Organizations Classified as Corporations for Federal Tax Purposes

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ORGANIZATIONS CLASSIFIED AS CORPORATIONS FOR FEDERAL TAX PURPOSES†

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The purposes of this paper are to define what is and what is not a corporation for federal tax purposes; to discuss the judicial responses to arguments made by either the government or tax counsel that, for tax purposes, a corporation should be disregarded, or at least treated merely as an agent of its shareholders; to evaluate the jurisprudential quality of some of the positions taken in the cases, the regulations, and the revenue rulings; and to make some tax planning recommendations. These taxpayer identity issues are important not only for the jurisprudence they have generated, which is substantial, but also because their resolution produces radically different tax treatment for closely held enterprises and their owners - the taxpayers primarily affected by the resolution of these issues.† Hence, the focus of this article is upon this group of taxpayers.

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† Courts have emphasized how keenly they will scrutinize arrangements between closely held enterprises and their owners. See, e.g., Red Carpet Car Wash, Inc. v. Commissioner, 73 T.C. 676, 685 (1980) (ownership status of partnership interest denied when no capital contribution or other activity with regard to partnership found); Strong v. Commissioner, 66 T.C. 12, 24 (1976) (corporation's purpose of avoiding usury laws and activities of borrowing money and mortgaging property deemed sufficient to require recognition as separate entity), aff'd mem., 553 F.2d 94 (2d Cir. 1977).
THE CORPORATION AS AN INDEPENDENT TAXABLE ENTITY

Subject to exceptions—a corporation, unlike a partnership or proprietorship, is an independent taxpaying entity, separate and distinct from its shareholders. It computes its own income, deducts its own losses, files its own return, and pays its own tax. It is not required to account for the income of its shareholders, and it is not allowed to deduct losses of its shareholders from its income. Correlatively, its shareholders are neither required to account for the income of the corporation nor allowed to deduct the corporation’s losses from their personal income. Despite the universal acceptance of these apothegms, the government or a taxpayer occasionally claims that a particular corporation should be disregarded for tax purposes or, at least, for a particular group of transactions. The courts, however, ignore the separate existence of corporations only in exceptional circumstances. In general, courts recognize rather than disregard the corporate entity. “The
doctrine of corporate entity,” the Supreme Court declared in a famous corporate tax opinion, “fills a useful purpose in business life.”

DISTINCTIVE TAX RULES FOR CORPORATIONS

The Internal Revenue Code applies distinctive rules to corporations;\(^\text{10}\) imposes the notorious system of double taxation on corporate income,\(^\text{11}\) and provides special tax rules for transactions between corporations and their shareholders.\(^\text{12}\) Although detailed enumeration of these various rules is unwarranted here, it is nevertheless noteworthy that the stakes in classification controversies can be enormous. For example, a real estate venture is likely to produce large deductions for its owners in the early years of its development.\(^\text{13}\) If the organization owning the venture is classified as a partnership, these deductions are passed through to the partners who can use them on their personal returns to shelter their income from other sources.\(^\text{14}\) Indeed, the sheltering effect of these deductions often is a prime inducement to investors in real estate ventures. If an organization is classified as a corporation, however, these deductions may be permanently lost.\(^\text{15}\) First, assuming the corporation does not meet the requirements for Subchapter S status, corporate deductions are not passed through to shareholders.\(^\text{16}\) Second, while theoretically the corporation itself is entitled to the tax benefits from its early losses,\(^\text{17}\) corporations involved in these real estate projects often do not have sufficient income against related to business activity, and business is, in fact, carried on. See Moline Properties, Inc. v. Commissioner, 319 U.S. 436, 438-39 (1943).


\(^{11}\) Compare I.R.C. § 1 (1985) (tax rates for noncorporate taxpayers) with id. § 11 (tax rates for corporations).

\(^{12}\) Corporate income is taxed to the corporation when earned, id. § 11, and any part of that income that is distributed to shareholders as dividends is taxable to the shareholders, but not deductible by the corporation, id. §§ 61(a)(7), 301, 316(a).

\(^{13}\) See, e.g., id. § 351 (special rules for transfers of property to controlled corporations in exchange for stock or securities).

\(^{14}\) See Hoffman, Straw or Nominee Corps. Must be as Passive as Possible to Protect Investors Deductions, 5 TAX’N FOR LAW. 10, 10 (1976).

\(^{15}\) See I.R.C. § 702 (1985) (a partnership’s losses from sale or exchange of capital assets may be deducted by individual partners in the amount of their distributive share).


\(^{17}\) See, e.g., id.; Bertane, Tax Problems of the Straw Corporation, 20 VILL. L. REV. 735, 737 (1975) (property losses of corporation not passed on to shareholders).
which the deductions can be applied, either in the year the expenses or losses were incurred or within the permissible time period for carrying back or carrying forward corporate net operating losses.\textsuperscript{18} Without these deductions, the project might be unattractive to the investor. With the deductions, the project might be viewed as an abusive tax shelter to the government. Thus, it is easy to understand that controversies result because of classification issues.

**Difficulties in Classifying Organizations**

Taxpayer identity issues can get quite murky. For example, many organizations have characteristics of more than one class of taxpayer. A limited partnership may look as much like a corporation as a partnership. The limited partners resemble shareholders in that they are passive investors who do not participate in managing the affairs of the business.\textsuperscript{19} They may have the power to transfer interests in the organization freely and without constraint,\textsuperscript{20} and sometimes even publicly.\textsuperscript{21} Limited partners have limited liability.\textsuperscript{22} Management of a limited partnership is centralized in the general partners,\textsuperscript{23} who might resemble the directors of a corporation. There may be only one general partner, and that partner may be a corporation with neither substantial assets of its own nor a significant proprietary interest in the partnership itself. A close corporation, on the other hand, may operate like a partnership, a course of conduct now expressly permitted by some state stat-

\textsuperscript{18} See Baker & Rothman, *supra* note 15, at 1264.

\textsuperscript{19} See, e.g., UNIF. LIMITED PARTNERSHIP ACT § 7 (1916) (limited partner liable as general partner only when active in control of the business); REVISED UNIF. LIMITED PARTNERSHIP ACT § 303(a) (1976) (same). See generally J. CRANE & A. BROMBERG, LAW OF PARTNERSHIP § 26(a) (1968) (limited partnership is result of desire to share profits without management responsibility and liability for losses); H. REUSCHLEIN & W. GREGORY, AGENCY AND PARTNERSHIP § 264 (1979) (limited partners barred from managerial capacity in business); L. RIBSTEIN, BUSINESS ASSOCIATIONS §§ 2.03(1), 3.03.

\textsuperscript{20} See UNIF. LIMITED PARTNERSHIP ACT § 19 (1916); REVISED UNIF. LIMITED PARTNERSHIP ACT § 702 (1976).


\textsuperscript{22} See, e.g., UNIF. LIMITED PARTNERSHIP ACT § 7 (1916) (limited partner generally not liable as general partner); REVISED UNIF. LIMITED PARTNERSHIP ACT § 303(a) (1976) (limited partner not liable for obligations of limited partnership unless involved in control of business); see also J. CRANE & A. BROMBERG, *supra* note 19, at § 26(a) & (c); H. REUSCHLEIN & W. GREGORY, *supra* note 19, at § 264; L. RIBSTEIN, *supra* note 19, at § 2.03(1).

\textsuperscript{23} See, e.g., UNIF. LIMITED PARTNERSHIP ACT § 9 (1916); see also J. CRANE & A. BROMBERG, *supra* note 19, at § 26(a); H. REUSCHLEIN & W. GREGORY, *supra* note 19, at § 264; L. RIBSTEIN, *supra* note 19, at § 3.03.
utes. Another organization may be incorporated, but may be not much more than a sham or dummy. Tax counsel or the government might for different reasons insist that such a corporate entity be ignored for federal tax consequences.

The Internal Revenue Code does not provide solutions for any of these taxpayer identity issues. The Treasury Regulations are the primary source of rules for classifying unincorporated entities, but they have been the target of extensive criticism. Furthermore, the regulations are inapplicable to other taxpayer identity problems, for example, when to disregard a corporation for tax purposes, and the problems governed by inconsistent caselaw.

THE ROLE OF STATE LAW

The regulations ascribe a preemptive role to federal law in classifying organizations for federal tax purposes. That is, classification issues are governed by federal law, not state law. Consequently, a particular organization, considered an unincorporated association under state law, may be deemed a corporation for federal tax purposes if it has enough of the corporate characteristics enumerated in the regulations. The regulations concede, however, that state law is necessary to determine the legal rights of the members of the organization in meeting the standards of a particular classification. For example, one of the corporate characteristics enumerated in the regulations is limited liability for members.


25 See, e.g., Ogoniy v. Commissioner, 617 F.2d 14, 16 (2d Cir.) (income from property not attributed to shareholder unless corporation is purely passive dummy), cert. denied, 449 U.S. 900 (1980); Love v. United States, 96 F. Supp. 919, 922 (Ct. Cl. 1951) (actions of corporation determine tax identity even though regarded as "straw," "dummy," or phantom); Strong v. Commissioner, 66 T.C. 12, 21 (1976) (use of sham or dummy corporations recognized New York practice), aff'd mem., 553 F.2d 94 (2d Cir. 1977).


28 See infra notes 59-83 and accompanying text.


30 See id. § 301.7701-2(a)(3).

31 See id. § 301.7701-1(c).
Because federal law generally says nothing about which types of organization provide limited liability for their members, one must refer to the state law governing a particular association to determine whether or not its members have limited liability.

Courts have accepted the preemptive role that the regulations assign to federal law in classifying unincorporated entities. This does not mean that the courts are pleased with the regulations. In one controversial Tax Court case involving the tax classification of a limited partnership, the majority opinion and one dissent lambasted the regulations. Though the court felt constrained "to apply the provisions of respondent's regulations as we find them and not as we think they might or ought to have been written," the majority encouraged the government to change them.

The role of state law is much cloudier in cases involving incorporated organizations. Prior to 1965, the government consistently treated entities chartered as corporations under state law and operated in good faith as corporations for federal tax purposes. The primary debate centered on proper classification of organizations not labeled "corporations" by state law. In 1965, the Government promulgated regulations that were "obviously" intended to prevent professional associations, for example, of doctors or lawyers, from obtaining corporation status for tax purposes. The courts, however, uniformly struck down these 1965 regulations. From this

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32 See id. § 301.7701-2(d).
34 See Larson v. Commissioner, 66 T.C. 159, 185-86 (1976); id. at 202, 206 (Quealy, J., dissenting).
35 Id. at 185-86.
36 See id.
37 See United States v. Empey, 406 F.2d 157, 165 (10th Cir. 1969).
39 See United States v. Empey, 406 F.2d 157, 164 (10th Cir. 1969); infra notes 57-58 and accompanying text.
40 See, e.g., Kurzner v. United States, 413 F.2d 97, 112 (5th Cir. 1969) (regulations struck when challenged by association of Florida physicians); O'Neill v. United States, 410 F.2d 888, 895 (6th Cir. 1969) (successful challenge by Ohio physicians); United States v. Empey, 406 F.2d 157, 170 (10th Cir. 1969) (professional service corporation of lawyers successfully challenges regulations); Smith v. United States, 301 F. Supp. 1016, 1021-22 (S.D. Fla. 1969) (regulations declared invalid); Van Epps v. United States, 301 F. Supp. 256, 257 (D. Ariz. 1969) (regulations held invalid in attempt to tax professional corporation of physicians); Williams v. United States, 300 F. Supp. 928, 932 (D. Minn. 1969) (regulations de-
line of authority, which was no more than a response to the outrageous 1965 regulations, came a hornbook-sounding maxim: a corporation created under state law is a corporation for federal tax purposes. In contrast to the regulations, this line of authority made state law paramount, because state law, with few exceptions, generally controls the procedures for incorporating. If the act of incorporation is paramount, the federal standards contained in the treasury regulations are rendered largely irrelevant.

The question in another line of cases was whether, despite compliance with state law requirements for incorporation, the court should disregard the corporate entity and look to the shareholders as being the taxpayers. Though the language in these decisions sometimes echoes state law rationales for piercing the corporate veil, the federal courts have created a body of common law tax principles to answer the question. In stark contrast to the authority invalidating the 1965 regulations, the courts in these cases accorded little significance to the act of incorporation. In one case, it was held that the mere label of "corporation" on an entity did not control its status for federal tax purposes. In a similar case, the court looked to state law to determine the legal relationships of the members of the organization, but only for the purpose of testing whether the organization met the federal standards for attaining corporate status.

It may be possible to harmonize these two apparently inconsistent lines of authority. According to the cases invalidating 1965 regulations, the detailed, mechanical rules contained in the federal
regulations (known as the "Kintner Regulations" and discussed in depth later)\textsuperscript{48} are not to be applied to associations incorporated under state law.\textsuperscript{49} This proposition would not prevent a court from disregarding the corporate entity in appropriate circumstances, which is what the other lines of authority allow courts to do. Thus, while the norm is to honor the corporate status conferred on entities by state business corporation acts, the presence of certain unusual circumstances—for example, lack of a business purpose for the corporation—may result in a court disregarding the corporation as a distinct taxable entity.\textsuperscript{50}

\section*{Classifications of Organizations - The Code}

In general, an organization may be classified as an "association" (i.e., a corporation), a partnership, a proprietorship, or a trust. Despite the importance of the classification issue, the Internal Revenue Code is unusually terse, leaving the delineation of the law to the courts and the regulations. Section 7701(a)(3), for example, defines "corporation" by stating merely that "the term 'corporation' includes associations, joint-stock companies, and insurance companies."\textsuperscript{51} Section 7701(a)(2) provides a catch-all definition of the term partnership that includes "a syndicate, group, pool, joint venture, or other unincorporated organization . . . which is not . . . a corporation."\textsuperscript{52} Neither the Internal Revenue Code nor the Treasury Regulations define the term "proprietorship," which is generally thought to refer to an unincorporated business operated by one person in his own right and without an independent organization separate and apart from himself.\textsuperscript{53} The Code similarly does not define the term "trust," although the Treasury Regulations differentiate between "ordinary trusts" and "business trusts." An ordinary trust is "an arrangement created either by a will or by an inter vivos declaration whereby trustees take title to property for the purpose of protecting or conserving it for the beneficiaries

\textsuperscript{48} See infra notes 67-75 and accompanying text.

\textsuperscript{49} See, e.g., O'Neill v. United States, 410 F.2d 888, 899 (6th Cir. 1969) (entity treated as corporation under state law is corporation for federal tax purposes regardless of regulations); United States v. Empey, 406 F.2d 157, 170 (10th Cir. 1969) (regulations which treat corporation under state law as partnership held invalid).

