Volume 47 | Issue 1 Article 6

1958

Disregarding the Corporate Entity for Income Tax Purposes

Edw. Glenn Sanderfur
University of Kentucky

Notes

DISREGARDING THE CORPORATE ENTITY FOR INCOME TAX PURPOSES

The corporate entity concept regards any corporation as a legal entity entirely distinct from those who own and control it.[1] When the corporation really came of age sometime around the turn of the eighteenth century,[2] the legal entity concept as applied to corporations reached its zenith.[3] This legal fiction not only expressed the classical theories of corporate function, but has played a great role in corporate development.[4] However, this concept is not nearly so effective today as a tool for legal decision. Although the corporate entity concept received early judicial acceptance in the famous *Dartmouth College* case,[5] for *tax* purposes the modern corporation has been viewed by courts and legislature as a special kind of legal entity. It has been necessary, due to our increasingly complicated tax structure, to "disregard the corporate entity in an increasing number of cases."[6]

The corporate entity concept, however, is generally very useful to business activity.[7] And unless to do so would be very inequitable and unjust under the particular circumstances, the separate entity of the corporation will be recognized by the legislature and courts even in modern tax cases.[8] In income tax situations, statutes and judicial opinions have generally upheld the corporate entity concept.[9] Whether

[1] 10A Mertens, Law of Federal Income Taxation 234 (1948).

[2] H. Ke Chin Wang, 58 Law Q. Rev. 498 (1942).

[3] Tillman, "Taxation and the Corporate Entity: A Case History," 4 Loyola L. Rev. 1 (1947).

[4] Id. at 1.

[5] Trustees of Dartmouth College v. Woodward, 4 Wheat. 636 (1819). The Supreme Court pointed out that a corporation exists only by virtue of law and that the corporation as a legal personality is capable of acting in many repects as a single individual—possessing the particular powers conferred upon it by its charter.

[6] Supra note 3, at 1.

[7] Such is the case "whether the purpose be to gain an advantage under the law of the State of incorporation or to avoid or to comply with the demands of creditors or to serve the creator's personal or undisclosed convenience. . . ." Moline Properties, Inc. v. Commissioner, 319 U.S. 436 (1943).

[8] I Prentice-Hall, Corporation Service 1120, 1121 (1957).

[9] The following situations have been listed as situations where the doctrine of corporate entity has been repeatedly affirmed: (1) transfers between corporation and stockholder; (2) determination of gain or loss arising from a sale or exchange; (3) liquidating dividends; (4) considering whether payments by employer to employee are gifts or compensation; (5) waivers; (6) capital net gain pro-

it be the legislature or the courts acting, the corporate entity will be respected unless special circumstances exist which are considered to demand the contrary.[10]

Recognizing the separate entity of a corporation in tax cases will be to the taxpayer's advantage in some cases, but will produce greater revenue for the government in others.[11] Thus, it seems pertinent to note whether it is the government or the individual, who in a given case seeks to disregard the corporate entity. Also, since the corporate entity is generally recognized, an overall picture of the corporate entity concept under federal income taxation can most easily be achieved by an analysis of the situation where the tax laws and the courts have disregarded the concept.

Statutory Disregard of the Corporate Entity

To prevent injustice Congress has frequently provided special relief to the government as well as to individual taxpayers by specifically providing for disregard of the separate corporate entity in many situations where the courts had upheld, or were expected to uphold, such separate corporate existence.[12] The constitutional power of Congress to do so seems unquestioned.[13]

Other than in the special situations just referred to, the 1954 Internal Revenue Code contains surprisingly few provisions purporting to define instances when a corporation will or will not be regarded as a separate entity for tax purposes.[14] The general provision of the Code dealing with taxation of corporations is Section 11. The Supreme Court has rejected the argument that this provision demands that a tax be levied upon the income of every corporation whatever the nature of its activity or ownership of its stock and, that the regard or disregard of the corporate entity should be determined accordingly.[15] The instances of disregard of the corporate entity in the Code may largely be determined by focusing attention on specific provisions and

---

vision; (7) provision for taxation of United States citizens in Philippine Islands; (8) consolidated returns provision; (9) amortization provisions; (10) worthless debt provision; (11) business expense provision; (12) interest or refunds provision; (13) net loss provision; (14) stock loss provisions of the 1932 Act; and (15) credit for taxes provision of 1921 Act. 10A Mertens, Law of Federal Income Taxation 243 (1948).

[10] Case, "Disregard of Corporate Entity in Federal Taxation—The Modern Approach," 30 Va. L. Rev. 398 (1944).

[11] I Prentice-Hall, op. cit. supra note 8, at 1121.

