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Incorporation of Family Property as a Device for Avoiding Taxes

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INCORPORATION OF FAMILY PROPERTY AS A DEVICE FOR AVOIDING TAXES

It is generally conceded that an individual or a corporation may regulate or change its business with a view to the reduction or avoidance of future taxation. But the line between legitimate avoidance and illegal evasion is extremely hazy and uncertain. The vagaries of the situation are suggested by Holmes in *Bullen v. Wisconsin*\(^1\) where he says: "We do not speak of evasion because when the law draws a line, a case is on one side of it or the other, and if on the safe side, is none the worse legally that a party has availed himself to the full of what the law permits. When an act is condemned as an evasion, what is meant is that it is on the wrong side of the line indicated by the policy if not by the mere letter of the law." As the tax burden has increased, the problem of what is evasion and what mere avoidance, has become more difficult; for as the tax laws have become more inclusive and scientific, correspondingly ingenious and intricate schemes have been utilized to escape their consequences. Corporate organizations for the handling of family property have become increasingly common,\(^2\) and while a more efficient handling of large estates may be a general motive back of the creation of many of these corporations,\(^3\) a desire to save taxes is doubtless the most significant single factor. While the corporate device forms a convenient instrumentality for manipulation, it seldom, in and of itself, solves a tax problem. Not only must the usual corporation taxes be borne in mind, but care must be taken to avoid such ordinary taxes as those on transfers in con-

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\(^1\) 1240 U. S. 625 (1916).

\(^2\) As to the situation in England see article by W. Sowden—*Conversion of Landed Estates and Baronial Manors into Limited Liability Companies*, 45 Tr. Co. Mag. 17, 1927.

\(^3\) For a discussion of this subject see article by H. B. Fraser—*Merits of Trusteering an Estate as against Incorporation,* 45 Tr. Co. Mag. 433, 1927.
templation of death, or on transfers to take effect in possession or enjoyment at or after death. In fact more than ordinary caution may sometimes be necessary due to a tinge of hostility which one feels in the attitude of many courts toward any scheme which approaches the line of evasion.

Where a family corporation is created to minimize inheritance taxes there is danger that the transfer of property to the corporation or the distribution of shares among the members of the family will be construed either as a gift in contemplation of death or as a transfer to take effect in possession or enjoyment at or after death, and as such taxable. No generalization can be made as to what constitutes a transfer in contemplation of death. The Federal Treasury Regulations provide that such a transfer occurs "wherever the person making it is influenced to do so by such an expectation of death, arising from bodily or mental conditions, as prompt persons to dispose of their property to those whom they deem proper objects of their bounty." Some state courts stress the sickness or peril of the grantor while others speak of such a gift as one actuated by the same motives as move one to make a will. It is quite apparent that whether or not a gift is to be construed as having been made in contemplation of death is a question of fact which is to be determined by the peculiarities of the individual case. Because it is a question of fact, the advantage lies largely with the taxpayer, for as was pointed out by the dissenting judge in *Matter of Muhlsteid*: "It is hardly to be expected that in transactions of this character positive proof can be given that the transaction was within the purview of the statute. The taxing power is not party to the transaction, and it is almost necessarily compelled to rely upon the attendant facts and circumstances which it may subsequently elicit, and the conclusions that may fairly be drawn therefrom."

Thus the advantages which the government may gain through a very general definition and whatever presumptions which may be

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4 Revenue Act of 1924—Regulations 68, Art. 16.
6 *Re Reynolds*, 169 Cal. 600, 147 p. 268 (1915).
7 *Spreckles v. State*, 30 Cal. App. 36, 175 P. 549 (1916); *McDougald v. Wulzen*, 34 Cal. App. 21, 166 Pac. 1033 (1917); *People v. Kelley*, 218 Ill. 599, 75 N. E. 1038 (1905); *Re Crary*, 64 N. Y. S. 560, 31 Misc. 72 (1900).
declared to exist, are largely offset by the taxpayer's being in control of the most important facts.