\textsuperscript{50} See, e.g., Gregory v. Helvering, 293 U.S. 465, 469 (1935) (corporate form disregarded when no bona fide business purpose supports its existence).


\textsuperscript{52} Id. § 7701(a)(2); see Harvard Note, supra note 27, at 746.

\textsuperscript{53} See L. Rinstein, supra note 19, at §§ 1.01, 1.04.
under the ordinary rules applied in chancery or probate courts."\(^{54}\) A "business trust" is a trust created by beneficiaries "as a device to carry on a profit-making business."\(^{55}\) Only an "ordinary trust" is a "trust" as used in the Internal Revenue Code.\(^{56}\)

**Organizations Classified as Corporations - The Regulations.**

Because of the virtual absence of statutory guidelines, the Treasury Regulations have served as the primary source of rules governing the classification issue. A product more of adversarial zeal than of deliberate rule-making, the Regulations represent the government's persistent efforts to stop a particular tax practice that, for some reason, has seemed particularly odious to the Commissioner: professionals treating their businesses as "associations" for tax purposes so they can achieve favorable tax treatment for fringe benefits and deferred compensation plans.\(^{57}\) This favorable treatment has not been available, or at least not as fully available, to self-employed persons or partnerships.\(^{58}\)

At one time it was thought that the imposition of the double tax on dividends resulted in a heavier income tax burden on corporations than on unincorporated entities. The approach of the government prior to 1954, therefore, was to classify business entities as corporations, whenever possible.\(^{59}\) However, while the Commissioner was building up precedent for this presumption in favor of corporate classification, Congress was passing laws that gave favorable tax treatment to corporations that set up deferred compensation plans.\(^{60}\) At some point in time, tax advisors began to realize that, for at least some clients, the tax laws for corporations were more advantageous than those for noncorporate entities. As a

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\(^{54}\) Treas. Reg. § 301.7701-4(a) (1967).

\(^{55}\) Id. § 301.7701-4(b).

\(^{56}\) See id. § 301.7701-4(a), (b).


\(^{59}\) Kurzner v. United States, 413 F.2d 97, 100 (5th Cir. 1969); see Eaton, *supra* note 57, at 6.

\(^{60}\) Kurzner, 413 F.2d at 101; see Eaton, *supra* note 57, at 23.
result, the Commissioner changed his attitude on the classification issue. He now wanted to narrow the definition of "association" and exclude the "clamoring welter of associations seeking corporate status." The turnabout it desired was impeded by precedent, however. The regulations and the cases evinced a conscious inclination in favor of corporate status. Such was the stage for the *Kintner* decision.

In *United States v. Kintner*, a 1954 decision, a group of doctors convinced the Ninth Circuit that the group's unincorporated association should be classified as a corporation for federal tax purposes. The *Kintner* result should not have surprised anyone, given that both judicial and administrative precedent inclined strongly toward the corporate classification. Incensed that doctors and other professionals could get the tax benefits of qualified pension plans, the Commissioner at first refused to follow the *Kintner* decision. After several subsequent courtroom defeats, however, the Commissioner finally conceded on the issue, but only briefly. He soon launched a new attack against doctors by proposing new regulations, adopted in 1960, and known as the "Kintner Regulations." These regulations, still in effect today, constituted an unabashed attempt to overrule *Kintner* administratively. Using criteria first promulgated in 1935 by the Supreme Court in *Morrissey v. Commissioner*, the "Kintner Regulations" are heavily weighted toward partnership classification and against association classification.

The professionals and the private tax bar, however, were not to be outdone. Rather than confront the Commissioner head-on, they used their political clout to pressure state legislators to enact

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61 Kurzner, 413 F.2d at 101.
62 See Kurzner, 413 F.2d at 100-01; Eaton, *supra* note 57, at 5-6.
63 216 F.2d 418 (9th Cir. 1954).
64 Id. at 428.
65 See Rev. Rul. 56-23, 1956-1 C.B. 598.
69 296 U.S. 344 (1935).
statutes permitting the incorporation of professionals. The intent of the state acts was clear. The state legislatures wanted to clothe their professional corporations with enough corporate attributes to qualify as “associations” under the Kintner Regulations, thereby entitling professionals to the tax advantages for fringe benefits and deferred compensation plans available to corporations. Playing a game of one-upmanship, the Commissioner amended the regulations in 1965 in a transparent attempt to thwart the efficacy of state professional incorporation acts. However, courts uniformly invalidated the amended regulations as being arbitrary and discriminatory. Seemingly daunted, the Commissioner at last conceded in a 1970 revenue ruling that it would allow association classification for professional corporations. A 1977 revenue ruling went even further, stating that professional corporations may qualify as corporations without running the gauntlet of satisfying the Kintner Regulations.

The Commissioner of The Internal Revenue Service, of course, has found other ways to attack professional corporations. For example, one case involved a general partnership for the practice of medicine. One of the partners formed a professional association with himself as the sole shareholder and made himself an employee so that he could secure the tax benefits of a defined benefit plan and a medical reimbursement plan. The doctor substituted the professional association for himself as the partner in the medical

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71 See Note, supra note 58, at 776-77.
72 See Treas. Reg. §§ 301.7701-1(c), 301.7701-2(h), T.D. 6797, 1965-1 C.B. 52. The amendments to the regulations, first proposed in December 1963, were adopted in February 1965. Treas. Reg. § 301.7701-(c) added a provision saying that state labels had no importance in classifying an organization for tax purposes, and that professional organizations were so inherently different, they would almost never be taxed as corporations.
73 See supra note 44.
74 See Rev. Rul. 70-101, 1970-1 C.B. 278. After losing in the courts, the government acknowledged the validity of professional corporation statutes in forty-six states. See id. at 278-80.
76 See, e.g., The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), Pub. L. No. 97-248, § 324. TEFRA reduced the fringe benefits available to professional corporations and increased their availability to non-corporate entities. See Comment, Is the Professional Association Dead after TEFRA? The Continuing Saga of Hunter and Hunted, 36 Ark. L. Rev. 508, 508 (1983). The government also has used common-law tax principles, such as the assignment of income, and statutory tax avoidance rules, such as those contained in §§ 269 and 269A. See id. at 518-21.
77 See Keller v. Commissioner, 77 T.C. 1014, aff’d., 723 F.2d 58 (10th Cir. 1981).
78 Id. at 1016.
The government unsuccessfully invoked section 482 in an effort to deny the doctor the fruits of his plan. Following this defeat, Congress overruled the case legislatively by enacting section 269A of the Code, which grants the government the power to reallocate deductions and income between a "personal service corporation" and its shareholder-employee when the corporation serves no meaningful purpose other than securing a tax benefit not otherwise available to the taxpayer. Additionally, the Commissioner is in the process of persuading Congress to overhaul the Code's treatment of fringe benefits and deferred compensation plans, generally equalizing their availability to corporations and unincorporated business entities. Once this process is complete, professionals will have less incentive to incorporate.

An unintended by-product of the Kintner Regulations has been the proliferation of tax shelter limited partnerships. Because the Kintner Regulations make it difficult for business organizations not incorporated under state statutes to achieve association status, tax planners have been able to construct limited partnerships that function like corporations but avoid association classification under the Kintner Regulations. Classified as partnerships for federal tax purposes, these businesses have been able to pass through losses to their investors and to avoid double taxation on their earnings, much to the chagrin of the Commissioner.

Although courts have noted the shortcomings of the Kintner Regulations, they have been unwilling to depart from them.
Rumblings in Congress and elsewhere indicate that changes in classification criteria may be forthcoming. As of yet, however, the Kintner Regulations remain the primary source of rules on the classification issue.

A Mechanical Test

The regulations take a mechanical approach to the classification issue. They list the six characteristics of the "pure" corporation, the same characteristics promulgated in Morrissey in 1935: first, the presence of associates; second, an objective to carry on business and divide the profits; third, continuity of life; fourth, centralized management; fifth, limited liability of investors; and sixth, free transferability of investors' interests. Following the lead of Morrissey, the regulations say that two of these characteristics, the presence of associates and a business objective, are essential to classification as an association. Without both of them, the organization is not an association and will not be treated as a corporation for federal tax purposes. If these two characteristics are present, the next step is to determine whether the organization has any of the other four corporate characteristics. An unincorporated organization should not be classified as an association unless it has more corporate characteristics than noncorporate characteristics. If, however, any of these characteristics is common to both a corporation and the noncorporate form under consideration, that common characteristic must be disregarded in the weighing process. For example, if two of the characteristics are common to both the corporation and the noncorporate form under considera-

(1976) (upholding regulations through disagreeing with way they were written).

See, e.g., S. REP. No. 95, 98th Cong., 1st Sess. 7, 23, 50-51, 80, 106 (1983); Fisher, supra note 57, at 63 (incompatibility of regulations and caselaw militates in favor of further regulations or legislation); Peel, Definition of a Partnership: New Suggestions on an Old Issue, 1979 Wis. L. Rev. 989, 1000; Rosen, Effect of Proposed Amendments to Section 7701 Regulations on Leveraged Issues, 9 J. Corp. Tax'n 53, 53-55 (1982) (discussing effect of proposed regulations); N.Y.U. Note, supra note 27, at 410.

See Treas. Reg. § 301.7701-2(a)(2) (1983); see also Morrissey, 296 U.S. at 353-54 & n.10 (discussing amendments to Tax Regulations distinguishing trusts and associations). For further discussion of the essential characteristics of an association, see infra notes 131-177 and accompanying text (associates requirement); infra notes 139-140 and accompanying text (business objective requirement).

See id.
tion, then the organization must have three of the four remaining characteristics to be classified as a corporation.91 Although the regulations provide that, in addition to the factors listed, other factors significant in classifying the organizational form may be considered, courts have been reluctant to depart from the listed characteristics in their examinations.92 Moreover, courts have been constrained by the regulations to give equal weight to the Morrissey characteristics, even when a flexible weighing system would more accurately measure the resemblance of the entity being evaluated to the corporate form.93

The following paragraphs will discuss the six enumerated characteristics in detail.

Presence of Associates

The requirement of associates is the least discussed and least understood of the six corporate characteristics. Although the regulations offer detailed explanations and examples for four of the other five characteristics,94 they contain virtually nothing about what the requirement of associates is supposed to mean. Cryptically, the regulations declare:

Since associates and an objective to carry on business for joint profit are essential characteristics of all organizations engaged in business for profit (other than the so-called one-man corporation and the sole proprietorship), the absence of either of these essential characteristics will cause an arrangement among co-owners of property for the development of such property for

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91 Id.; see, e.g., Kurzner v. United States, 413 F.2d 97, 109 (5th Cir. 1969) (possession of more than half of four characteristics requires classification as corporation); Zuckman v. United States, 524 F.2d 729, 744 (Ct. Cl. 1975) (presence of three or more characteristics warrants classification as association).
93 See, e.g., Kurzner v. United States, 413 F.2d 97, 105 (5th Cir. 1969) (court applied regulations and Morrissey characteristics and found corporate status under both tests); Larson v. Commissioner, 66 T.C. 159, 172, 185 (1976) (court described Morrissey principle as “starting point” of regulations’ definition of association).
94 See Treas. Reg. § 301.7701-2(b) (1983) (continuity of life); id. § 301.7701-2(c) (centralized management); id. § 301.7701-2(c) (limited liability); id. § 301.7701—2(e) (free transferability of interests). As with the requirement of associates, the regulations neither discuss nor exemplify the requirement of a business objective. For further discussion of that requirement, see infra note 105 and accompanying text.
the separate profit of each not to be classified as an association.\textsuperscript{95}

Some commentators have inferred from this sentence that a solely-owned business cannot be classified as an association for federal tax purposes, because it does not have associates.\textsuperscript{96} But if the second clause is limited to organizations formed from the development of co-owned property, then the sentence does not apply to organizations formed for the development of solely-owned property. Likewise, if the second clause is limited to organizations that develop property, for example, firms that develop shopping centers, then the sentence does not apply to organizations formed to carry on other types of business ventures such as firms in the service industries. Additionally, the first clause provides the rationale for the rule of law in the sentence, which is stated in the second clause. The parenthetical language in the first clause states in effect that the proposition contained in that first clause is inapplicable to the "so-called one-man corporation and the sole proprietorship." If the rationale is declared to be inapplicable to one-man corporations and sole proprietorships, it follows that the rule of law based on that rationale is likewise inapplicable to such businesses.

In short, contrary to what some people think, the regulations, though confusing, do not necessarily require that an entity have multiple owners before it can be classified as an association. What, then, is the intent of the garbled sentence quoted above?

The answer to this question probably rests in history. Many of the early classification cases, including \textit{Morrissey}, involved business trusts used to develop real estate.\textsuperscript{97} Courts sought criteria to differentiate these business trusts from more traditional trusts, such as testamentary trusts, which might also hold title to real estate for multiple beneficial owners.\textsuperscript{98} In evaluating the trust before

\begin{itemize}
\item \textsuperscript{95} \textit{Treas. Reg. § 301.7701-2(a)(2) (1983).}
\item \textsuperscript{96} \textit{See} B. BITTKER & J. EUSTICE, \textit{FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS} ¶ 2.07 (4th ed. 1979); J. MERTENS, \textit{LAW OF FEDERAL INCOME TAX} § 38A.11 (1984); 10 \textit{Fed. Taxes (P-H) ¶ 41,617 (1985).}
\item \textsuperscript{97} \textit{See, e.g., Morrissey v. Commissioner, 296 U.S. 344, 356-57 (1935) (describing trust involved as association rather than ordinary trust where combination is for conducting business enterprise); Helvering v. Coleman-Gilbert Assocs., 296 U.S. 369, 370 (1935) (trust agreement wherein trustees held property for beneficiaries); Helvering v. Combs, 296 U.S. 365, 366 (1935) (trust created to finance and drill oil well); Swanson v. Commissioner, 296 U.S. 362, 363 (1935) (trust agreement for purpose of carrying title to property).}
\item \textsuperscript{98} \textit{See, e.g., Morrissey, 296 U.S. at 359-60 (describing association as those trusts whose participants carry on business and divide gains accruing from the undertaking); Coleman-}
\end{itemize}
Morrissey properly emphasized the use of the trust as a medium to conduct business.\textsuperscript{99} Unfortunately, however, the Morrissey Court became hooked, momentarily, on the word "association" (which was in the statute) and tried to ascribe to it a significance it did not deserve. "‘Association,’" the Court opined, "implies associates."\textsuperscript{100} Business trusts and ordinary trusts differ, the Court continued, in that parties to business trusts, unlike beneficiaries of ordinary trusts, voluntarily join together in their common undertaking.\textsuperscript{101} They choose to associate with each other. Hence, they are "associates." The beneficiaries of a testamentary trust may be beneficial co-owners of real estate, but they do not voluntarily associate with each other in a joint enterprise. Therefore, they are not "associates," and their trust is not an "association."\textsuperscript{102}

This bit of attenuated reasoning was at best subsidiary to the Court's primary theme that the business objective differentiates business trusts from ordinary trusts. It added nothing to the strength of the Court's analysis. Indeed, the Morrissey opinion would have been better off without it. Moreover, the reasoning in Morrissey should never have been used to elevate the presence of associates to its current rank in the regulations as one of the six pure corporate characteristics. At the very least, applicability of the associates requirement should be limited to its original purpose: to distinguish between business trusts, especially those used for the development of real estate, and ordinary trusts. Courts should apply literally the language of the current regulation, limiting its application to arrangements to develop co-owned property. The associates requirement should not be interpreted as requiring an entity to have multiple owners before it can be classified as an association. It should not be used to disqualify a business trust with a single beneficiary from classification as an association.\textsuperscript{103}

\textit{Gilbert Assocs.}, 296 U.S. at 372 (trust where trustees owned and operated twenty apartment houses deemed association); \textit{Combs}, 296 U.S. at 367-68 (trust agreement to finance and drill for production and sale of oil wherein trustees were not individually liable except for willful misconduct and were empowered to sell products of well and borrow money warrants finding of association); \textit{Swanson}, 296 U.S. at 363-65 (trust agreement wherein trustees could manage and control property or borrow money secured by property warrants finding of association).

