed to an “independence” test, regarding control through stock ownership. Establishing a true corporate agency relationship, therefore, would appear to be easier under the standard set forth in Revenue Ruling 76-26 than under the test enunciated in Revenue Ruling 75-31.⁸³

A second possible test to govern non-owner-principal cases could be derived from *Connelly v. Commissioner*.⁸⁴ In *Connelly*, a case involving an individual acting as a nominee for another individual, the Tax Court stated:

[W]e have found certain factors are helpful in deciding the factual issue of who is the owner of property for tax purposes. These factors include the intent of the parties, which party controlled and enjoyed the property, and the financial stake of the parties.⁸⁵

In *Connelly*, the taxpayer's son-in-law, Van Dyke, wanted to lease 800,000 acres of land in Alaska but understood that federal regulations prohibited him from leasing more than 300,000 acres. To accomplish his goal, therefore, he arranged for lease applications to be transferred to Mrs. Connelly. Van Dyke and Mrs. Connelly agreed that she would be merely the nominal owner of the property. Mrs. Connelly's only function with respect to the lease applications was to allow Van Dyke to accomplish indirectly what he believed he could not do directly. Applying its test to these facts, the Tax Court found that Mrs. Connelly was a nominee for the real taxpayer, Van Dyke:

Mrs. Connelly had no independent control over the lease applications; nor did she enjoy any of the benefits derived from them. It was Mr. Van Dyke who controlled the property, used it for his purposes, and enjoyed the benefits therefrom. Every action Mrs. Connelly took with respect to the applications was pursuant to a request from Mr. Van Dyke. Every aspect of Mrs. Connelly's involvement in the transaction was arranged, orchestrated, and implemented by Mr. Van Dyke.⁸⁶

The tests promulgated in Revenue Ruling 76-26 and in *Connelly* make sense. Both tests lessen the requirements for proving that a nominee

83. The authors have been informally advised, however, that the Internal Revenue Service is interpreting Revenue Ruling 76-26 to require proof of “independence,” and that the Service is not relaxing the test of corporate agency as a result of Revenue Ruling 76-26.

84. 34 T.C.M. (CCH) 1429 (1975).

85. *Id.* at 1431.

86. *Id.* at 1431-32.

corporation is a true corporate agent in non-owner-principal situations, and emphasize the substance rather than the form of the transaction.⁸⁷

D. *Weaknesses of Corporate Nominees*

When a real taxpayer asserts an agency argument, the Commissioner may counter by arguing that the principal-agent relationship is void. The Commissioner might argue, for example, that if the principal retains a corporate agent to perform an act (*e.g.*, secure a loan)⁸⁸ that the principal could not have performed itself, or which would be illegal if done by the principal, then the principal-agent relationship should not be recognized for tax purposes.

This argument, although advanced by the Commissioner in prior cases,⁸⁹ is unsound. In both Revenue Rulings 75-31 and 76-26, a corporation secured a loan on behalf of a limited partnership which the limited partnership itself could not have obtained. Thus, the Commissioner has implicitly conceded in two Revenue Rulings the weakness of any voidness claim. Furthermore, the Tax Court has already rejected the argument that an agency relationship should not be acknowledged where the agent's act would be illegal if done by the principal. In *Connelly*, for example, the Tax Court concluded that whether or not Van Dyke (the real taxpayer) had violated certain federal regulations was irrelevant for tax purposes. In other words, the possible illegality of Van Dyke's conduct did not affect the tax result of the transaction.⁹⁰ Similarly, in *Shaw v. Commissioner*,⁹¹ the Tax Court attributed income earned from insurance sales to the corporation, even though state law prohibited corporations from selling insurance for

87. *Gregory v. Helvering*, 293 U.S. 465 (1935). If the IRS succeeds in shifting the incidence of taxation from a real taxpayer to a straw or nominee corporation, it in effect has elevated the form of the transaction over the substance. Assume, for example, that a real estate project increases in value and is sold for a profit of \$1 million. The IRS's position leads to the conclusion that the stockholder of the corporate agent (whether or not an owner-principal) is technically entitled to the sale proceeds and the gain from the sale. This result, of course, is illogical and unintended, because in reality the transaction was designed and intended to benefit the owner-principal, not the stockholder of the corporate agent.

88. *See, e.g.*, cases cited note 6 *supra*.

89. *See, e.g.*, *Guaranty Trust Co. v. United States*, 139 F.2d 69 (9th Cir. 1943). This argument has also been urged in an audit originating out of the St. Louis District IRS office.

90. *See* notes 84-87 *supra* and accompanying text.

