

# Michigan Law Review

---

Volume 38 | Issue 8

---

1940

## TAXATION - FEDERAL INCOME TAX - EVASION THROUGH USE OF THE CORPORATE ENTITY

G. Randall Price  
*University of Michigan Law School*

Follow this and additional works at: <https://repository.law.umich.edu/mlr>



Part of the [Securities Law Commons](#), and the [Taxation-Federal Commons](#)

---

### Recommended Citation

G. R. Price, *TAXATION - FEDERAL INCOME TAX - EVASION THROUGH USE OF THE CORPORATE ENTITY*, 38 MICH. L. REV. 1359 (1940).

Available at: <https://repository.law.umich.edu/mlr/vol38/iss8/32>

This Regular Feature is brought to you for free and open access by the Michigan Law Review at University of Michigan Law School Scholarship Repository. It has been accepted for inclusion in Michigan Law Review by an authorized editor of University of Michigan Law School Scholarship Repository. For more information, please contact [mlaw.repository@umich.edu](mailto:mlaw.repository@umich.edu).

**TAXATION — FEDERAL INCOME TAX — EVASION THROUGH USE OF THE CORPORATE ENTITY** — The taxpayer purchased *A* Company stock from *X* for \$100,000 and later sold it for \$7,500, deducting the loss in his tax return for that year. Following the discovery of fraud on the part of *X* he reacquired the stock for \$8,000 and then negotiated a settlement with *X* providing for a resale to *X* for \$100,000. To avoid high taxes on the resulting profit, the taxpayer organized *B* corporation and purchased all its stock. He then sold to it the *A* Company stock and all his claims against *X* in return for its promise to pay back the \$100,000 in forty annual installments. On the following day the taxpayer, acting as the agent of *B* corporation, sold the *A* Company stock and released the tort claim to *X* for \$100,000. The *B* corporation remained in existence, making the installment payments and engaging in investment transactions. Contending that the entire gain from the sale was income to the taxpayer, the commissioner determined a deficiency which was not sustained by the board of tax appeals. The circuit court of appeals reversed, and on certiorari to United States Supreme Court, *held*, the sale should be considered as the taxpayer's and hence the gain should be taxable to him. *Griffiths v. Helvering*, 308 U. S. 355, 60 S. Ct. 277 (1939).

Courts generally say they will respect the corporate entity in the field of taxation.<sup>1</sup> Yet they often disregard it.<sup>2</sup> To determine under what circumstances they will respect it and under what circumstances they will disregard it is a difficult problem.<sup>3</sup> Several principles have been developed that will sustain a decision either way without any accurate tests for the application of these principles. When the court wishes to disregard the corporate entity, it need only say that in the field of taxation courts look at the substance of the transactions the parties have carried out and disregard the particular forms they have gone through.<sup>4</sup> On the other hand, when the court wishes to uphold the corporate entity, it will repeat the well recognized entity doctrines and say that the taxpayer's motive of avoiding taxes is immaterial since every taxpayer has the right to arrange his affairs in such manner as to minimize his taxes.<sup>5</sup> Hence the real difficulty in a given case arises in trying to determine which set of principles will be applied. In the principal case the Court chose to disregard the elaborate scheme of the taxpayer, which had as its purpose the evasion<sup>6</sup> of the high

<sup>1</sup> *Burnet v. Clark*, 287 U. S. 410, 53 S. Ct. 207 (1932); *Lynch v. Hornby*, 247 U. S. 339, 38 S. Ct. 543 (1918); 5 PAUL and MERTENS, FEDERAL INCOME TAXATION, § 53.20 (1934).

<sup>2</sup> *S. A. Macqueen Co. v. Commissioner*, (C. C. A. 3d, 1933) 67 F. (2d) 857; *United States v. Barwin Realty Co.*, (D. C. N. Y. 1928) 25 F. (2d) 1003.

<sup>3</sup> See Finkelstein, "The Corporate Entity and the Income Tax," 44 YALE L. J. 436 (1935).

<sup>4</sup> "Fictional corporate camouflage cannot be made the device to escape taxation." *North Jersey Title Ins. Co. v. Commissioner*, (C. C. A. 3d, 1936) 84 F. (2d) 898 at 901. Accord: *Kaspere Cohn Co.*, 35 B. T. A. 646 at 665 (1937); *Groves v. Commissioner*, (C. C. A. 4th, 1938) 99 F. (2d) 179.