As has been intimated, transfers in contemplation of death which take place through the medium of a family corporation present no very unique problem. In Abstract and Title Guaranty v. State, H. organized a corporation, transferring real estate of considerable value to it, and dividing its stock between his three sons. H. was eighty years old and in poor health at the time of the transaction. Part of the agreement with the corporation was that it should suitably support H. for life. He died within six months and the transfer to the sons was quite reasonably held to be one in contemplation of death.

A case much more difficult to agree with is that of In re Pauson. Here the decedent when seventy years old and in good health formed a corporation and distributed its stock to the members of his family; he was elected president of the new corporation at an annual salary of $20,000, and was to attain active management of the business. He died about a year later and the gifts of stock were held to be gifts in contemplation of death. The court did not seem to agree entirely with the attitude of the trial court toward the facts but held that if from the evidence, the trial court could properly infer that the transfer was or was not made in contemplation of death, the finding of the trial court was not to be disturbed even though the conclusion of the appellate court on the same evidence might be different. One is inclined to believe that the lower court frowned upon the corporate organization as an undesirable device to evade taxation, and was willing to strain the facts in order to hold that the transfers in question were in contemplation of death. The case furnishes an interesting contrast with the earlier one of Spreckels v. State, which arose in the same jurisdiction. In this case, some seven months after the death of her husband Mrs. S. organized the San Christina Investment Co. "to employ it as an instrumentality for properly conserving, handling, and managing with profit" the vast and varied property interests left by her husband. Mrs. S. had an ample independent income and the evidence tended to show that she was desirous of making an imme-

173 Cal. 691, 161 P. 264 (1916).
186 Cal. 353, 199 P. 331 (1921).
diate provision for her three children rather than attempting to avoid a will or evade inheritance taxes. Though she had not been in any immediate fear of death, her health was not good and she died at the age of seventy-nine, within a month after the time when she gave most of the San Christina stock to her children. The appellate court held that there was sufficient evidence to sustain the lower court's finding that the gifts were not in contemplation of death.

These cases indicate that the courts will go much farther to construe a transfer of an interest in a family corporation as in contemplation of death when its apparent primary object is tax saving, than they will when the tax saving element is merely incidental to some other purpose, such as the immediate benefiting of the grantee or the relieving of the grantor of some of the burdens of the management of his property. Furthermore, it is frequently desirable that the grantor retain one or more of the shares in the corporation on the theory that if he were contemplating impending death or peril, there would be no point to his retaining any shares.\(^1\)

Most jurisdictions impose a tax upon transfers not intended to take effect in possession or enjoyment until at or after the death of the transferrer and thus further minimize the possibility of one transmitting his estate to the objects of his bounty free from inheritance taxes. The cases in which these provisions have been most commonly applied have involved trusts, but the principles laid down are equally applicable to certain corporate organizations and are of special significance in those instances where family corporations are organized and a portion of the stock placed in trust for certain beneficiaries.

A settlor may retain the income; the supervision over the funds; the power of revocation; the power to change beneficiaries; or the power to vote shares forming a part of the trust fund. The extent to which the retention of one or more of these powers will make the transfer taxable will vary necessarily with the individual case, but according to the ordinary view, where the net income is to be paid to the settlor for life, the trust is tax-

\(^1\)\textit{In re Mahlstedt, 67 App. Div. 176, 73 N. Y. S. 818 (1901), aff'd. without opinion in 171 N. Y. 652, 63 N. E. 1119.}
able. So too, where only a part of the income is retained by the grantor, the tax is imposed upon a proportionate share of the corpus. Under the federal Estates Tax and some state statutes where the settlor reserves the power of revocation, the fund is taxable even though he does not retain the income. But the general view is that the power of revocation alone will not render the trust subject to taxation as part of the grantor’s estate. The amount of control which one may retain over the corpus without thereby rendering it taxable as part of his estate varies with the facts of the particular case.