[12] Case, supra note 10, at 403.

[13] Case, supra note 10, at 401.

[14] Case, supra note 10, at 398.

[15] Such a contention was made in the Government's brief, but was rejected by the Court. Moline Properties, Inc. v. Commissioner, 319 U.S. 436 (1943).

noting the direct or indirect effect they have upon the corporate entity concept.

Several Code provisions directly or indirectly disregard the corporate entity concept. For instance, in certain situations the stockholders are taxed on gain or income realized by corporations.[16] Sections 336 and 337 of the Code provide that if the terms of the statutes are met, the corporation will not be taxed on proceeds derived from liquidations.[17] Also, the Code provides, in effect, for disregard of the corporate entity for tax purposes in certain situations where corporations are the subject of reorganization.[18] Section 532[19] provides for penalty taxation on corporations that have accumulated surpluses for the purpose of "avoiding the income tax with respect to its shareholders or the shareholders of any other corporation." Such a provision tends to pierce the corporate veil and look through form to substance in order to protect federal revenues. Section 1501[20] allows certain affiliated corporations[21] the privilege of making consolidated income and excess profit tax returns for a taxable year instead of separate returns if the corporations so elect, thus, in a sense disregarding the separate legal entity of certain related corporations. And Section 369[22] of the 1954 Code disregards the separate corporate entity of a corporation whose control is acquired by a person, persons, or another corporation for the principal purpose of evading or avoiding income taxes, by denying the income benefit otherwise derived from such acquisition. Also, the Code[23] will not allow certain stockholders, including those owning more than fifty per cent of the outstanding stock of a corporation, a deduction for losses arising from sales and

[16] Secs. 312(h) and 551 of 1954 Int. Rev. Code. See secs. 394 and 337 of 1939 Int. Rev. Code; Revenue Act of 1934, sec. 115(e), P.L. No. 216, 73d Cong., 1st sess. (1934); Revenue Act of 1932, sec. 115(e), 47 Stat. 204, 26 U.S.C.A., sec. 3115 (1932); Revenue Act of 1921, sec. 218, 42 Stat. 245 (1921); and Revenue Act of 1918, sec. 218(e), 40 Stat. 1070 (1919).

[17] Since such proceeds are merely the current value of the assets that went into the formation of the corporation, and they are derived now in transactions designed to terminate either completely or partially the legal existence of the corporation, they are not taxed to the corporation. This provision has the effect, then, of looking through the separate identity of the corporation.

[18] Int. Rev. Code of 1954, secs. 354, 355 and 361; Int. Rev. Code of 1939, sec. 112.

[19] See sec. 102(a) of 1939 Int. Rev. Code; Revenue Act of 1934, sec. 102, P.L. No. 216, 73d Cong., 1st sess. (1934).

[20] See sec. 141 of 1939 Int. Rev. Code; Revenue Act of 1928, sec. 141, 45 Stat. 831, 26 U.S.C.A. sec. 2141 (1928); Revenue Act of 1926, sec. 240, 44 Stat. 46, 26 U.S.C.A., sec. 993 (1926); and Revenue Act of 1918, sec. 240, 40 Stat. 1081 (1919).

[21] Defined in sec. 1504 of 1954 Int. Rev. Code.

[22] See Int. Rev. Code of 1939, sec. 129.

[23] Int. Rev. Code of 1954, sec. 267. And see sec. 24(b) of 1939 Int. Rev. Code; Revenue Act of 1934, sec. 24(a) (6), P.L. No. 216, 73d Cong., 1st sess. (1934).

exchanges of property between the individual and the corporation. Lastly, under Section 341[24] of the 1954 Code, the separate existence of a collapsible corporation is disregarded by treating certain corporate transactions as taxable gain to the shareholders.

Judicial Treatment of the Corporate Entity

Where Congress has left open the question of regard or disregard of the corporate entity, the courts have often been called upon by litigants to disregard the concept in order to attach the corporation's income to certain persons or to allow them to deduct a corporate loss from their own income. Although Congress has not ignored the separate existence of a corporation for tax purposes, in a great number of situations, court decisions doing so are legion.[25] The courts have found it a difficult task to lay down uniform rules as to when the corporate entity will be disregarded, a difficulty partly explainable by the maze of varying factual situations surrounding corporate existence. Likewise, it is very difficult to extract a uniform rule out of the courts inconsistent theories as to when the corporate entity concept will be ignored.[26] However, by inquiring in each case into the purpose for which the corporation was formed, it may then be possible to formulate something like a consistent rationalization of most of the cases. But even then, it is necessary to divide the cases into those in which disregard of the corporate entity is sought by the government for the collection of taxes, and those in which the individual or corporate taxpayer seeks disregard in order to avoid the payment of certain taxes.