91. 59 T.C. 375 (1972). *See also* *Guaranty Trust Co. v. United States*, 139 F.2d 69 (9th Cir. 1943).

commissions. Thus, the argument that the agency relationship is void because of the impossibility or illegality of the act by the principal is without merit.

The Commissioner is most likely to raise a voidness argument when a nominee corporation secures a loan at an interest rate that would be usurious to the real taxpayer.⁹² If state usury laws have been repealed or amended to permit such a loan to be made directly to the real taxpayer, however, the real taxpayer can also rely on the doctrine of *Ewell v. Daggs*.⁹³ In *Ewell*, the Supreme Court upheld a judgment for the entire interest on a promissory note which was usurious when made but which would have been valid, due to repeal of the usury law, at the time litigation began. The Supreme Court held that repeal of the usury law operated retroactively to validate the entire transaction. Thus, if usury law restrictions are repealed, the repeal generally operates retroactively to cut off the defense of usury and to render the entire loan contract valid and enforceable from its inception.⁹⁴

A word of caution may be necessary: The agency concept is not without certain inherent disadvantages. First, if an agent secures a loan or otherwise acts on behalf of the principal-real taxpayer, the principal may be bound by the agent's acts and may face unexpected personal liability.⁹⁵ Second, a corporate agent, particularly one not controlled through stock ownership, has the power to hypothecate or encumber the principal's real estate and improvements, to the principal's obvious financial detriment.

E. *Planning the Use of a Corporate Nominee*

Because of the unsettled law in this area, a taxpayer using a nominee corporation has no assurance that he will obtain the desired tax result. If he must use a nominee corporation (and he should do so only as a last resort), the real taxpayer should adopt several initial tax planning procedures to try to secure the desired tax consequences.⁹⁶

92. See note 6 *supra* and accompanying text.

93. 108 U.S. 143 (1883).

94. *Id.* at 150-51; 91 C.J.S. *Usury* § 10(b)(2) (1975); 73 AM. JUR. 2D *Statutes* §§ 384, 388 (1974).

95. One obvious way to avoid liability on loans is to secure exculpatory financing. Even if the real taxpayer asserts the corporation's nominee status for tax purposes, he may have defenses against third parties who seek to bind him on an agency theory. See U.C.C. § 3-401(1).

96. See sources cited note 3 *supra*.

The following steps for planning and implementing the use of a nominee corporation are suggested as the best known means toward the desired end:

1. The nominee corporation must be owned and operated by a truly independent party who is not an owner-principal (real taxpayer).

2. No owner-principal should be a director or officer of the nominee corporation.

3. The articles of incorporation of the nominee corporation should limit its corporate purpose to the exclusive purpose of acting as an agent.

4. Each shareholder of the nominee corporation should subscribe for his stock and purchase it with his own funds. The corporation should open a bank account in its name and pay its own legal and accounting fees, franchise fees, and incorporation costs.

5. An agency agreement between the nominee corporation and the principal *must* be prepared. The agreement should specify a fixed fee for the nominee's services; this fee should be reasonable in light of the services rendered. The agency agreement must include all the legal requisites of a valid agency.⁹⁷

6. The nominee corporation should file a Form 56 for each transaction, to notify the IRS of the fiduciary relationship.

7. The nominee corporation should apply for its own identification number (Form SS-4), and state as the nature of its business (line 10) "corporate agent and nominee."

8. The nominee corporation should file its own state and federal income tax returns and other state corporate forms consistent with its stated purpose.

9. The nominee corporation should pay salaries to its officers or employees out of the income it receives for services rendered and file all related information and forms.

10. Corporate resolutions and minutes should be drafted to reinforce and support the corporation's actions as a corporate nominee and agent. Only the proper officers of the nominee corporation should sign any documents.

11. All monetary payments to third parties should come directly from the principal for whom the nominee is acting. If this is impossible,

97. See notes 48-62 *supra* and accompanying text.

the payment from the nominee corporation to the third party should indicate the identity of the principal, and the nominee corporation's books should reflect the principal's payment through the nominee corporation to a third party.

12. The nominee corporation should promptly transfer any money it receives to the principal; if this is not feasible, the nominee should credit any receipts to the principal's account.

13. The nominee corporation should act in an agency capacity for as many principals as possible.

14. Agency-related documents should be recorded, so that the public has some knowledge of the agency relationship between the nominee corporation and the real taxpayer. Revenue Ruling 75-31 emphasized this factor, but the public knowledge issue has not yet been subjected to a court test.

IV. CONCLUSION

Under present law, courts will disregard straw corporations only under highly unusual circumstances. If a corporate entity must be used in real estate tax shelter transactions, a nominee corporation offers an alternative to try to secure the desired tax benefits of the real taxpayer's investment.