A few cases have arisen where transfers to a family corporation or the distribution of the stock of such an organization have been held to be within the provisions taxing transfers not intended to take effect in possession or enjoyment until at or after death. In the case of In re Ball, B, four years prior to his death, placed one-half of the shares of a corporation, owned by himself, in an envelope and handed it to one of his sons saying “I give you one-half of the stock of the B. Realty Co.” In like manner he gave the other half of the stock to another son. No transfer stamps were used, no evidence of the transfer was shown on the books of the company, and B continued to act as the sole stockholder. The two envelopes containing the stock were placed in the safe of the company, where they remained until B’s death. The transfer was held taxable as one not intended to be complete until after the death of B. It is, of course, impossible to say just how much more parties would need to do to make the transfer nontaxable but certainly if it had been entered on the books of the company in the instant case the court would have had much

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26 In re Dolen’s Estate, 279 Pa. 582, 124 A. 176 (1924); People v. Northern Tr. Co., 289 Ill. 475, 124 N. E. 662 (1919); Matter of Cochrane, 117 Misc. 18, 190 N. Y. S. 895 (1921); Matter of Miller’s Estate, 236 N. Y. 290, 14 N. E. 701 (1923).


greater difficulty in reaching the conclusion that the transfer was taxable.

A somewhat similar defect existed in the plan found in the case of Re Romney only here it was the transfer to the corporation rather than the distribution of stock to the members of the family which the court decided was not intended to take effect until after the death of the transferrer. The facts showed that in 1903, R. and his ten sons agreed to form a corporation. Of 2,000 shares, 1990 were subscribed to by R. and one share by each of the other incorporators. The entire capital stock was paid for by R's conveying certain real estate to the corporation, and he then proceeded to distribute 1982 shares among his 24 children. A few days later R. executed an instrument by which he purported to transfer to the corporation $500,000 worth of securities for "$1 and for good and valuable consideration." Again in 1908, R. purported to "sell and assign" certain stocks and bonds to the corporation; but on neither occasion were the securities transferred on the books of the corporation issuing them. The securities were indorsed and kept in the company safe but R. continued to be paid the dividends personally until his death some time after 1918. It was held that the ownership and beneficial interest of the securities did not rest in the corporation during the life of the donor. These cases show the danger in not carrying the transfer through in regular fashion on the books of the corporation involved. If the grantor wishes to retain control, the better plan seems to be for him to depend merely upon the physical control of the securities. This idea was successfully carried out in the case of In re Bassett's Estate. Here B was an executive of General Motors and as such was given the opportunity of purchasing 4,800 shares of Manager's Security Co. stock (subsidiary of General Motors). The price was $300,000 and B. borrowed $290,000, giving the stock as collateral. Later he caused the G. Co. to be formed "partly to facilitate the handling of his investments and partly to minimize taxes." B. then offered his 4,800 shares of Manager's Security stock to the G. Co. in consideration of its issuing to him 12,500 shares of no par common stock. After this certificate was issued to B, he exchanged it for several others issued

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60 Utah 173, 207 P. 139 (1922).
incorporation of family property; these individuals indorsed the shares allotted to them and returned them to B. together with demand notes in payment for them. (The members of the family were not solvent). B. retained possession of these indorsed certificates and payments were made on the demand notes from dividends of the G. Co. of which B. was president and manager. On his death (age 52) the value of the Manager’s Security stock was about $1,000,000 and the state sought to collect an inheritance tax on this. The court held that the transfer of the stock certificates to the G. holding company effectively transferred the decedent’s interest, precluding the assessment of an inheritance tax thereon. In reaching this conclusion the court said “Incorporation to reduce future taxes has no fraudulent or illegal undertone. Both the state and federal governments take account of the differences between individuals and corporations and impose taxes upon them of different bases. No just criticism can be made of individuals who accept the option thus offered and use that method of ownership and management which best serves their advantages.” Michigan, like most other jurisdictions, taxes gifts to take effect in possession or enjoyment at or after death, but the instant case seems to be correct in refusing to regard this as such gift; for even though the actual physical control was in B. the members of his family were legally entitled to their respective shares in the G. Co. and through it, to the Manager’s Security stock.