\textsuperscript{99} See 296 U.S. at 357.
\textsuperscript{100} See id. at 356.
\textsuperscript{101} Id. at 357.
\textsuperscript{102} Id. at 356-57.
\textsuperscript{103} Business trusts, even if deemed to have "associates," are likely to be disqualified for lacking the other corporate characteristics — for example continuity of life and transferabili-
Neither the courts nor the government have harped on the presence of associates as constituting a requirement for association status. Indeed, there exists some case authority that finds one-person organizations to be corporations for federal tax purposes.\textsuperscript{104} Undoubtedly, thousands of organizations owned by single persons file corporate tax returns each year without encountering classification problems. Hopefully, neither the government nor the courts will treat the associates requirement as an inchoate trap against unwary taxpayers. The notion that the term "association" implies multiple owners contradicts not only the literal language of the regulation, but also the expectation of entrepreneurs and tax planners that one-person corporations are indeed corporations and should be taxed as corporations.

\textit{Objective to Carry on Business and Divide Profits}

An objective to carry on business and divide profits is the other corporate characteristic that is neither explained nor exemplified in the regulations. Like the associates requirement, this requirement originated in \textit{Morrissey} as a method to differentiate business trusts from ordinary trusts.\textsuperscript{105} Unlike the associates requirement, however, it is not abstruse. An entity without an objective to carry on a business for profit clearly should not be classified as a corporation.

\textit{Continuity of Life}

A corporation is an independent legal entity, separate and distinct from its shareholders, and unaffected by changes in the identity of the parties owning its shares.\textsuperscript{106} Thus, continuity of life is a corporate characteristic. An organization has continuity of life for federal tax purposes, according to the regulations, if the death, insanity, bankruptcy, retirement, resignation, or expulsion of any member will not cause a dissolution of the organization.\textsuperscript{107} If local law establishes a technical dissolution of the organization upon

\textsuperscript{104} See, e.g., Lombard Trustees, Ltd. v. Commissioner, 136 F.2d 22, 23-24 (9th Cir. 1943) (sole shareholder deemed corporation for federal tax purposes); Hynes v. Commissioner, 74 T.C. 1266, 1280 (1980) (associate similar to shareholder, even if only one associate).

\textsuperscript{105} See \textit{Morrissey} v. Commissioner, 296 U.S. 344, 356 (1935).

\textsuperscript{106} See \textit{supra} note 4.

such an event, even if all of the members agree to continue the operations of the business, continuity of life is lacking.\textsuperscript{108} Dissolution is said to be an alteration of the identity of an organization by reason of a change in the relationship between the members as determined under local law.\textsuperscript{109} For example, the resignation of a partner ordinarily destroys the partnership.\textsuperscript{110} Hence, the typical partnership lacks continuity of life.\textsuperscript{111}

**Centralized Management**

State corporation law ordinarily invests the board of directors with the power to manage the affairs of corporations.\textsuperscript{112} Hence, centralized management is a corporate characteristic. An entity has centralized management for federal tax purposes, according to the regulations, if it invests one or more people with management authority resembling the powers and functions of the directors of a corporation.\textsuperscript{113} Generally, that resemblance exists when the designated parties hold a continuing power to make business decisions without ratification by the owners of the business.\textsuperscript{114} Centralized management does not exist, however, when the managers perform ministerial acts only.\textsuperscript{115} Then they are more like agents acting at the direction of a principal.\textsuperscript{116} Similarly, there is no centralized management unless the parties invested with the power of management have sole authority to make decisions.\textsuperscript{117} "For example, in the case of a corporation or a trust, the concentration of management powers in a board of directors or trustees effectively prevents a stockholder or a trust beneficiary, simply because he is a stockholder or beneficiary, from binding the corporation or the trust by his acts."\textsuperscript{118}

\textsuperscript{108} Id. § 301.7701-2(b)(1)-(2).
\textsuperscript{109} Id. § 301.7701-2(b)(2).
\textsuperscript{110} See UNIF. PARTNERSHIP ACT § 31 (1914); J. CRANE & A. BROMBERG, supra note 19, at § 73.
\textsuperscript{111} See infra notes 146-149 and accompanying text.
\textsuperscript{112} See generally 2 F.H. O'Neal, supra note 24, at § 3.12.
\textsuperscript{113} Treas. Reg. § 301.7701-2(c)(1)(1983).
\textsuperscript{114} Id. § 301.7701-2(c)(3).
\textsuperscript{115} Id.
\textsuperscript{116} Id.
\textsuperscript{117} Id. § 301.7701-2(c)(4).
\textsuperscript{118} Id.
Limited Liability

Because a corporation is an independent legal entity, separate and apart from its shareholders, the personal assets of the shareholders are generally free from liability for corporate obligations. The shareholders' risk of loss is limited to their investment in the corporation.119 This limited liability is a primary advantage in choosing the corporate form for closely-held businesses.120 An entity provides its members with limited liability if, under local law, none of its members are personally liable for the debts of the entity merely by virtue of their membership in the organization.121

Free Transferability of Interest.

According to the traditional corporate norm, shareholders have the power to transfer or to retain their shares without interference by the other shareholders or the corporation.122 For shareholders in close corporations, this right may be chimerical, because often there is no market for the shares, or the shares are subject to stock transfer restrictions.123 Nevertheless, the free transferability of shares is generally considered to be a corporate characteristic and is one of the six corporate characteristics enumerated in the regulations.124 According to the regulations, an entity has free transferability of interest if each of its members (or those members owning virtually all the interests in the entity) has the power, without the consent of other members, to transfer all of the attributes of his interest, pecuniary and managerial, to a person who is not a member of the organization.125 Unfortunately, neither the regulations nor the courts are especially helpful in delineating the impact of stock transfer restrictions on this particular corporate characteristic. According to the regulations, if a member can transfer his interest in the organization only after offering such interest to the other members at fair market value (a type of first option), he has a "modified form of free transferability," but "this modified corporate characteristic will be accorded less significance than if

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119 See generally 2 F.H. O'Neal, supra note 24, § 1.10.
120 Id.
123 2 F.H. O'Neal, supra note 24, §§ 1.07, 7.02.
125 Id. § 301.7701-2(e)(1).
such characteristic were present in a nonmodified form." It is difficult to see why this minimal restraint on alienability should result in discounting the factor of free transferability. It is closely akin to a right of first refusal, which is a true restraint on transferability only on the rare occasion when the transferor cares about the identity of the transferee. The regulations are silent about rights of first refusal, buy-sell agreements, consent restrictions, and first options at less than fair market value. Presumably, rights of first refusal would create a "modified form of free transferability," like the first option at fair market value. A consent restriction should destroy the characteristic of free transferability. Buy-sell agreements and first options at less than fair market value might destroy free transferability, too, but their terms are so variegated that such a determination likely would depend on their terms and the facts and circumstances of the particular situation.

TRUST OR ASSOCIATION?

The regulations declare that continuity of life, centralization of management, limited liability, and free transferability of inter-

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126 Id. § 301.7701-2(e)(2); see Kurzner v. United States, 413 F.2d 97, 108-09 (5th Cir. 1969).

127 The right of first refusal is a stock transfer restriction that prohibits the sale of stock unless the shares are first offered to the corporation, the other shareholders, or both, on the same term offered by a third party. See W. Cary & M. Eisenberg, Cases and Materials on Corporations 474-75 (5th ed. unabr. 1980). Of the basic types of stock transfer restrictions, the right of first refusal is the least restrictive in its impact on the selling shareholder. Id. at 475. The right of first refusal merely limits the selling shareholder's choice of transferees, while ensuring him the price and terms equal to those offered by the outsider. See Tu-Vu Drive-In Corp. v. Ashkins, 61 Cal. 2d 283, 285, 391 P.2d 828, 830, 38 Cal. Rptr. 348, 350 (1964).

128 Under a buy-sell agreement, the shareholder is obligated to sell, and the corporation or the other shareholders to purchase, upon the terms delineated in the agreement. See 2 F.H. O'Neal, supra note 24, § 7.05; Garrity, Buy-Sell Agreements, 46 Pa. Bar A.Q. 190, 190 (1975); Rands, supra note 4, at 461.

129 Consent restrictions require the transferring shareholder to give notice of intention to transfer and get the consent or approval by the directors for the other shareholders. See 2 F. H. O'Neal, supra note 24, at § 7.06; Rands, supra note 4, at 461.

130 A first option is a reservation by the corporation or the shareholders of an option to purchase the shares of the corporation in preference to outsiders. See 2 F. H. O'Neal, supra note 24, at § 7.05; Rands, supra note 4, at 461. Typically, the right to exercise the option is triggered by any proposed sale, gift, bequest, pledge, or other disposition of the shares, or by bankruptcy, adjudicated insanity, death, or termination of employment of the shareholder. The first option price can be determined in a variety of ways, for example by the book value of shares. See Rands, supra note 4, at 461.
est are common characteristics of both trusts and corporations.\textsuperscript{131} Thus, classification of a trust as an association requires the presence of both associates and a business objective.\textsuperscript{132} As discussed above, although some authorities suggest that the term "associates" implies co-owners or a joint venture, the requirement of associates is of dubious merit,\textsuperscript{133} and it has been held that a one-man grantor "business" trust can be an association.\textsuperscript{134} The term "trust," according to the regulations, refers to an arrangement in which trustees take title to property for the purpose of protecting or conserving it for the beneficiaries.\textsuperscript{135} In contrast, "business trusts" are devices to carry on a profit-making business that would normally have been carried on through corporations or partnerships.\textsuperscript{136} A business trust will generally be considered an association for federal tax purposes.\textsuperscript{137}

The regulations also speak briefly about "investment" trusts and liquidating trusts. Investment trusts are treated as associations only if the trustees have power under the trust agreement to vary the investment of the certificate holders.\textsuperscript{138} Liquidating trusts are classified as trusts for federal tax purposes if they are formed for the primary purpose of liquidating and distributing assets transferred to them— that is, if they do not have the purpose of carrying on a profit-making business.\textsuperscript{139} If the liquidation is unreasonably prolonged or is subsequently used to control or operate a business on a continuing basis, however, it will be classified as an association rather than a trust.\textsuperscript{140} In short, the key in determining the classification of most trusts is the presence or absence of a profit-making objective.\textsuperscript{141}

\textsuperscript{132} See id.
\textsuperscript{133} See supra notes 94-104 and accompanying text.
\textsuperscript{134} See Lombard Trustees, Ltd. v. Commissioner, 136 F.2d 22, 23-24 (9th Cir. 1943); Hynes v. Commissioner, 74 T.C. 1266, 1286 (1980).
\textsuperscript{135} Treas. Reg. § 301.7701-4(a) (1985).
\textsuperscript{136} Id. § 301.7701-4(b); see Barrett & de Valpine, Taxation of Business Trusts and Other Unincorporated Massachusetts Entities with Transferable Shares, 40 B.U.L. Rev. 329, 333-34 (1960).
\textsuperscript{137} See, e.g., Morrissey v. Commissioner, 296 U.S. 344, 361 (1935) (business trust created to enable participants to carry on business and divide gains deemed association); Outlaw v. United States, 494 F.2d 1376, 1386 (Ct. Cl. 1974) (trust formed for ownership and management of farm lands for investment deemed association).
\textsuperscript{138} Treas. Reg. § 301.7701-4(c) (1983).
\textsuperscript{139} Id. § 301.7701-4(d).
\textsuperscript{140} Id.
\textsuperscript{141} See Morrissey v. Commissioner, 296 U.S. 344, 360-61 (1935); Howard v. United
Corporation or Partnership

The regulations, the primary source of rules governing the classification issue, are heavily weighted in favor of partnership classification and against corporation classification. Indeed, only certain types of hybrid partnership arrangements have any chance at all of being classified as a corporation. As discussed below, the regulations make it virtually impossible for a partnership organized under statutes similar to the Uniform Partnership Act (UPA) or the Uniform Limited Partnership Act (ULPA) to be classified as a corporation.

According to the regulations, because both partnerships and corporations are assumed to have associates and a business objective, these two characteristics must be disregarded in the classification process. Therefore, the classification of a partnership depends upon the characteristics of continuity of life, centralized management, limited liability, and free transferability of interests. For a partnership to be classified as a corporation, it must possess three of these four major characteristics. General partnerships generally are thought not to possess any of these four corporate characteristics. On the other hand, a limited partnership may closely resemble a typical corporation, especially if the partnership has only one general partner, which is a corporation with neither substantial assets of its own nor a significant proprietary interest in partnership itself. A casual observer unfamiliar with the details of the Kintner Regulations might conclude that such a partnership has all of the six characteristics of the pure corporation and would be classified as a corporation for federal tax purposes. At some point the classification rules indeed may be changed to reflect the equivalence between such a limited partnership and a corpora-

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2 Typical general partnerships lack continuity of life because any of a number of events—for example, death of a partner—results in termination of the partnership. See H. Reuschlein & W. Gregory, supra note 19, at § 229. Also, the typical partnership has nothing resembling a board of directors, for each partner usually has an equal vote in partnership matters. See id. § 184. Partners in a typical general partnership risk unlimited personal liability for business obligations. See id. § 206. Finally, general partners are rarely free to transfer their interest without consent of the other partners. See id. § 171.