The vast majority of cases where courts have disregarded the corporate entity have been those in which the disregard was sought by the government.[27] Some authorities attribute this result to an underlying tendency on the part of courts to disregard the corporate entity only when the collection of additional revenue will thereby be served.[28] It is not believed that the cases completely justify such a conclusion, although the courts, certainly, are unwilling to perpetuate a policy of disregarding an established concept to the detriment of government revenue in the absence of unusual circumstances.

[24] See sec. 117(m) of 1939 Int. Rev. Code.
[25] Case, "Disregard of Corporate Entity in Federal Taxation—The Modern Approach," 30 Va. L. Rev. 414 (1944); and see Meldman, "Corporations, Entity Theory, Taxation," 7 Wis. L. Rev. 252 (1932).
[26] Case, op. cit. supra at 407 and 408.
[27] 43 Colum. L Rev. 234, 235 (1943).
[28] Case, "Disregard of Corporate Entity in Federal Taxation—The Modern Approach," 30 Va. L. Rev. 414 (1944); and see Stickells, "Corporate Entity and Taxation," 29 B.U.L. 486, 501 and 508 (1949).

In *Moline Properties, Inc. v. Commissioner*,[29] the Supreme Court refused to accept the Government's contention that the courts may never disregard the corporate entity at the taxpayer's request. The Court cited cases where the proposition that the corporate entity could only be rejected for the collection of additional taxes had, in effect, been discounted. Although the Court refused to accept a rule as to disregarding corporate entity based upon when additional revenues would result, in actual application the results of the cases have not been too inconsistent with such a proposition. However, in view of the fact that the Supreme Court in the *Moline Properties* case would not accept the Government's theory, it is believed that some more appropriate rule should be found, and that a more sound rule can be evolved from the cases.

At government insistence, courts have disregarded the corporate entity in cases involving corporate reorganization,[30] subsidiary corporations,[31] wholly-owned or controlled corporations,[32] and situations where one corporation leases property to another with the rent payable directly to the stockholders of the lessor.[33] Generally, special circumstances[34] must be shown in all these cases to justify the court's making an exception in tax cases to the general rule that corporations are distinct entities. These special circumstances have been found in cases where the recognition of the entity would contravene directly or indirectly an act of Congress,[35] where the sole purpose of forming the corporation (or its sole use) was to avoid taxes,[36] and where the

[29] 319 U.S. 436 (1943).

[30] Weiss v. Stearn, 265 U.S. 242 (1924); Minnesota Tea Co. v. Helvering, 302 U.S. 609 (1938); but see other cases referred to in Finkelstein, "The Corporate Entity and the Income Tax," 44 Yale L. J. 439 and 440 (1935).

[31] Mehrlust v. Higgins, 112 F. 2d 717 (C.C.A. 2d 1940); cf. Burnett v. Commonwealth Improvement Co., 287 U.S. 415 (1932); but see Finkelstein, supra note 30.

[32] Gregory v. Helvering, 293 U.S. 465 (1934); Higgins v. Smith, 308 U.S. 473 (1939); Griffiths v. Helvering, 308 U.S. 355 (1939); C.I.R. v. Court Holding Co., 324 U.S. 331 (1944); Bazley v. C.I.R., 331 U.S. 737 (1947); C.I.R. v. Sunnen, 333 U.S. 591 (1948). This situation is partly controlled by statute today, see note 22.

[33] American Telegraph and Cable Co. v. United States, 61 Ct. Cl. 326 (1925), cert. denied 271 U.S. 660 (1926); Rensselaer and Saratoga Rr. v. Irwin, 249 F. 726 (C.C.A. 2d 1918); and see Finkelstein, "The Corporate Entity and the Income Tax," 44 Yale L. J. 441 and 442 (1935).

[34] I Prentice-Hall, Corporate Service 1123 (1957).

[35] In Gregory v. Helvering, 293 U.S. 465 (1935), the Court pointed out that the statute involved would indirectly be given an improper interpretation if the corporate entity were upheld. Similarly, see Higgins v. Smith, 308 U.S. 473 (1939).