A number of variations in the use of the corporate organization may be obtained to effect a device which most nearly meets the peculiar individual needs of the creator and the members of his family. Thus, for example, a holding company may be formed with two classes of stock—voting—(common) and non-voting (preferred). If the voting stock is then issued to the original holder, he retains control; the non-voting stock might all be given to the spouse or distributed among various members of the family. In either event it would be possible to regulate the dividends so as to give the non-voting stockholders the bulk or only a small share of the income. In so far as they received any income, it would tend to reduce the amount of income tax paid the family as a whole, and in so far as an interest in the securities of the holding company was passed, there would be a cutting down of probable succession taxes.
Under some such general plan, varying results may be reached by changing the proportions of the voting and non-voting stocks; by placing the non-voting stock in trust for members of the family; or by not declaring any dividends on the voting stock and allowing the income to be accumulated by the corporation while the tax of such income is paid by the stockholders. By paying the tax in this manner the penalty imposed by the federal Revenue Act of 1928, section 104, for accumulating to evade surtaxes would not be incurred.

While the provision mentioned (No. 104 of 1928 Revenue Act) is very difficult to enforce and no court or board decision has been rendered on it, the penalty is so severe and the phrasing so inclusive that one should hesitate to encroach on to any of the territory which seems to be forbidden. The section provides in substance that if a corporation is organized to avoid surtaxes by allowing profits to accumulate, it shall pay a penalty of fifty per cent of its income in addition to the regular tax. Furthermore "the fact that any corporation is a mere holding or investment company, or that the gains or profits are permitted to accumulate beyond the reasonable needs of the business, shall be prima facie evidence of a purpose to escape the surtax." The phrase "beyond the reasonable needs of the business" furnishes a loophole of escape for the ordinary business corporation. Not only may there be many "reasonable needs" justifying accumulation but it is possible for accountants to concoct reserves which may actually amount to illegal accumulations but the validity of which is extremely difficult to attack, as a practical matter. It is probably due to this fact and the extreme severity of the penalty that so few cases have arisen under section 104. However, a holding company for family property could not create

\[\text{In an article on "Surtax Evasion Through Corporate Form", in the February, 1930, number of the International Revenue News (v. 3, no. 8) p. 9, W. W. Grimes, of the Office of the General Council, says:}
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\[\text{"While the provision substantially in the same form appeared first in the 1918 act, no court or board decision has been rendered, although the department has released the information that more than $5,000,000 has been collected in cases handled under the provision. At the close of 1929 there were 3 cases pending in the courts, 38 in the Board of Tax Appeals (only 1 of which has been tried), 38 in the general council's office in the prima facie stage, and 65 in the Income Tax Unit in preparation. The general counsel's office has disposed of 385 cases, exclusive of those in the unit."}\]

\[\text{\textsuperscript{22} "Section 220 —— Should Corporations Worry?" by James L. Dohr, 6 Nat. Income Tax Mag. 169 (1928).}\]
fictitious reserves with the facility of a regular business corporation and so the risk of incurring the penalty is greater in instances of the family corporation. In the case of such an organization, the danger might be somewhat lessened by diversifying the shareholders or by paying some dividends.

The difficulties presented by the prohibition of accumulations, as well as a desire to avoid the twelve per cent tax on incomes of corporations, where the company organized to take over the family property and business is not simply a holding company, has given rise recently to an interest in incorporating in foreign countries. The countries most frequently mentioned as desirable for such purposes are Newfoundland, Canada, and Panama. There is good reason to suppose that there are a number of other countries whose corporation laws are just as advantageous and that it is partly proximity and partly pure chance which has thus far caused the lawyers interested in this work to investigate and stress the advantages of these particular countries. While Panama laws are considered favorable, instances of incorporation in that country seem to be very rare. This may be attributed to a certain distrust and fear of "the instability of conditions" in Latin-American countries generally. Canada and Newfoundland, therefore, are apparently the chief competitors for whatever business of this type which there may be. Newfoundland, doubtless influenced by lobbyists from the United States, has gone so far as to solicit the business of foreign holding companies, as is evidenced by the following provision in its Income Tax Act of 1929 (No. 2 (2)). "Nothing herein shall be construed to tax the gain, profits, interests or other income of "Personal Holding Companies" organized under the Companies Act of this Colony, derived from the investment in trading stocks, bonds, debentures or other securities where such stocks, bonds, debentures or other securities are located outside the colony of Newfoundland at all times during the taxable year; however, said "Personal Holding Corporation" shall be liable to an annual Franchise Tax computed on the basis of their authorized capital as set forth in sub-section (s)." (In no case to exceed $250).