3 See supra notes 19-28 and accompanying text; see also Peel, supra note 86, at 1000; Harvard Note, supra note 27, at 745 (discussing characteristics that make limited partnership resemble corporation more than partnership); Note, supra note 57, at 1269 (discussing factors that lead to finding that limited partnership resembles corporation).
The heavy bias in the Kintner Regulations toward partnership classification, however, predetermines the classification of virtually all limited partnerships as a partnership for federal tax purposes, despite their resemblance to corporations.

The paragraphs below discuss the treatment of partnerships in the regulations and examine the corporate characteristics not shared by all partnerships and corporations.

Partnerships: Lack of Continuity of Life

The regulations make it clear that both UPA general partnerships and ULPA limited partnerships lack continuity of life. UPA partnerships lack continuity of life, because a myriad of events, for example, death of a partner, may terminate them. ULPA limited partnerships lack continuity of life because the death, legal incapacity, resignation, or bankruptcy of a general partner causes a dissolution. A limited partnership can avert death or incapacity problems by using a corporation as its general partner, but it cannot eliminate the possibility of a bankruptcy for that corporation. This mere possibility has led courts and the drafters of the regulations to conclude that ULPA limited partnerships lack continuity of life.

Partnerships: Lack of Centralized Management

The regulations state explicitly that partnerships organized under statutes similar to the UPA lack centralized management because, under these statutes, the act of any partner within the scope of partnership business binds all the partners. Even if the partners agree among themselves to delegate the power of management to a group of managing partners, this agreement is ineffective as against outsiders who have no notice of it. Management of limited partnerships is concentrated in the general partners, thus

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145 A Senate report suggests that publicly traded limited partnerships should be classified as corporations for federal tax purposes. See S. Rep. No. 95, 98th Cong., 1st Sess. 7, 23, 50-51, 80, 106 (1983).
147 See UNIF. PARTNERSHIP ACT § 31 (1914); Treas. Reg. § 301.7701-2(b) (1983).
151 See id.
giving the appearance of centralized management, but the regulations nevertheless take the position that limited partnerships usually lack the centralized management characteristic.\footnote{See id.} The regulations emphasize that, unlike a board of directors, general partners usually act partially in their own behalf, and therefore do not act in a purely representative capacity.\footnote{Id. \S 301.7701-2(c)(4); see Zuckman v. United States, 524 F.2d 729, 737-38 (Ct. Cl. 1975); Larson v. Commissioner, 66 T.C. 159, 176-77 (1976); Felton, \textit{A Larson-Zuckman Checklist for Partnership Tax Classification of ULPA Real Estate Shelters}, 11 U. Rich. L. Rev. 743, 757 (1977); Peel, \textit{supra} note 86, at 993.} Thus, a limited partnership has centralized management only if the limited partners hold substantially all of the partnership interests and the general partners hold virtually none.\footnote{Id. \S 301.7701-2(c)(4); \textit{see} Zuckman \textit{v. United States}, 524 F.2d 729, 737-38 (Ct. Cl. 1975); Larson \textit{v. Commissioner}, 66 T.C. 159, 176-77 (1976); Felton, \textit{A Larson-Zuckman Checklist for Partnership Tax Classification of ULPA Real Estate Shelters}, 11 U. Rich. L. Rev. 743, 757 (1977); Peel, \textit{supra} note 86, at 993.} An unrestricted power in the limited partners to remove a general partner is an indication that a limited partnership possesses centralized management.\footnote{Id. \S 301.7701-2(c)(4).}

\textbf{Partnerships: Lack of Limited Liability}

General partnerships almost always lack limited liability because partners are personally responsible for the debts and obligations of the partnership.\footnote{Id. \S 301.7701-2(c)(1)-(2), (4).} While the limited partners of a limited partnership ordinarily are not personally liable, the general partner is.\footnote{Id. \S 301.7701-2(c)(4); see Zuckman \textit{v. United States}, 524 F.2d 729, 737-38 (Ct. Cl. 1975); Larson \textit{v. Commissioner}, 66 T.C. 159, 176-77 (1976); Felton, \textit{A Larson-Zuckman Checklist for Partnership Tax Classification of ULPA Real Estate Shelters}, 11 U. Rich. L. Rev. 743, 757 (1977); Peel, \textit{supra} note 86, at 993.} The personal liability of the general partner eliminates the possibility of a limited partnership having the corporate characteristic of limited liability, because the regulations require that, for an organization to possess the characteristic of limited liability, every member must have limited liability.\footnote{See generally H. Reuschlein & W. Gregory, \textit{supra} note 19, at \S 206 (discussing nature of partnership liability).} The regulations seem to recognize a limited exception, but there is a Catch-22. When the general partner has no substantial assets outside of the limited partnership and is "merely a 'dummy' acting as an agent of the limited partners," the general partner is deemed to have no personal liability.\footnote{See Treas. Reg. \S 301.7701-2(c)(4) (1983).} When the general partner is merely the agent of the limited partners, however, the limited partners lose their limited liability.\footnote{See \textit{id.} \S 301.7701-2(d)(1); \textit{Unif. Partnership Act} \S\S 13-15 (1914). \textit{See generally} H. Reuschlein & W. Gregory, \textit{supra} note 19, at \S 206 (discussing nature of partnership liability).} Again, the limited partnership lacks limited liability because

\footnote{See \textit{id.} \S 301.7701-2(d)(2).}
at least one of the partners (this time the limited partners) lacks limited liability. The end result is that the regulations make it impossible for both UPA general partnerships and ULPA limited partnerships to have limited liability.

**Partnerships: Lack of Free Transferability of Interests**

An organization has the corporate characteristic of free transferability of interests if each of its members can, without the consent of other members, substitute a person not currently a member of the organization for themselves. The member must be able to confer upon his substitute all of the attributes of his interests in the organization. According to the UPA, a conveyance by a partner of his interest in the partnership does not dissolve the partnership, but, in absence of a contrary agreement with the other partners, it does not entitle the assignee to interfere in the management of the partnership or even to inspect the partnership books. Thus, a UPA partnership lacks free transferability of interests.

A ULPA limited partnership, on the other hand, can have the corporate characteristic of free transferability of interests, provided it meets two conditions. First, the limited partnership agreement must grant the limited partners the right to transfer their interests to an outside party and thereby confer all of their rights in the organization on their transferee, both without the consent of the other partners (a type of provision allowed by the ULPA but not by the UPA). Second, the limited partners must own substantially all of the partnership interests. The second condition is grounded on the following reasoning. According to the Kintner Regulations, every “member” of the organization must be able to transfer its interest freely for the organization to have free transferability of interest. Under the ULPA, transfer of a general

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161 See id.; Treas. Reg. § 301.7701-2(d)(2) (1983); Zuckman v. United States, 524 F.2d 729, 741 (Ct. Cl. 1975); see also Felton, supra note 154, at 761-62 (discussing lack of corporate entity).


164 Id.

165 UNIF. PARTNERSHIP ACT § 27(1) (1914).


167 Id.; see Zuckman v. United States, 524 F.2d 729, 742 (Ct. Cl. 1975); Larson v. Commissioner, 66 T.C. 159, 182, 184 (1976); Felton, supra note 154, at 762-63.

partner's interest causes dissolution of the partnership. If the general partner does not own a significant partnership interest, however, it is not a "member" of the organization. Because the general partner is not a "member," its inability to transfer its interest without causing a dissolution is irrelevant to the issue of the free transferability of interests of the "members" of the organization.

If the limited partners do not own substantially all of the partnership interests, then the general partner is a "member" of the organization. If this is the case, because the general partner cannot transfer its interest without causing a dissolution under the ULPA, the partnership will not have the characteristic of free transferability of interests.

**Impossibility of Association Status for Partnerships Under the Kintner Regulations**

As the foregoing analysis demonstrates, the current regulations (the Kintner Regulations) make it clear that a partnership formed under a statute similar to the Uniform Partnership Act will never qualify as an association under section 7701. It is impossible for such a partnership to have any of the four corporate characteristics not generally shared by corporations and partnerships. A limited partnership formed under a statute similar to the Uniform Limited Partnership Act or the Revised Uniform Limited Partnership Act occasionally can have centralized management and free transferability of interests, but never can have continuity of life and limited liability. It needs at least three of the four characteristics, however, and, thus, under the regulations' preponderance test cannot be classified as an association. In recent years, the government has nonetheless sought to classify several limited partnerships as associations. The courts, however, have required the government to abide by its own regulations mechanically applying the preponderance test to find partnerships not to be associations.

In 1977, the government proposed new regulations that

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171 See id.
172 Zuckman v. United States, 524 F.2d 729, 742-44 (Ct. Cl. 1975).
174 See Zuckman, 524 F.2d at 734-44; Larson, 66 T.C. at 173-86.
were decidedly less mechanical than the Kintner Regulations.\textsuperscript{175} Amidst howls of protests from the real estate community, the government quickly withdrew them.\textsuperscript{176} Changes are likely to occur sometime, however; a preliminary congressional study has suggested that publicly traded limited partnerships be taxed as corporations.\textsuperscript{177}

**Disregarding the Corporate Entity**

*Introduction*

Because use of the corporate form can produce either good or bad tax consequences for the owners of a closely held business enterprise, taxpayers and the government often fight over whether or not a particular corporate entity should be respected as a distinct, taxable entity. Sometimes the taxpayer wants the corporate entity to be be disregarded for tax purposes,\textsuperscript{178} and sometimes the government wants it to be disregarded.\textsuperscript{179} The party arguing against corporate status sometimes adds an alternative argument: even if the corporation is to be recognized as a separate taxable entity, the tax consequences from its activities (or its ownership of property)

\textsuperscript{175} 42 Fed. Reg. 1038 (1977); see Peel, *supra* note 86, at 1000-02.

\textsuperscript{176} Peel, *supra* note 86, at 1000. The real estate community was fearful that the new regulations would have made limited partnerships taxable as corporations instead of as partnerships. Unlike partnerships, the corporations would have been unable to pass through the tax benefits of the project to the investors. See *id.*; N.Y. Times, Jan. 6, 1977, at 1, col. 1; Wash. Post, Jan. 6, 1977, at A1, col. 5.


\textsuperscript{178} See, e.g., Moline Properties, Inc. v. Commissioner, 319 U.S. 436, 440 (1943) (taxpayer unsuccessfully urging that corporation is mere agent for stockholder); Elath Rafferty Farms, Inc. v. United States, 511 F.2d 1234, 1237 (8th Cir.) (taxpayer unsuccessfully urging court to find corporate entity either a fictional farce or agent), cert. denied, 423 U.S. 834 (1975); Taylor v. Commissioner, 445 F.2d 455, 457 (1st Cir. 1971) (taxpayer unsuccessfully urging that corporate entity was straw and corporation in name only); Red Carpet Car Wash, Inc. v. Commissioner, 73 T.C. 676, 684 (1980) (taxpayer unsuccessfully urging entity was corporation in name only); Rogers v. Commissioner, 34 T.C.M. (CCH) 1254, 1256 (1975) (taxpayer unsuccessfully urging that entity was dummy corporation whose existence should be ignored for tax purposes).

\textsuperscript{179} See, e.g., Britt v. United States, 431 F.2d 227, 232 (5th Cir. 1970) (government urging business activity insufficient to justify recognition as corporation); Lowndes v. United States, 384 F.2d 635, 637 (4th Cir. 1967); Kimbrell v. Commissioner, 371 F.2d 897, 898 (5th Cir. 1967) (government urging lack of business activity by two corporations); National Investors Corp. v. Hoey, 144 F.2d 466, 467 (2d Cir. 1944) (government denying deduction to corporation urging that corporation not engaged in business activity); Noonan v. Commissioner, 52 T.C. 907, 909 (1969) (government urging that corporations with no business purpose and that generated no income not be recognized as corporations for tax purpose), *aff'd per curiam*, 451 F.2d 992 (9th Cir. 1971).
nevertheless should be attributed to the real parties in interest, not the corporation itself.\footnote{See, e.g., National Carbide Corp. v. Commissioner, 336 U.S. 422, 426 (1949) (taxpayer unsuccessfully urging that agency relationship existed and thus corporate entity should not be taxed); Given v. Commissioner, 298 F.2d 579, 580 (8th Cir. 1966) (taxpayers unsuccessfully urging that corporation was agent and thus without tax liability); Harrison Property Management Co. v. United States, 475 F.2d 623, 624 (Cl. Ct. 1973) (taxpayers unsuccessfully urging beneficial interest from property and right to receive tax advantages, though title was passed to corporation), cert. denied, 414 U.S. 1130 (1974); Carver v. United States, 412 F.2d 233, 235 (Cl. Ct. 1969) (taxpayer unsuccessfully urging no corporate tax liability where corporation never owned assets and never in receipt of income); Collins v. United States, 386 F. Supp. 17, 19 (S.D. Ga. 1974) (taxpayers unsuccessfully urging that corporation conducted no business activity and thus no corporate tax status), aff'd per curiam, 514 F.2d 1282 (5th Cir. 1975).}

The courts have developed several lines of authority to respond to these arguments. Generally, the opinions evince a decided reluctance on the part of the courts to disregard the corporate entity; the norm in tax law, as in other areas of the law, is to honor the corporate form.\footnote{See, e.g., Moline Properties, Inc. v. Commissioner, 319 U.S. 436, 438-39 (1943) (choice of corporate advantages of doing business requires acceptance of tax disadvantages) (citing Burnet v. Commonwealth Improvement Co., 287 U.S. 415 (1932)); New Colonial Ice Co. v. Helvering, 292 U.S. 435, 442 (1934) (general rule that corporation and its shareholders are deemed separate entities for tax purposes disregarded only in exceptional circumstances); Red Carpet Car Wash, Inc. v. Commissioner, 73 T.C. 676, 685 (1980) (generally, taxpayer who chooses to incorporate is bound by consequences of that choice, including tax consequences); Bolger v. Commissioner, 59 T.C. 760, 766 (1973) (corporations organized to avoid state tax law restrictions on loans undoubtably viable, separate entities for tax purposes).}

Whether or not they succeed, the controversies have generated a substantial amount of jurisprudence that neither tax counsel nor the government can ignore.\footnote{See, e.g., Valley Fin., Inc. v. United States, 629 F.2d 162, 166, 171-72 (D.C. Cir. 1980) (IRS convinced court that brokerage firm should not be treated as separate entity), cert. denied, 451 U.S. 1018 (1981); Lowndes v. United States, 384 F.2d 635, 637-38 (4th Cir. 1967) (government convinced court that corporate form was merely form, not substance); Jackson v. Commissioner, 233 F.2d 289, 291 (2d Cir. 1956) (taxpayer succeeded in convincing court to disregard corporate entity); Sellers v. Commissioner, 36 T.C.M. (CCH) 305, 313-14 (1977) (taxpayer succeeded in convincing court to disregard corporate entity), aff'd, 592 F.2d 227 (4th Cir. 1979); Miller, The Nominee Conundrum: The Live Dummy is Dead, But the Dead Dummy Should Live!, 34 Tax L. Rev. 213, 228-29 & n.33 (1979) (citing number of cases in which corporate form has been disregarded). But see Miller, supra, at 229 & n.34 (citing unsuccessful attempts by both government and taxpayers to have corporate form disregarded).}

\footnote{See generally Baker & Rotham, supra note 15, at 1256-57 (discussing nominee and agency theories for disregarding corporate form); Miller, supra note 182, at 220 (classification should be determined by substance rather than form); Note, The Use of Corporations

TAX PURPOSES

The question in these cases has been whether, notwithstanding compliance with state law requirements for incorporation, the courts should disregard the corporate entity and look to someone else, usually the shareholders, as being the taxpayers.\textsuperscript{184} For purposes of analysis, the cases can be divided into three groups. The first group of cases is headed by a landmark 1943 Supreme Court case, \textit{Moline Properties, Inc. v. Commissioner}.\textsuperscript{185} According to \textit{Moline}, the corporate entity should be respected for tax purposes as long as it serves a business purpose or engages in business activities.\textsuperscript{186}

The second group of cases involves the argument, made mostly by taxpayers, that in certain circumstances a corporation is merely an agent for someone else, usually the shareholders.\textsuperscript{187} In these cases, the taxpayer typically asserts that because the corporation is merely an agent, the income tax consequences generated by its activities should be attributed to whomever its principal happens to be.\textsuperscript{188} This argument has been used frequently by real estate investors who, for various nontax reasons, convey bare legal title in real estate to a corporation, but retain the beneficial ownership in the property for themselves.\textsuperscript{189} Recent cases show sharp disagreement


\textsuperscript{185} 319 U.S. 436 (1943).