<sup>5</sup> *Jones v. Helvering*, 63 App. D. C. 204, 71 F. (2d) 214 (1934); *Fruit Belt Telephone Co. v. Commissioner*, 22 B. T. A. 440 (1931). For a collection of cases on the effect of the taxpayer's motive to avoid taxes, see 101 A. L. R. 204 (1936).

<sup>6</sup> The term "evasion" is used, since the scheme was actually held to be unlawful.

surtaxes on the \$92,000 capital gain through the use of the corporate entity as an instrumentality to spread out the distribution over a period of forty years. The case came within the broad principle of *Gregory v. Helvering*,<sup>7</sup> which applies the test of whether the use of the corporate entity had any business purpose other than the tax purpose. Where the corporation has been dissolved after the tax purpose has been accomplished, it is clear that the corporation has not served a business purpose.<sup>8</sup> However, where the corporation has gone on engaging in security transactions and other lawful businesses, the court is compelled to look at the nature of the particular transaction. The principal case is significant in that the Court recognized that the motive of the taxpayer becomes material when the Court is determining whether to disregard the form and follow the substance of a particular transaction.<sup>9</sup> Under this view, regardless of the past or future use of the corporation, if the sale to it and subsequent resale be merely part of a plan to evade taxes which would result from a direct transfer, they will be regarded as a direct sale by the taxpayer to the third person for purposes of taxation.<sup>10</sup> The Court could have based its decision in the principal case on a wholly different ground. The use of the corporation was simply a method to keep this capital gain from vesting for an instant in the taxpayer, and to deflect it immediately over to *B* company. This is essentially a case of deflection of income in which the taxpayer attempted to "attribute the fruits to a different tree from that on which they grew" within the principle of *Lucas v. Earl*.<sup>11</sup> There have been many instances of this practice in husband-wife cases<sup>12</sup> and in transactions between a corporation and its stockholders.<sup>13</sup> The cases on this principle are in state of confusion,<sup>14</sup> but the true view seems to be that where a person has performed everything necessary upon his part to receive income, he should not be permitted to enter into an agreement with another to deflect the income to that other person and thus avoid taxes. *G. Randall Price*

If it had been held to be permitted within the law, the term "avoidance" would be the proper description of the result. Thus the two terms merely serve as labels for the legal result reached. For a further understanding of the terms, see Buck, "Income Tax Evasion and Avoidance: Some General Considerations," 25 *GEORGETOWN L. J.* 863 (1937).

<sup>7</sup> 293 U. S. 465, 55 S. Ct. 266 (1935).

<sup>8</sup> *Electrical Securities Corp. v. Commissioner*, (C. C. A. 2d, 1937) 92 F. (2d) 593. See also 37 *MICH. L. REV.* 679 (1939).

<sup>9</sup> The language of Justice Frankfurter in the principal case plainly shows that the motive of the taxpayer is material: "That was the crux of the business to Griffiths, and that is the crux of the business to us." 308 U. S. at 357.

<sup>10</sup> There are many cases where the reverse situation is presented. The corporation is about to make an advantageous sale, so it transfers the property to its stockholders, who then proceed to sell it in order to escape the corporate income tax. *Boggs-Burnham & Co. v. Commissioner*, 26 B. T. A. 988 (1932), and cases collected in 101 A. L. R. 205 at 208 (1936).

<sup>11</sup> 281 U. S. 111 at 115, 50 S. Ct. 241 (1930).

<sup>12</sup> *Washington v. Commissioner*, 30 B. T. A. 788 (1934); *Daugherty v. Commissioner*, 24 B. T. A. 531 (1931). For a collection of cases, see 83 A. L. R. 88 (1933).

<sup>13</sup> *Dickey v. Burnet*, (C. C. A. 8th, 1932) 56 F. (2d) 917, and cases collected in 101 A. L. R. 204 (1936).

<sup>14</sup> See Buck, "Income Tax Evasion and Avoidance: The Deflection of Income," 23 *VA. L. REV.* 107 (1936), 265 (1937).