"The Term 'Personal Holding Corporation' as used in this Act, shall be construed to mean a company having not more than five stockholders all of whom are non-residents and 80% or more
of whose assets, other than cash, consists of stocks, bonds, debentures, or other securities and which does not do business with the public of this colony."

While no such strong invitation is to be found in the Companies Act of the Dominion of Canada or the similar acts of any of the Provinces, they contain liberal provisions making incorporation quite easy and inexpensive. Under the Dominion Companies Act, for instance, it is not necessary for any of the officers or directors to be British subjects or residents of Canada. No meetings need be held there except the annual general meetings of stockholders at which the directors are elected; and the inconvenience of this requirement may be minimized by proxy voting. Fees for incorporation on the granting of letters Patent are by no means prohibitive. Holders of bonds or stock of such Canadian Companies who are not residents or engaged in business in Canada are not subject to personal property taxes in Canada, nor to income taxes on interest and dividends received from the Company.

The principal drawback to a Canadian corporation as against a Newfoundland one lies in the tendency of the Income Tax Department to bring such companies within the Income Tax Act. To date, the opinions given out have tended to exclude this type of company from the operation of that act but their position is precarious and it seems highly probable that if the question presents itself frequently the Tax Department may decide that these organizations are "doing business" within the meaning of the act, and so, subject to its provisions.

A factor which would have to be taken into consideration regardless of whether the Corporation were organized in Canada or Newfoundland is the Succession Taxes on Death Duties. Taking as typical the situation of a company organized under the Dominion Companies Act with headquarters in Quebec, we find that the Provincial government includes to the imposition of this tax even where such securities are transferrable only outside the Province.

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23 The assertions made on this and the following pages are based upon information gathered from New York lawyers who have been in actual contact with instances of incorporation in foreign countries.

24 Where the capital is $100,000 or less the fee is $100; then there is an additional dollar charged for each thousand up to and including $200,000; then fifty cents for each additional thousand to and including $500,000; and then twenty cents for each additional thousand.
But the collection of this tax may be made extremely difficult and perhaps entirely evaded by making the securities "bearer" instruments. If the deceased resided outside of Canada and held no other Canadian securities, his executors would be under no enforceable duty of reporting the death of such debenture holder to the Provincial authorities. Furthermore, while a corporation having its chief office in the Province in which the person dying outside was possessed of an interest, is to notify the Provincial Treasurer of such death, it is not likely that in the ordinary course of events, the company would be apprised of the death of the holder if they were transferable by delivery.

Even when viewed in the most favorable light, the formation of a foreign holding company for the handling of family property is not as efficient and sure working a device for the avoidance of taxes as one might desire. If one wishes to accumulate he is certainly gambling on the U. S. Treasury's failing to enforce No. 104 against him. While information on foreign organizations may be more difficult to obtain, the language of the section in question seems broad enough to include all holding companies seeking to evade the federal surtaxes, regardless of where they may be incorporated. In addition there are the foreign income taxes and death duties to be considered. These may be avoided temporarily and even for the entire life of the corporation but there can be no certainty that they will not be enforced and collected.

It cannot be denied that certain estates profit by incorporation. If the securities of a wealthy individual are highly diversified geographically the surest way to avoid multiple succession taxation is by incorporating in the state of such individual's domicile or in a state which has no inheritance tax (Florida). The state of residence and the federal government are then the only ones which are entitled to impose a succession tax. However, there are few advantages to incorporation as clear cut as the one just mentioned. The needs and possibilities of the individual estate should be considered by experts in estate planning. It may be that incorporation will prove to be advantageous in the particular case considered or it may prove otherwise for incorporation of family estates, is no certain panacea for the tax burden.

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