\textsuperscript{186} Id. at 438-39; \textit{see infra} notes 200-204 and accompanying text.


\textsuperscript{188} See, e.g., \textit{National Carbide}, 336 U.S. at 426-27 (wholly owned subsidiary acting as agent of parent corporation argued that percentage of profits turned over to parent should be taxable only to parent); \textit{Moncrief}, 730 F.2d at 278-79 (corporation created to borrow money as agent or nominee of partnership); \textit{Roccaforte}, 708 F.2d at 987-88 (corporation organized as agency of partnership to avoid usury laws).

\textsuperscript{189} See, e.g., \textit{Roccaforte}, 708 F.2d at 987 (partners converted title of property to corporation but reserved beneficial interest to themselves); \textit{Jones}, 640 F.2d at 748-49 (title to partnership property in corporate name); Harrison Property Management Co. v. United States, 475 F.2d 623, 624 (Ct. Cl. 1973) (partnership placed title to oil leases in name of management corporation but retained beneficial ownership), \textit{cert. denied}, 414 U.S. 1130 (1974).
as to the circumstances that must exist for this argument to succeed. The leading case is a 1949 Supreme Court case, *National Carbide Corp. v. Commissioner*, which is discussed in a later section.

The cases in the third group are lumped together mostly for the sake of convenience. In these cases, the government has relied on a potpourri of common-law tax principles in disregarding the corporate entity, including fraud and the assignment of income, step transaction, tax avoidance, substance over form, and business purpose doctrines. For example, courts have sometimes disregarded the corporate entity at the behest of the government when the corporation had no purpose except to avoid taxes. The most famous case in this group is probably *Gregory v. Helvering*, also discussed below. Analysis of cases within this group can be difficult, because courts sometimes inextricably intertwine these doctrines with each other and with the *Moline* and *National Carbide* rules.

Some opinions discuss statutory tax avoidance rules, such as those contained in sections 269 and 482 of the Code, in addition to common law tax principles.

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190 Compare Ourisman v. Commissioner, 82 T.C. 171, 181 (1984) (application of six indicia of agency established in *National Carbide*), vacated, 760 F.2d 541 (4th Cir. 1985) and *Roccaforte*, 77 T.C. at 285-87 (fact that corporation owned by principal need not defeat claim that corporation is true nontaxable corporate agent) with *Roccaforte*, 708 F.2d at 989-90 (arms-length relations between corporation and principal mandatory for finding corporation to be true nontaxable corporate agent).


193 See, e.g., *Gregory v. Helvering*, 293 U.S. 465, 469-70 (1935) (court finding sole purpose to be avoidance of taxes); *Haberman Farms, Inc. v. United States*, 305 F.2d 787, 793 (8th Cir. 1962) (court finding corporate form with distinct tax purpose but no reality beyond lessening of tax burdens); *Aldon Homes, Inc. v. Commissioner*, 33 T.C. 582, 597 (1959) (corporations found to be organized solely to obtain tax benefit and thus not given recognition for tax purposes).


196 See, e.g., *Foglesong v. Commissioner*, 621 F.2d 865, 869-72 (7th Cir. 1980) (§ 482 available to prevent tax evasion or clearly reflect controlled taxpayer's income); *Peter Pan Seafoods, Inc. v. United States*, 20 A.F.T.R.2d (P-H) 5080, 5084-86 (W.D. Wash. 1967) (section 269 precluded recovery of tax refund); *Keller v. Commissioner*, 77 T.C. 1014, 1022-23
The Business Purpose/Business Activity Test

Sometimes a taxpayer argues that a corporation should be considered completely nonexistent for tax purposes. The taxpayer in such a case desires to have the tax consequences attributable to corporate operations passed through to the shareholders. Despite occasional judicial incantations of state law reasons for piercing the corporate veil, for example, that the corporation is a mere "dummy" or "alter ego" for its shareholders, most of these arguments fail; they cannot pass the test of *Moline Properties, Inc. v. Commissioner.* In *Moline,* the taxpayer sought to have the gain attributable to the sale of corporate property by the corporation taxed to the sole shareholder, instead of to the corporation. The shareholder wanted the "corporate existence ignored as merely fictitious." The Supreme Court responded:

The doctrine of corporate entity fills a useful purpose in busi-
ness life. 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, so long as that purpose is the equivalent of business activity or is followed by the carrying on of business by the corporation, the corporation remains a separate taxable entity. 203

This language begs for clarification of what "purposes" amount to the "equivalent of business activity." Numerous later decisions, however, have avoided the difficult analysis that such a clarification would entail. Lower courts instead have taken an easier route. They have interpreted Moline as dictating an alternative test: the presence of either a business purpose or business activity will result in recognition of the corporation as a separate taxable entity. 204

It is especially difficult to concoct a reason for incorporating, except perhaps for tax avoidance, that does not amount to a business purpose. It would seem, therefore, that a literal interpretation of the business purpose prong of the Moline test would result in every corporation being recognized for tax purposes, unless it was formed purely for tax avoidance (in which case government, not the taxpayer, would want it disregarded). 205 The cases are not quite that literal, but they are close. For example, the Tax Court has held that organization of a corporation for the purpose of avoiding state usury laws is a business purpose that requires the recognition of the corporation as a separate taxable entity. 206 Since use of the corporation allows the owners to obtain financing that they could not obtain as individuals or partners, the corporations could not be considered as fictional or non-existent for tax purposes. In this type of case, anybody not versed in tax law would consider the corporations as empty shells that do not operate busi-

203 Id. at 438-39 (footnote omitted).
205 See Horwood, supra note 204, at 14-1 to 14-25.
nesses— as fronts to avoid archaic state statutes. In another case, the corporate shell was used to protect against the disruptive effect that the death of a partner would have had on efficient management of the enterprise and to decrease the need for multiple signatures for routine operations.\textsuperscript{207} Although every pertinent document presented to the court indicated that the corporation was merely a conduit, the corporation was held to be a taxable entity.\textsuperscript{208}

Although courts could end the inquiry upon finding a business purpose for the corporation, they nevertheless usually continue the analysis by investigating whether or not the corporation engaged in any business activity.\textsuperscript{209} Shortly after \textit{Moline}, Judge Learned Hand gave what remains today the best explanation of the business activity test:

\begin{quote}
[T]o be a separate jural person for purposes of taxation, a corporation must engage in some industrial, commercial, or other activity besides avoiding taxation: in other words, 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.\textsuperscript{210}
\end{quote}

Although business activity is required for recognition of the corporation as a taxable entity, that activity may be minimal. Indeed, the degree of corporate purpose activity mandating corporation status for the taxable entity is extremely low.\textsuperscript{211} Recent cases have indicated that even ministerial acts constitute "business activities" under \textit{Moline}.\textsuperscript{212}

\begin{footnotesize}
\begin{enumerate}
\item See id. at 624-25.
\item See, e.g., Sarkisian v. Commissioner, 43 T.C.M. (CCH) 1074, 1078-79 (1982) (corporation engaged in business activities consistent with its purpose recognized as separate taxable entity); Strong v. Commissioner, 66 T.C. 12, 24-25 (1976) (low degree of corporate purpose and activity sufficient to require recognition as taxable entity), aff'd \textit{without opinion}, 553 F.2d 94 (2d Cir. 1977); Preferred Properties, Inc. v. Commissioner, 35 T.C.M. (CCH) 68, 70 (1976) (taxpayer had bona fide business purpose and carried on significant business activities); Rogers v. Commissioner, 34 T.C.M. (CCH) 1254, 1257 (1975) (business activities included maintaining bank accounts, lending money, and filing corporate statements and reports).
\item National Investors Corp. v. Hoey, 144 F.2d 466, 468 (2d Cir. 1944).
\item Britt v. United States, 431 F.2d 227, 237 (5th Cir. 1970); Sarkisian v. Commissioner, 43 T.C.M. (CCH) 1074, 1078 (1982); Strong v. Commissioner, 66 T.C. 12, 24 (1976), aff'd \textit{without opinion}, 553 F.2d 94 (2d Cir. 1977).
\item See, e.g., Ogiony v. Commissioner, 617 F.2d 14, 15-16 (2d Cir.) (corporation held title to property to obtain financing but all expenses were paid and rental incomes received by partnership), \textit{cert. denied}, 449 U.S. 900 (1980); Collins v. United States, 386 F. Supp 17,
\end{enumerate}
\end{footnotesize}
It is tempting to conclude that *Moline* has settled the area, constructing impassable barriers for litigants who want a corporation to be disregarded completely for tax purposes. This conclusion is most accurate when it is the taxpayer who wants the corporation to be disregarded. The taxpayer has succeeded in a few rare instances, and these few successes may be mere aberrations.

The successes can be divided roughly into four groups. The first group is headed by the most prominent of the cases in favor of the taxpayer, *Paymer v. Commissioner*. In *Paymer*, the Court of Appeals for the Second Circuit held that a corporation created by two partners, solely to remove partnership property from the reach of the partnership creditors, should be disregarded for tax purposes. The court characterized the corporation as a “passive dummy” that did nothing but hold title to real estate; the court found no business purpose because the corporation served only to deter creditors. However, a strong argument could be made that deterrence of creditors is indeed a business purpose. Decided in 1945, *Paymer* predated those cases holding that the *Moline* business purpose/business activity test is conjunctive in nature. Although the corporation in *Paymer* held legal title to property, it never performed any business activity. It is therefore distinguishable from most of the modern cases, which almost always find business activity in addition to a business purpose. No one has called *Paymer* bad law, however, and courts and commentators

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19 (S.D. Ga. 1974) (corporation formed to avoid state usury restrictions and secured only one mortgage), *aff’d*, 514 F.2d 1282 (5th Cir. 1975) (per curiam).

213 150 F.2d 334 (2d Cir. 1945).

214 *See id.* at 336-37.

215 *See id.* at 337.

216 Apparently the first case to hold that the *Moline Properties* test is conjunctive—i.e., requiring both business purpose and business activity—was *Jackson v. Commissioner*, 233 F.2d 289 (2d Cir. 1956). In *Jackson*, the Court of Appeals for the Second Circuit found a clear business purpose, but insufficient business activity, when a corporation was formed for the sole purpose of protecting the taxpayer's spouse from the taxpayer's creditors. *See id.* at 289-90; *Bertane, supra* note 16, at 745.

217 *See Paymer*, 150 F.2d at 337.

continue to cite it. More importantly, a 1980 tax court opinion, Red Carpet Car Wash, Inc. v. Commissioner, relied on Paymer in determining that a corporation was not a separate taxable entity. The corporation in Red Carpet was a front for a Ford dealership that had invested in a tax shelter and wanted to conceal its investment from Ford’s main office, which frowned on such investments. The corporation was no more than a nominee for furnishing a name for the partnership; it engaged in no business activity whatsoever.

In the second group of cases, courts have used almost an inverted assignment of income rationale to find for the taxpayer. Although the taxpayers in these cases created corporations, the shareholders personally operated the businesses while the corporations did nothing. Because only the shareholders operated the businesses, the tax consequences of the businesses were attributed to the shareholders, not to the corporations.

The third group contains only a few modern cases. In these cases, although the corporations were deemed to have been separate entities in the past, they had since ceased to conduct any business activity or to have any business purpose. They had become mere conduits. The courts in each case disregarded the corporations for the years after they had stopped engaging in any business.

\[\text{See, e.g., Britt v. United States, 431 F.2d 227, 236 (5th Cir. 1970) (Paymer reflects judicial reluctance to disregard corporate form where National Investors “business” test satisfied); Red Carpet Car Wash, Inc. v. Commissioner, 73 T.C. 676, 686 (1980) (used Paymer in determining whether corporation was mere nominee); Strong v. Commissioner, 66 T.C. 12, 23 (1976) (Paymer reflects Second Circuit’s focus on business purpose with respect to property in question), aff’d without opinion, 553 F.2d 94 (2d Cir. 1977); Horwood, supra note 204, at 14-1, 14-25 to 14-26; Miller, supra note 182, at 241; Note, The Use of Corporations, supra note 183, at 367 n.43.}\]

\[\text{See id. at 686-87 (1980).}\]

\[\text{See id. at 685.}\]

\[\text{See, e.g., Kimbrell v. Commissioner, 371 F.2d 897, 901-02 (5th Cir. 1967) (type and amount of business activities insufficient for finding of separate taxable entity); Kittle v. United States, 19 A.F.T.R.2d (P-H) 976, 978-79 (W.D. Tenn. 1967) (corporation operated as sole proprietorship entitled shareholder to depreciation deduction); Red Carpet Car Wash, Inc. v. Commissioner, 73 T.C. 676, 685-87 (1980) (corporation which engaged in no activity with regard to partnership not entitled to deduction for partnership losses).}\]

\[\text{See Haberman Farms, Inc. v. United States, 305 F.2d 787, 793 (8th Cir. 1962); Minnesota Farm Bureau Sec., Inc. v. United States, 10 A.F.T.R.2d (P-H) 6102, 6104 (D. Minn. 1962).}\]

In Sarkisian v. Commissioner, 43 T.C.M. (CCH) 1074 (1982), the Tax Court refused to disregard the corporation because the corporation still served a legitimate nontax purpose.
Finally, two district court opinions have disregarded the corporate entity at the taxpayer's insistence, citing only pre-\textit{Moline} authority.\footnote{See \textit{Baltimore Aircoil Co. v. United States}, 333 F. Supp. 705, 710-11 (D. Md. 1971); \textit{Dobyns-Taylor Hardware Co. v. United States}, 278 F. Supp. 538, 542-44 (E.D. Tenn. 1967).} These cases should not be accorded any precedential weight, but they show that the government does not always win.