[36] Gregory v. Helvering, 293 U.S. 465 (1935); Griffiths v. Helvering, 408 U.S. 355 (1940). In National Investors Corporation v. Hoey, 144 F. 2d 466 (C.C.A. 2d 1944), the Court admitted that Moline Properties, Inc. v. Commissioner, 619 U.S. 436 (1943), had been interpreted to contradict the doctrine that

corporation was not created to serve a useful business purpose.[37]

As previously concluded, courts seem much more hesitant to disregard the corporate entity at the insistence of a corporate or individual taxpayer. The power of one to deny the corporate entity is very limited if he in fact set up the corporation or directly benefits from its existence.[38] A few cases tending to make an exception to this rule have been expressly overruled[39] by subsequent decisions or possibly such cases may be distinguished on their particular facts so as to lay down no general rule.[40] Others have reached their results solely in order to preserve statutory or public policy.[41] There are a few

---

the motive to avoid taxation is never relevant as to whether a court will disregard the corporate entity. The circuit court pointed out that the Moline Properties case:

> merely declares that to be a separate jural person for purpose of taxation, a corporation must engage in some industrial, commercial, or other activity besides avoiding taxation: in other words, that the term 'corporation' will be interpreted to mean a corporation which does some 'business' in the ordinary meaning; and that escaping taxation is not 'business' in the ordinary meaning."

Thus, the factor of whether a corporation was formed merely in order to avoid taxation is still believed to be an important consideration in determining whether a court will disregard the corporate entity, even after the Moline Properties case which talked merely in terms of "business" or "non-business" purposes. It is not believed that National Carbide Corporation v. Commissioner, 336 U.S. 422 (1949), in any way changes the above rationalization, but, rather, goes along with it. This rationalization is also supported by a great number of Federal District and Circuit Court cases which preserve the test of whether a corporation is attempting to avoid taxes in determining if the corporate entity should be preserved. It is believed that the Moline Properties case, as well as the National Carbide case, are in accord with Federal District and Circuit Court cases in their rationalizations as to when the corporate veil will be lifted. And see Case, "Disregard of Corporate Entity in Federal Taxation—The Modern Approach," 30 Va. L. Rev. 420 and 432, note 112 (1944).

[37] National Carbide Corp. v. Commissioner, 336 U.S. 422 (1949); Moline Properties, Inc. v. Commissioner, 319 U.S. 436 (1943); Burnett v. Commonwealth Improvement Co., 287 U.S. 415 (1932); Gregory v. Helvering, 293 U.S. 465 (1935). For a list of factors which courts have used in determining whether a corporation is "doing business," see Case, supra note 36 at 426. Generally, see I Prentice-Hall, Corporation Service 1120, note 1 (1957).

[38] 43 Colum. L. Rev. 234 and 235 (1943); Kotte, "Corporations—Corporate Entity Recognized for Purpose of Taxation," 30 Geo. L. J. 91 (1944).

[39] If any rule could possibly be derived from Southern Pacific Co. v. Lowe, 247 U.S. 330 (1918), and Gulf Oil Corp. v. Lewellyn, 248 U.S. 71 (1918), as to disregard of the corporate entity, it seems to have been effectively overruled by National Carbide Corp. v. Commissioner, 319 U.S. 432 (1949); Burnett v. Commonwealth Improvement Co., 287 U.S. 415 (1932), and Moline Properties, Inc. v. Commissioner, 319 U.S. 436 (1943).

[40] Southern Pacific Co. v. Lowe, 247 U.S. 330, 338-339 (1918); Gulf Oil Corp. v. Lewellyn, 248 U.S. 71 (1918). That these two cases lay down no general rule of law, but are distinguishable on their particular factual situations, see National Carbide Co. v. Commissioner, 319 U.S. 432 (1949); Moline Properties, Inc., v. Commissioner, 319 U.S. 436 (1943); Burnett v. Commonwealth Improvement Co., 287 U.S. 415 (1932); Case, "Disregard of Corporate Entity in Federal Taxation—The Modern Approach," 30 Va. L. Rev. 409 (1944).

[41] A parent with strict control over its subsidiary may be allowed to deny the corporate entity for tax purposes where the subsidiary was created solely to overcome the parent's disability to hold and convey legal title to land. 112 W. 59 St.

reorganization cases that seem to be outside these categories. For instance, in *Weiss v. Stearn*,[42] the Supreme Court said that the transaction creating a new corporation amounted to a financial reorganization under which each stockholder retained half his interest and disposed of the remainder. In this situation, the new stock merely did not come within the statutory definition of income. Although this result was sought by the taxpayer, the result was not based, it is believed, on a disregard of corporate entity at judicial discretion, but rather, on the statute defining taxable income. A similar result was reached in *Eisner v. Macomber*,[43] on the same basis.