When use of the corporate form produces tax disadvantages for closely-held enterprises and their owners, tax planners must tell their clients that they cannot readily disassociate themselves from the corporate form and have it disregarded for tax purposes. Neither the planners nor their clients should ever expect that they will be capable of persuading the government or a court that their corporation should be disregarded. They might be better off using a proprietorship or partnership, despite the problem of expanded exposure to personal liability. They might be able to incorporate and elect to use the partnership—like tax treatment afforded by

\textit{Id. at} 1078-79. In the first four of the five years at issue, the corporation borrowed money, held title, mortgaged property, executed several leases, and accepted several rent checks. \textit{Id. at} 1078. The court here was correct that the corporation was not inactive, as claimed by the taxpayers. In the fifth year, however, the corporation seems to have done little more than reconvey the property to the beneficiaries. See \textit{id. at} 1077, 1079. Thus, it is perhaps surprising that the court considered it a taxable entity for that year. The court listed the following factors in support of its legal conclusion: (1) the corporate charter granted the corporation broader powers than the mere ability to obtain financing for one parcel of real estate; (2) the beneficial owners of the real estate made no effort to liquidate the corporation, even though the corporation supposedly had no reason for its continued existence; (3) when notified by state officials that the corporation was about to be dissolved for failure to file state franchise tax returns, the owners of the real estate filed the returns to prevent the dissolution; and (4) the use of the corporate form "carried with it the usual baggage," including limited liability. \textit{Id. at} 1079. The court stated that the presence of limited liability was "not determinative," but significant. \textit{Id.} The second and third factors, which suggest an argument akin to an estoppel, might be sufficient to justify a determination that the corporation should not be disregarded. However, the first and the fourth factors—the broad purpose clause in the charter and limited liability—seem legalistic. The owners of the real estate had personally guaranteed the mortgage note, see \textit{id.}, and it can be presumed that the mortgagee will be the owner's sole, or at least major, creditor. The limited liability accorded by the corporate form is mostly theoretical when the shareholders personally guarantee large corporate debts. The broad purpose clause is likewise unimportant to a nominee corporation that does nothing except to hold title to real estate. In \textit{Sarkisian}, the clause was no doubt merely a minute, although unfortunate, drafting error by an attorney, who failed to tailor the corporate charter to the needs of his client. Nothing in \textit{Sarkisian} remotely suggests that the corporation was about to embark upon any active trade or business. Thus, though \textit{Sarkisian} did not suggest that \textit{Haberman Farms} and \textit{Minnesota Farm Bureau} should be overruled, the legalistic tenor of the \textit{Sarkisian} opinion contrasts sharply with those earlier decisions, and perhaps evinces a reluctance on the part of the Tax Court to accept an agreement that a corporation whose original business had ended should be disregarded for federal tax purposes.
the liberalized Subchapter S provisions. They might even be able to convince a court that the corporation is an agent for the shareholders, an argument finding increasing support and achieving objectives similar to those sought by taxpayers in the *Moline* type cases. If shareholders of a close corporation are engaged in a dispute with the government and they can formulate a plausible argument in favor of disregarding the corporation, they probably should not forego at least making the argument. Although it might be frivolous to go to court with only that argument, there are enough cases in favor of taxpayers to show that success is not completely impossible.

**The Corporation as an Agent or Nominee**

Numerous nontax advantages may impel the owners of a closely held enterprise to select the corporate form. They may want to use a corporation to limit personal liability,\(^2\) to avoid restrictive usury laws\(^2\) or government regulation,\(^2\) to facilitate estate planning,\(^2\) to avoid personal liability on mortgage indebtedness,\(^2\) to conceal title from personal creditors,\(^2\) to simplify title

\(^2\) See, e.g., Given v. Commissioner, 238 F.2d 579, 581 (8th Cir. 1956) (corporate form chosen to avoid risk of suits against owners of enterprise); Siegel v. Commissioner, 45 T.C. 566, 569 (1966) (corporation organized to insulate personal assets of investor and protect his reputation).

\(^2\) See, e.g., Roccaforte v. Commissioner, 708 F.2d 986, 987 (5th Cir. 1983) (lender required incorporation of lendee when state usury laws did not cover corporations); Jones v. Commissioner, 640 F.2d 745, 747 (5th Cir.) (loan conditioned on borrower’s incorporation to avoid state usury laws), *cert. denied*, 494 U.S. 965 (1981); Ogiony v. Commissioner, 617 F.2d 14, 15-16 (2d Cir.) (partnership incorporated because it could not obtain loan at other than usurious rates), *cert. denied*, 449 U.S. 900 (1980); Strong v. Commissioner, 66 T.C. 12, 14 (1976) (corporation formed to obtain loans to which state usury laws would not apply), *aff’d without opinion*, 553 F.2d 94 (2d Cir. 1977); *see also* Hoffman, *supra* note 13, at 11 (“the most prevalent reason for the use of a [nominee] corporation is the circumvention of state usury laws”).

\(^2\) See, e.g., Elot H. Raffety Farms, Inc. v. United States, 511 F.2d 1234, 1236 (8th Cir.) (Mexican corporation formed by United States partners to avoid Mexican law prohibiting farming operations in Mexico by foreign nationals), *cert. denied*, 423 U.S. 834 (1975); Dallas Downtown Dev. Co. v. Commissioner, 12 T.C. 114, 123-24 (1949) (intermediate corporation formed by Texas bank to circumvent Texas banking law restriction on amount banking companies could spend on bank buildings).


\(^2\) See, e.g., Love v. United States, 96 F. Supp. 919, 920 (Ct. Cl. 1951) (title to property on which residence was to be erected transferred to corporation).
transfer, or to achieve innumerable other benefits. The use of
the partnership form may produce far better federal tax conse-
quences, however. Generally speaking, for federal tax purposes a
partnership is a conduit that passes the tax consequences of busi-
ess operations through to the individual partners, who report
them on their own personal tax returns. Partnership tax conse-
quences are especially attractive in the first years of a business,
when the business frequently generates large deductions that can
be passed through to the partners to shelter other income. The
taxpayer is thus presented with a dilemma: tax factors heavily
favor the use of a partnership, but nontax factors favor the use of a
corporation.

The solution proposed by many attorneys, especially for real
estate ventures, has been the “nominee corporation.” The inves-
tors form a partnership and acquire the property to be developed
in the partnership name. They then form a corporation and, while
retaining beneficial ownership in the partnership, transfer record
legal title of the property to the corporation. The partners make it
clear to lenders (and anyone else with a need to know) that the
partnership is the real owner of the property, and that the corpo-
rations is a mere nominee for the partnership, nothing more than a
vehicle for holding record title. Thus, the corporation is merely the
agent of the partnership, with no powers of its own, acting only at
the instruction of the partnership. The partners hope that the cor-
poration will be respected for whatever nontax purposes it is cre-
ated, but will be treated as a conduit for federal tax purposes.
Thus, although the corporation at some point participates nomi-
nally in developing the project, for example, holding record title to
the property, the partners, who are usually shareholders, neverthe-
less treat themselves as owners of the project for federal income

231 See, e.g., Paymer v. Commissioner, 150 F.2d 334, 335-36 (2d Cir. 1945) (corporation
formed to protect partnership assets from attachment by creditors of partner).
232 See, e.g., Tomlinson v. Miles, 316 F.2d 710, 711 (5th Cir.) (corporation formed to
avoid complexities in transferring property owned by large group of individuals), cert. de-
233 See, e.g., Taylor v. Commissioner, 445 F.2d 455, 456 (1st Cir. 1971) (corporation formed to
conceal identity of politically active individual submitting zoning application); Brit v. United States, 431 F.2d 227, 229 (5th Cir. 1970) (corporation formed to provide
partners' children with additional income and functional interest in business).
235 See Hoffman, supra note 13, at 10; Harvard Note, supra note 27, at 745.
236 Hoffman, supra note 13, at 11.
tax purposes. Thus, the partners report the gains and losses realized from the project on their own tax returns, claiming deductions for interest, taxes, and depreciation, and capitalizing other expenditures that increase their basis in the project. At the soonest practicable moment, the partnership liquidates the corporation with title to the property reverting to the partnership. Because the partners were never divested of beneficial ownership, they do not feel compelled to report the liquidation as a taxable event.\(^{237}\)

Except for two narrow (and perhaps anomalous) revenue rulings in the mid-1970's,\(^{238}\) the government generally has posited that, because the nominee corporation has a role in developing the project, it is the actual taxpayer, and therefore should report any income or gains and deduct any expenses or losses realized from the project.\(^{239}\) If the government wins, the expenses and losses from the project are not passed through to the partners, who likely have income from other sources against which the project deductions can be offset.\(^{240}\)

Although judicial responses have not been fully consistent, the opinions nevertheless evidence some common generalizations. Most decisions reject claims made by taxpayers that a corporation should be deemed a mere agent of its shareholders and that its income or losses should be attributed to the shareholders.\(^{241}\) The


\(^{239}\) See, e.g., Vaughn v. United States, 740 F.2d 941, 946-47 (Fed. Cir. 1984) (holding that although corporation held title to property as agent of owners, facts at bar failed to reveal such status); Harrison Property Management Co. v. United States, 475 F.2d 623, 623-26 (Ct. Cl. 1973) (profits derived from property held by nominee corporation taxable to corporation rather than individuals retaining beneficial ownership), cert. denied, 414 U.S. 1130 (1974); Taylor v. Commissioner, 445 F.2d 455, 457 (1st Cir. 1971) (finding that nominee corporation did more than merely hold title to land and was therefore more than straw corporation).

\(^{240}\) See Baker & Rothman, supra note 15, at 1264.

\(^{241}\) See, e.g., National Carbide Corp. v. Commissioner, 336 U.S. 422, 438 (1949) (corporation managing property for owner held not true agent, owner could not escape tax consequences of corporate form); Moline Properties, Inc. v. Commissioner, 319 U.S. 436, 440-41 (1943) (corporation wholly owned by one stockholder not treated as agent of stockholder); Vaughn v. United States, 740 F.2d 941, 946-47 (Fed. Cir. 1984) (although corporation may hold property as mere agent, under facts involved it did not); Elot H. Raffety Farms, Inc. v. United States, 511 F.2d 1234, 1239 (8th Cir.) (taxpayers who maintained that corporation was not a mere agent to escape liability could not later gain tax advantage by claiming it was an agent), cert. denied, 423 U.S. 834 (1975).
rejection generally is accompanied by a homily for impudent share-
holders, such as: "[t]he choice of the advantages of incorporation
to do business . . . required the acceptance of the tax disadvan-
tages." Recent decisions from the Tax Court and several other
federal courts, however, have accepted agency arguments made by
taxpayers.

It is easier to catalog the results of the agency cases than it is
to find satisfactory analysis within the opinions. The problem
stems partly from the ill-fitting approach some courts have taken
to nominee corporation problems. Often the courts have looked to
see whether the activities of the corporation are so insufficient that
it should be disregarded for tax purposes. Typically, the courts
have questioned whether the real owners of the property derive
any advantage from using the corporation. If they do, these
courts have concluded, the corporation is a taxable entity and the
tax consequences generated from owning the property are attribu-
table to it. This analysis is virtually a replication of the Moline
business purpose/business activity test, and displays a misconcep-
tion of the issue. The Moline test was designed to determine

homily has been frequently cited. See, e.g., Harrison Property Management Co. v. United
States, 475 F.2d 623, 626 (Ct. Cl. 1973) ("choice of the advantages of incorporation . . .
requires 'the acceptance of the tax disadvantages' ") (quoting Moline, 319 U.S. at 439), cert.
(emphasized Moline's corporate entity doctrine) (quoting Moline, 319 U.S. at 438-39), aff'd,
514 F.2d 1282 (5th Cir. 1975) (per curiam).

244 See supra note 245.

245 See supra note 244.

formed to avoid state usury laws), aff'd, 514 F.2d 1282 (5th Cir. 1975)(per curiam); see
Kurtz & Kopp, supra note 244, at 648.

247 See supra note 245.
whether a corporation should be considered as a distinct taxpayer, separate and apart from its shareholders. It is quite possible for one taxpayer, be it a corporation or an individual, to be an agent or a nominee for another taxpayer. The dual status of taxpayer and nominee or agent is not intrinsically inconsistent. Fortunately, courts have begun to understand the difference between the argument that a corporation, though a taxable entity, is an agent, and the argument that a corporation, because it has no business purpose and does no business, is not even a taxable entity.

*The National Carbide Test*

*National Carbide Corp. v. Commissioner,* a 1949 Supreme Court decision, is still the leading authority on the agency issue. In *National Carbide*, a parent corporation used four operating subsidiaries to conduct its businesses. Each of the subsidiaries signed a contract that designated it as agent for the parent and required it to turn over all profits to the parent, minus a nominal fee it retained for services rendered as agent. The subsidiaries reported their fees as income, but claimed that the profits produced by the businesses they operated should be taxed to their principal, the parent corporation. The Supreme Court declined to honor the agent status sought by the subsidiaries. The guise of an agency relationship, the Court held, could not conceal what was an anticipatory assignment of income; the income from running the businesses had to be taxed to the subsidiaries who had

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553 F.2d 94 (2d Cir. 1977).

248 See, e.g., Snyder v. Commissioner, 66 T.C. 785, 791 (1976) (individual holding title to property was nominee for real owner); Estate of Connelly v. Commissioner, 34 T.C.M. (CCH) 1429, 1433 (1975) (individual taxpayer holding legal title to property was merely nominee for real owner); see Kurtz & Kopp, supra note 244, at 648; Miller, supra note 182, at 223, 252.

249 See, e.g., Moncrief v. United States, 730 F.2d 276, 280 (5th Cir. 1984) (recognized both agency theory and “disregard” theory); Roccaforte v. Commissioner, 708 F.2d 986, 988-89 (5th Cir. 1983) (corporations, though taxable entities, may qualify as non-taxable agents); Jones v. Commissioner, 640 F.2d 745, 750-51 (5th Cir.) (taxpayers argued that corporation be recognized as such and also as agent for partnership), cert. denied, 454 U.S. 965 (1981).


251 See Vaughn v. United States, 740 F.2d 941, 946-47 (Fed. Cir. 1984); Moncrief v. United States, 730 F.2d 276, 280 (5th Cir. 1984); Roccaforte v. Commissioner, 708 F.2d 986, 989-90 (5th Cir. 1983).

252 336 U.S. at 424-25.

253 Id. at 425.

254 Id. at 426-27.

255 Id. at 438.
Despite the trappings of an agency relationship, the Supreme Court saw nothing more than a normal parent-subsidiary relationship—subsidiaries operating businesses and transmitting profits to a parent. 257

The result of National Carbide was sensible. If a corporation operates a business, it should not be able to avoid the tax consequences of its business activities by claiming that it is an agent for its shareholders. All corporations could make that claim, for a corporation is by nature a device or instrument for carrying on the business of its shareholders. If the subsidiaries' argument in National Carbide had been accepted, shareholders could opt into or out of the corporate tax regime by designating or not designating their corporations as agents, choosing whichever status produces better tax consequences. The holding of National Carbide effectively squelches any arguments that a corporation with an active trade or business should be treated as an agent of its shareholders for tax purposes. For close corporations with active trades or businesses, the price to pay for achieving agency status for their corporation would probably be unduly high anyway; certainly, the shareholders would be shed of the protection of limited liability accorded to them by the use of a corporate form. 258

National Carbide nevertheless suggested that a corporation might sometimes be treated as an agent or trustee for its shareholders-principals and thereby avoid taxation in certain circumstances. 259 The Court proffered the following “relevant considerations” in determining whether a “true agency” exists: “[w]hether 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.” 260 In addition to these “relevant factors,” the court noted two characteristics that must exist for a corporation to be a “true agent”: first the relations of the corporation with its principal must not depend on the fact that it is owned by the principal; and second, the business purpose of the corpora-

256 Id. at 436.
257 Id.
258 See generally Note, The Use of Corporations, supra note 183, at 384-85 (assumption of agent’s liabilities by principal is necessary evil of agency relationship).
259 336 U.S. at 437.
260 Id.
tion must be to carry on the normal duties of an agent. 261

It is not difficult to set up an arrangement that meets National Carbide's four "relevant factors." Reported decisions are virtual formbooks for language to use in drafting documents that create corporate nominees. 262 The first of the required characteristics, however, is not easily satisfied and is the focal point of current controversy.

One interpretation of the first requirement is that the relationship between the principal and agent must be at arms-length and independent. 263 Obviously, the relationship between shareholders and their close corporations is rarely arms-length and independent. This especially restrictive interpretation has been used to defeat attempts by shareholders to have their close corporations treated as agents. 264 Whether or not this interpretation produces good tax policy, it hardly seems to be consistent with the realities of the business world: numerous principal-agent relationships are not arms-length, and no urgent issue of social welfare demands that they should be. A variation of this interpretation, slightly less restrictive, is to test whether the agent would have made the agreement if the principal were not its owner, and whether the principal would have made the agreement if the agent was not under its con-

261 Id. In Roccaforte v. Commissioner, 708 F.2d 986, 989 (5th Cir. 1983), the Fifth Circuit renumbered National Carbide's four "relevant considerations" and two "required conditions," listing them as six "conditions," or "factors." Id. Subsequent courts frequently have adopted the Roccaforte method of numbering the factors. See, e.g., Moncrief v. United States, 730 F.2d 276, 282-84 (5th Cir. 1984) (applied six Roccaforte factors in agency determination); Ourisman v. Commissioner, 82 T.C. 171, 181-84 (1984) (applied National Carbide indicia of agency, as interpreted in Roccaforte).

262 See, e.g., Roccaforte v. Commissioner, 77 T.C. 263, 270 (1981) (language evidencing agency relationship indicated), rev'd, 708 F.2d 986 (5th Cir. 1983). The agreement, in Roccaforte, which was found by the court to create an agency relationship, included the following provisions: a designation of the corporation as agent of the partnership; an affirmation that the partners were the true owners of the property involved; a statement that the corporation was formed merely to facilitate the acquisition, development, and financing of the property; a disclaimer of ownership by the corporation; a statement that the owners would primarily be responsible for all debts and that the corporation was held harmless for all liabilities; a statement that the owners would be brought in as third party defendants in litigation brought against the corporation; and an agreement that the corporation would not engage in business activities other than those authorized by the owners. Id. See generally Hoffman, supra note 13, at 12 (recommendations for drafting agreements).


264 See id.
In other words, the arrangement need not be arms-length in fact, but its terms must match those that unrelated parties would have reached in arms-length negotiations. Most current arrangements, to be sure, would fail under this test, too; shareholders are unlikely to convince a court that they would have entrusted their property to a corporation that they did not own or control. Moreover, to make the transaction resemble an arms-length arrangement, the shareholders would need to pay a fee to their own corporation for services rendered. Besides being somewhat of a charade, this requirement might exacerbate liquidity problems for cash-strapped shareholders and their fledgling enterprises.

Recently, several courts have evinced an inclination to relax the restrictive interpretations of National Carbide and have become more receptive to agency arguments made by taxpayers. In Moncrief v. United States,267 the Court of Appeals for the Fifth Circuit held that a true agency relationship existed between a partnership (the beneficial owner of the real estate) and a corporation (the legal owner of the real estate) when a twenty-five percent partner, who dealt with the other partners at arms-length, both operated the corporation and owned all of its shares.268 In two recent cases, Roccaforte v. Commissioner,269 and Ourisman v. Commissioner,270 the Tax Court opined that the first “requirement” in National Carbide is not really a requirement at all, but instead is merely one of a variety of factors that a court should consider in testing the purported agent status of the corporation.271 That is, the Tax Court has held that taxpayers need not show that the shareholders and the corporation dealt with each other at arms-length and that the corporation was independent.272 The Tax Court in Ourisman interpreted the first requirement of National

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265 Harrison Property Management Co. v. United States, 475 F.2d 623, 627 (Ct. Cl. 1973), cert. denied, 414 U.S. 1130 (1974); see also Vaughn v. United States, 740 F.2d 941, 946 (Fed. Cir. 1984) (corporation would not have entered into agreement if partners had not owned and controlled it).

266 See, e.g., Jones v. Commissioner, 640 F.2d 745, 754 (5th Cir.) (agency relationship not proven in absence of showing compensation determined on arms-length basis), cert. denied, 454 U.S. 965 (1981); see Baker & Rotham, supra note 15, at 1300; Bertane, supra note 16, at 763; Hoffman, supra note 13, at 12.

267 730 F.2d 276 (5th Cir. 1984).

268 Id. at 285-86.


270 82 T.C. 171 (1984), vacated, 760 F.2d 541 (4th Cir. 1985).

271 See Ourisman, 82 T.C. at 184; Roccaforte, 77 T.C. at 286-87.

272 See Ourisman, 82 T.C. at 184; Roccaforte, 77 T.C. at 287-88.
Carbide as meaning that the corporation must be able to prove its agent status by evidence other than the control automatically possessed over their corporation.\textsuperscript{273} According to the Tax Court in Ourisman, the taxpayer must prove that the agency existed independently of the shareholders’ ownership and control.\textsuperscript{274} In neither case did the Tax Court offer a checklist of factors for proving an agency relationship. Both cases involved the most common use of a corporation as agent—the use of a nominee corporation to hold legal title to property while others retain beneficial ownership. In each case, the court looked at the entire substance of the relationship between the close corporation and its shareholders, and decided that an agency relationship did indeed exist.\textsuperscript{275}

The Court of Appeals for the Fifth Circuit reversed Roccaforte, the first of these Tax Court opinions.\textsuperscript{276} Relying on the restrictive precedent discussed above, the court declared that the first “requirement” is indeed mandatory and that the partnership failed to show any agency attributes in the corporation that did not arise naturally from ownership and control of the corporation.\textsuperscript{277} In Ourisman, the Tax Court acknowledged this reversal of Roccaforte by the Fifth Circuit, but opined that the Fifth Circuit was wrong, and consequently decided that it would not change its own position.\textsuperscript{278} However, the Court of Appeals for the Fourth Circuit reversed the Tax Court’s decision in Ourisman, holding that

\textsuperscript{273} See Ourisman, 82 T.C. at 186; accord Jones v. Commissioner, 640 F.2d 745, 754 (5th Cir.) (taxpayer must show relationship independent of acknowledged ownership and control), cert. denied, 454 U.S. 965 (1981).

\textsuperscript{274} See Ourisman, 82 T.C. at 186.

\textsuperscript{275} See id at 184; Roccaforte, 77 T.C. at 287-88.

\textsuperscript{276} 708 F.2d 986, 990 (5th Cir. 1983), rev’g 77 T.C. 263 (1981).

\textsuperscript{277} Id. at 999-90. Curiously, less than one year after Roccaforte the Fifth Circuit held that a true agency relationship existed between a partnership and a corporation when a 25% partner operated the corporation and owned all of its shares. See Moncrief v. United States, 730 F.2d 276, 285-86 (5th Cir. 1984). The Moncrief court seemed to disapprove of the Roccaforte opinion (none of the judges on the Moncrief panel were on the Roccaforte panel), noting that the Fifth Circuit forbade a single panel from assessing the correctness of the Roccaforte opinion. Id. at 282. Moreover, the Moncrief court noted the “tension between this absolute and mandatory ‘factor,’” [i.e., National Carbide’s first “requirement” that the corporation’s relations with its principals must not depend upon the fact that it is owned by the principal] and National Carbide’s explicit statement that it did not intend to “foreclose a true corporate agent. . . from handling the property and income of its owner-principal without being taxable therefor.” Id. at 283 (quoting National Carbide, 336 U.S. at 437). The Moncrief court found it unnecessary to resolve that tension because it was clear to the court that the purported principal, the partnership, was in fact not the owner of the purported corporate agent. 730 F.2d at 283.

\textsuperscript{278} See Ourisman, 82 T.C. at 185.
the Tax Court misconstrued National Carbide. 279 In fact, the Fourth Circuit relied specifically on the Fifth Circuit’s decision in Roccaforte to overrule the Tax Court’s decision in Ourisman. 280

Several lower courts have also adopted the beneficial ownership approach in corporate nominee cases, 281 an approach advocated by various commentators for years. 282 Under this approach, the question is not whether the corporation exists for tax purposes, or whether it meets the National Carbide test, but instead whether the corporation is the beneficial owner of the property or is serving only as nominal titleholder. 283 In other words, the court should determine who actually owns the property, and attribute the tax consequences for owning the property to that party. 284 The government remains intransigent in declining to accept this argument 285 despite taxpayers’ recent successes in the lower courts. 286 As with the varying interpretations on the agency issue, the ultimate ac-

279 See Ourisman v. Commissioner, 760 F.2d 541, 547-48 (4th Cir. 1985).

280 See id. at 549.


282 See, e.g., Bertane, supra note 16, at 762 (taxing income to beneficial owner achieves desired result by less circuitous route); Miller, supra note 182, at 252 (whether corporation should be taxed turns on factual determination of whether it is beneficial owner) (quoting Kurtz & Kopp, supra note 244, at 648); Note, The Use of Corporations, supra note 183, at 367 (focus should be on whether corporation is beneficial owner).

283 Kurtz & Kopp, supra note 244, at 648; see, e.g., Raphan, 52 A.F.T.R.2d (P-H) at 83-5991 (passive holding of title consistent with agent status); Schlosberg, 47 A.F.T.R.2d (P-H) at 81-1211 (legal and beneficial ownership vested in one with “actual command” over property) (citing Griffiths v. Commissioner, 308 U.S. 355, 357 (1939)); Miller, supra note 182, at 251 (focus on whether corporation had substantive law ownership); Note, The Use of Corporations, supra note 183, at 267-68 (whether admittedly existing corporation should be taxed on income from property turns on whether beneficial owner or nominal titleholder).

284 See Raphan, 52 A.F.T.R.2d (P-H) at 83-5991; Schlosberg, 47 A.F.T.R.2d (P-H) at 81-1211; Kurtz & Kopp, supra note 244, at 648; Note, The Use of Corporations, supra note 183, at 367-68.

285 See, e.g., Red Carpet Car Wash, Inc. v. Commissioner, 73 T.C. 676, 684 (1980) (Commissioner urged court not to disregard title in making determination); Raphan, 52 A.F.T.R.2d (P-H) at 83-5991 (despite government's arguments, court focused on actual ownership rather than nominal title); Schlosberg, 47 A.F.T.R.2d (P-H) at 81-1210-11 (court refused to acknowledged change of ownership as being substantive).

286 See, e.g., Raphan, 52 A.F.T.R.2d (P-H) at 83-5993; Schlosberg, 47 A.F.T.R.2d (P-H) at 81-1210-11 (judgment for taxpayer where conveyance not substantive change of ownership).
ceptance or rejection of the beneficial ownership approach depends on future judicial decisions. The fate of the doctrine is unclear at this time.

TAX PLANNING RECOMMENDATIONS

The preceding paragraphs discuss the problems encountered by shareholders in close corporations who wish to avoid the tax consequences generated by use of the corporate form. The business purpose/business activity test of Moline virtually ensures defeat to shareholders who argue that the corporation should be disregarded completely for tax purposes.\footnote{See Bertane, supra note 16, at 749; Kalb & Lapidus, Nominee Corporations: Legislation is the Only Solution, 5 J. REAL ESTAT. TAX'N 142, 147 (1977-1978); McEntee, Use of Controller Corporation in Real Estate Development, 58 TAXES 520, 521-22 (1980); Note, The Use of Corporations, supra note 183, at 367.} Several courts recently have accepted arguments made by taxpayers that corporations holding real estate are merely agents for the true owners of the property.\footnote{See, e.g., Moncrief v. United States, 730 F.2d 276, 282-85 (5th Cir. 1984) (corporation holding legal title not entitled to claim losses from property because holding merely as agent for true owner); Ourisman v. Commissioner, 82 T.C. 171, 173 (1984) (facts compelled finding that corporation acted as shareholder's agent), vacated, 760 F.2d 541 (1985); Roccaforte v. Commissioner, 77 T.C. 263, 286-88 (1981) (for tax purposes, corporations with legal title deemed agent of partnership possessing equitable title), rev'd, 708 F.2d 986 (5th Cir. 1983).} Other courts, however, recently have rejected agency arguments.\footnote{See, e.g., Vaughn v. United States, 740 F.2d 941, 946-47 (Fed. Cir. 1984) (taxpayer failed to meet burden of showing true agency relationship); Roccaforte v. Commissioner, 708 F.2d 986, 989-90 (5th Cir. 1983) (taxpayer must show more than agency attributes that flow from ownership and control); Jones v. Commissioner, 640 F.2d 745, 754-55 (5th Cir.) (taxpayer failed to carry burden of showing independent arms-length relationship), cert. denied, 454 U.S. 985 (1981).} Moreover, even if this new lenient attitude on the agency issue prevails, it would probably be helpful only to real estate ventures. There is no indication that courts would be willing to treat operating companies as agents for the shareholders. Furthermore, the shareholders of many close corporations undoubtedly would be unwilling to be treated as principals of their corporations, because they would then lose the cloak of limited liability.\footnote{See Note, The Use of Corporations, supra note 183, at 384-85.} In light of these problems, the purpose of this section is to suggest several alternative planning strategies that might help some close corporations.