There are some federal cases that go very far in allowing a taxpayer to take advantage of the corporate entity for some purposes and disregard it for purposes of taxation in other instances. In *Industrial Cotton Mills v. Commissioner*,[44] the court said:

> It is true that ordinarily the loss sustained by one of a number of affiliated corporations cannot be carried forward and deducted from the consolidated return, but must be deducted only from the income of the corporation which has sustained the loss. . . .
> But the rule has no application, we think, where there is in reality but one taxpayer, and the merger, as here, is with a mere holding company which owns no property except the stock and obligations of the company which produces the entire income. In such case the law should look through form to substance and treat the income in law, as it is in fact, as the income of the corporation which has sustained the loss.

A similar result was reached in a few other federal cases,[45] but a different view was taken in others.[46] The Supreme Court has expressly

---

Corp. v. Helvering, 68 F. 2d 397 (App. D.C. 1933); Law v. McLaughlin, 2 F. Supp. 601 (N.D. Cal. 1933). And a taxpaying corporation was allowed to deny its separate existence for tax purposes in order to meet a great emergency threatening the very existence of the parent. The parent had clean hands, and its preservation was important to the public. North Jersey Title Ins. Co. v. Commissioner, 84 F. 2d 898 (3rd Cir. 1936). These cases are merely unusual situations laying down no rules to be followed in the general case where a taxpayer seeks disregard of the corporate entity. Likewise, see the following cases: Inland Development Co. v. Commissioner, 120 F. 2d 986 (10th Cir. 1941); Consolidated Coal Co. v. Nat'l. B. Coal Commissioner, 103 F. 2d 124 (7th Cir. 1939); Munson S.S. Line v. Commissioner, 77 F. 2d 849 (2d Cir. 1935); Olds v. Commissioner, 75 F. 2d 272 (2d Cir. 1935). Contra: Keystone Mining Co. v. Gray, 120 F. 2d 1 (3d Cir. 1941); cf. American Package Corp. v. Commissioner, 125 F. 2d 413 (4th Cir. 1942).

[42] 265 U.S. 242 (1924).

[43] 252 U.S. 189 (1920).

[44] 61 F. 2d 291, 293 (4th Cir. 1932).

[45] Pioneer Pole and Shaft Co. v. Commissioner, 55 F. 2d 861 (6th Cir. 1932); H. H. Miller Industries Co. v. Commissioner, 61 F. 2d 412 (6th Cir. 1932); and Appeal of H. E. Brubaker, 4 B.T.A. 1171.

[46] Athol Mfg. Co. v. Commissioner, 54 F. 2d 230 (1st Cir. 1931); Turner-Farber-Love Co. v. Helvering, 68 F. 2d 416 (App. D. C. 1933).

overruled a result like that in *Industrial Cotton Mills*,[47] and by implication in other cases[48] so as to effectively overrule the result of the former federal cases.

Thus, the previous rationalization of the cases where courts have disregarded the corporate entity in behalf of the Government may still be retained in cases where the taxpayer seeks disregard of the corporate entity, if one equitable rule is added: that the corporate entity cannot be recognized for one purpose and disregarded for another.[49] In other words:

> The organizer of a corporation . . . will not be afforded the exceptional remedy [disregard of the corporate entity] where he affirms the existence of the subsidiary for some tax purposes and denies it for others, or where the subsidiary was set up to shield property from creditors or otherwise put third persons at a disadvantage, or where he invokes the benefits of a statute without bringing himself clearly within the limitations set by it.[50]

The same principle applies to any person who derives benefits from the separate existence of a corporation and who seeks to deny the separate entity of the corporation for tax purposes.

Conclusion

Thus, the corporate entity is disregarded for tax purposes where statutes so provide and in certain other situations by judicial decision. These situations exist where the recognition of the entity would contravene directly or indirectly an act of Congress, where the sole purpose of forming the corporation (or its sole use) was to avoid taxes, and where the corporation was not created to serve a useful business purpose. And, where a taxpayer seeks disregard of the corporate entity, the courts seem to feel that the utilization of legal benefits flowing from the separate corporate existence requires the acceptance of any disadvantages.

Edw. Glenn Sanderfur

[47] New Colonial Co. v. Helvering, 292 U.S. 435 (1934).

[48] National Carbide Corp. v. Commissioner, 336 U.S. 422 (1949); Moline Properties, Inc. v. Commissioner, 319 U.S. 436 (1943); Burnett v. Commonwealth Improvement Co., 287 U.S. 415 (1932).

[49] Burnett v. Commonwealth Improvement Co., 287 U.S. 415 (1932), seems to lay down this general principle. And see Case, "Disregard of Corporate Entity in Federal Taxation—The Modern Approach," 30 Va. L. Rev. 425 (1944); Kotte, "Corporations—Corporate Entity Recognized for Purposes of Taxation," 30 Geo. L. J. 91 (1944).

[50] 43 Colum. L. Rev. 235 (1943).