The National Carbide line of cases seems to offer a seldom
exploited loophole that might work for real estate ventures. Most close corporations have been unable to overcome the restrictive interpretation of some courts requiring that the shareholders and the corporation deal with each other at arms-length and that the corporation be independent. Even if courts ultimately decide to follow this restrictive interpretation of the National Carbide test, shareholders and their close corporations may be able to achieve the desired tax objectives by hiring an independent party to run the agent corporation. An obvious choice to serve as the independent party would be an attorney. In Moncrief v. United States, the Court of Appeals for the Fifth Circuit accepted an agency argument made by taxpayers in which a minority partner operated the corporate nominee and owned all of its shares. The court emphasized that the purported principal, the partnership, did not own the stock of the corporate nominee. Moreover, neither the partnership itself nor any of the other partners “controlled” the minority partner’s management of the nominee corporation, as they could if they were controlling shareholders of a close corporation. Hence, the corporation did not run afoul of National Carbide’s first “requirement,” that the corporation’s status as agent must not depend on the fact that it is

291 See, e.g., Vaughn v. United States, 740 F.2d 941, 944-47 (Fed. Cir. 1984) (fact that entities did not deal at arms-length ends need for further inquiry); Jones v. Commissioner, 640 F.2d 745, 755 (5th Cir.) (arms-length dealing crucial factor for taxpayer to demonstrate), cert. denied, 454 U.S. 965 (1981); Harrison Property Management Co. v. United States, 475 F.2d 623, 627 (Cl. Ct. 1973) (if corporation true agent, relations with principal must not depend on fact that principal owns it), cert. denied, 414 U.S. 1130 (1974); Collins v. United States, 386 F. Supp. 17, 21 (S.D. Ga. 1974) (for finding of corporate agency “its relations with its principal must not be dependent upon the fact that it is owned by the principal”) (quoting National Carbide, 336 U.S. at 437), aff’d, 514 F.2d 1282 (5th Cir. 1975)(per curiam).

292 Attorneys are knowledgeable in the formation of corporations and easily can perform the ministerial tasks required for modern real estate deals. The attorney can charge a marketplace fee, which, because the tasks are relatively simple, need not be too large. This suggested course of conduct is not new, for lawyers typically are entrusted with such paperwork anyway. Moreover, the shareholders have never truly operated nominee corporations; their role has been little more than signing whatever documents the attorney advises them to sign. The government might question the independence of the attorney, but it would be difficult to argue that the attorney be considered an agent for tax purposes.

Other possible independent parties that might be chosen to run the corporation would be accountants or bank trust officers.

293 730 F.2d 276 (6th Cir. 1984).

294 See id. at 284-85.

295 Id. at 285.

296 Id.
If Moncrief is followed in other jurisdictions, excellent tax planning opportunities will result. If a partnership can find a minority partner who is not so closely aligned with the majority partners that he would be considered under their control, that partner could form the agent corporation, take all of its shares, and operate it without direction from the partnership. A minority partner who has acted at arms-length with the other partners should suffice. Because the activities of the corporation would be ministerial only, this partner would need no real discretion anyway. According to Moncrief, the partnership would avoid the usual pitfall under the National Carbide test—failing that first "requirement." The taxpayers, of course, would need to satisfy the other requirements of National Carbide, but those requirements are much more easily met.

If they qualify, shareholders can avoid corporate tax consequences through Subchapter S, which provides the dual benefits of partnership-like tax consequences and limited liability. Prior to the Subchapter S Revision Act of 1982, a corporation did not qualify for Subchapter S status if its passive income exceeded twenty percent of its gross receipts. This twenty-percent limitation made it especially difficult for real estate ventures, the type of business most likely to use a corporate nominee, to qualify under Subchapter S. The 1982 Act virtually eliminated the passive income limitation and made a host of other liberal changes in the law. Subchapter S, however, is not a panacea. First, though the deductions and losses of a Subchapter S corporation flow through to the shareholders, who can use them on their personal returns, section 1366(d)(1) sets each shareholder's basis in his stock and in any indebtedness of the corporation to him as a ceiling on the amount of deductions and losses that the shareholder can use in

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297 See id. at 280-86.
298 See I.R.C. §§ 1361-1379 (1982); supra note 3.
302 See I.R.C. § 1362(d)(3) (1982); Crumbley & Dickens, supra note 301, at 38-39; Kanter, To Elect or Not to Elect Subchapter S — That Is a Question, 60 TAXES 882, 883-84 (1982). The passive income limitation still applies in some instances, such as when a subchapter S corporation previously has accumulated earnings and profits but elects Subchapter C status. See I.R.C. § 1362(d)(3) (1982); Kanter, supra, at 884.
any taxable year. Unlike a partner, who can add his proportionate share of the partnership's liabilities to his basis, an S corporation is not entitled to add liabilities incurred by the corporation to his basis in his shares. Because a shareholder's basis in a highly leveraged real estate venture may be too low to absorb all the corporate deductions and losses, Subchapter S status may be less useful than partnership status for most real estate ventures. Tax counsel must pay careful attention to how much of the corporate deductions and losses the shareholders are likely to be able to use on their own returns. Even if shareholders cannot use all of those deductions and losses, however, an S Corporation is apt to be an improvement over traditional corporation status. The S Corporation may pass through at least some of their deductions and losses to the shareholders. Other corporations may not. Second, the 1982 Act did not eliminate all the old irksome requirements of Subchapter S. For example, an S Corporation still cannot have a corporation or a partnership as a shareholder, or have multiple classes of stock.

A third alternative is not to incorporate in the first place. Because proprietorships and partnerships are not independent taxpaying entities, proprietors and partners are allowed, on their own personal tax returns, to deduct business losses from income derived from other sources. The basic cost in not using the corporate form is forfeiting limited liability for the investors. This cost might be too high for some types of businesses. In the case of real estate ventures, however, limited liability can be achieved by alternative means, such as obtaining insurance or using a limited partnership. If the real estate investors need to borrow funds, however, they may have no choice but to incorporate, because lenders may require incorporation to avoid state usury laws.

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304 Compare id. § 752(a) (partners' liabilities deductible beyond basis in partnership) with id. § 1366(d)(1) (shareholders' deductions and losses limited to basis in stock and indebtedness); see also Friedman, Choosing Between Corporate and Partnership Entities for Real Property Depends on its Use, 11 Tax'n for Law. 366, 367-68 (1983) (unlike subchapter S corporation, partners' basis in partnership includes share of liabilities of partnership); Kanter, supra note 302, at 883-84, 912-13, 916-17 (partnership loss limited to adjusted basis in partnership interest, which includes pro rata share of partnership liabilities).
305 See Friedman, supra note 304, at 367-68; Kanter, supra note 302, at 916-18.
307 See id. at § 752 (1982).
308 See 2 F.H. O'Neal, supra note 24, at § 2.03.
309 See, e.g., Moncrief v. United States, 730 F.2d 276, 278 (5th Cir. 1984) (Texas usury
TAX PURPOSES

Disregarding the Corporation at the Request of the Government

The government has enjoyed greater success than taxpayers have in convincing courts to disregard corporate entities for federal tax purposes.\(^{310}\) The government’s higher success ratio stems from the greater flexibility displayed by courts toward the government. According to the Supreme Court, the government is not always “required to acquiesce in the taxpayer’s election” of the corporate form for doing business.\(^{311}\) The government may look at “actualities” and determine that the corporation is “unreal or a sham,” and it “may sustain or disregard the effect of the fiction as best serves the purposes of the tax statute.”\(^{312}\) On the other hand, when shareholders request courts to disregard their corporation, the courts frequently admonish that those who choose to incorporate must live with the tax consequences of their choice.\(^{313}\) Thus, the taxpayer is stuck with his decision to incorporate, regardless of any unfavorable tax consequences, but the government necessarily is afforded flexibility to enforce the tax laws.\(^{314}\)

When the government urges a court to disregard a corporation completely for tax purposes, the keystone of the government’s case usually is the business purpose doctrine.\(^{315}\) The corporation, the laws permit lenders to charge corporate borrowers substantially higher rates); Roccaforte v. Commissioner, 708 F.2d 986, 987 (5th Cir. 1983) (corporations not covered by Louisiana usury statute which was applicable to partnerships).

\(^{310}\) See, e.g., Interstate Transit Lines v. Commissioner, 319 U.S. 590, 596 (1943) (Jackson, J., dissenting); Lowndes v. United States, 384 F.2d 635, 638 (4th Cir. 1967) (sustained government’s contention that corporate entity be disregarded); National Investors Corp. v. Hoey, 144 F.2d 466, 468 (2d Cir. 1944) (Treasury may disregard transactions with corporations not engaged in business activities); Noonan v. Commissioner, 52 T.C. 907, 910 (1969) (taxpayer at a disadvantage when attempting to disregard own corporate creation; government not similarly burdened), aff’d, 451 F.2d 992 (9th Cir. 1971) (per curiam); Bertane, supra note 16, at 739-40 (taxpayer at disadvantage when attempting to disregard own corporate creation; government not similarly burdened).


\(^{312}\) Id.; see Bertane, supra note 16, at 739.


\(^{315}\) See Moline Properties, Inc. v. Commissioner, 319 U.S. 436, 439 (1943); Shaw Constr.
government typically argues, was formed purely for a tax avoidance purpose. To be recognized as a separate taxable entity, the corporation needs to have a business purpose beyond the avoidance of taxation. Avoiding taxation, the government maintains, does not count as a business purpose. To counter the government's argument, the taxpayer typically relies on the Moline business purpose/business activity test, with tax counsel attempting to show either that the shareholders had a business reason for incorporating or that the corporation engaged in business activities. Taxpayers sometimes prevail, but courts frequently reject the proposed business justifications for incorporating, especially if tenuous and coupled with an obvious tax-avoidance purpose. According to the business purpose doctrine, however, a tax-avoidance motive does not destroy the validity of a transaction otherwise motivated by a nontax purpose.

Co. v. Commissioner, 323 F.2d 316, 319-20 (9th Cir. 1963); National Investors Corp. v. Hoey, 144 F.2d 466, 468 (2d Cir. 1944).

316 See, e.g., Shaw Constr. Co. v. Commissioner, 323 F.2d 316, 320 (9th Cir. 1963) (government not required to acquiesce in form chosen for doing business if form is unreal); National Investors Corp. v. Hoey, 144 F.2d 466, 468 (2d Cir. 1944) (purpose of tax statute best served if sham corporate form is disregarded); Aldon Homes, Inc. v. Commissioner, 33 T.C. 582, 595-96 (1959) (alphabet corporations "tax shams" not formed for legitimate business purposes); McEntee, supra note 287, at 521-22 (sham corporation argument employed by government).

317 See, e.g., Shaw Constr. Co. v. Commissioner, 323 F.2d 316, 320 (9th Cir. 1963) ("escaping taxation is not 'business' in the ordinary meaning") (quoting National Investors, 144 F.2d at 468); Aldon Homes, Inc. v. Commissioner, 33 T.C. 582, 597 (1959) (substantive business activity required for viable entity does not include escaping taxation).

318 See, e.g., Shaw Constr., 323 F.2d at 320; National Investors, 144 F.2d at 468; Aldon Homes, 33 T.C. at 597.

319 See, e.g., Britt v. United States, 431 F.2d 227, 231 (5th Cir. 1970) (activities of corporation constituted sufficient amount of business activity); Haberman Farms, Inc. v. United States, 305 F.2d 787, 788 (8th Cir. 1962) (genuine and valid business purpose in industry's operation); Aldon Homes, 33 T.C. at 597 (corporation held to be viable business entity).


321 See, e.g., Shaw Constr., 323 F.2d at 321 (corporation characterized as unreal sham with no business purpose); Haberman Farms, 305 F.2d at 793 (corporate form no more than alter ego of taxpayers); National Investors, 144 F.2d at 468 (escaping taxation not business in ordinary sense of word); Aldon Homes, 33 T.C. at 597 (sham corporation disregarded).

322 See, e.g., United States v. Cumberland Pub. Serv. Co., 338 U.S. 451, 455 (1950) (corporation may liquidate or dissolve without subjecting itself to corporate gains tax even though primary motive was to avoid brunt of corporate taxation); Master Eagle Assocs., Inc.
The quintessential example of a corporation formed solely for a tax avoidance purpose is *Gregory v. Helvering*, a landmark Supreme Court case. In *Gregory*, a sole shareholder in a close corporation wanted to extract a particular piece of property from her corporation to sell it to an unrelated third party. She could have made her corporation distribute it to her as a dividend-in-kind, but then the full fair market value of the property would have been ordinary income to her. Consequently, she concocted a plan, resembling what would now be called a spin-off, which met the literal statutory requirements for a reorganization. She created a new corporation, made the old corporation transfer the coveted property to the new corporation, liquidated the new corporation, and distributed the property to herself as part of the liquidation. She then sold the property to the unrelated third party and reported the transaction as a capital gain. Though the shareholder undoubtedly followed the proper state law procedures for incorporating, the second corporation had no business purpose and had been created for the sole purpose of tax avoidance. The Supreme Court refused to recognize it for federal tax purposes.

Even when a taxpayer can prove a business purpose for a corporation, or that the corporation engaged in business activity, the government still may prevail by attacking the participation by the corporation in a particular transaction rather than its separate identity as a taxpayer. The government has a formidable array of common-law tax principles to support this attack. For example, the government might argue that the corporation’s participation in the particular transaction lacked any purpose other than tax avoidance. The transaction might have been a mere intermedi-
ary step in a series of transactions begun by the shareholder.\textsuperscript{330} Inversely, the corporation might have used its shareholders as mere conduits to sell its property to outsiders.\textsuperscript{331} The corporation may have shifted the right to collect income to its shareholders,\textsuperscript{332} or its shareholders might have shifted the right to collect income to the corporation.\textsuperscript{333} Even when the taxpayer has shown a business purpose or activity, the government has urged the application of the doctrines of step transaction\textsuperscript{334} and assignment of income.\textsuperscript{335} The government might also invoke the old bromide that the court should place substance over form.\textsuperscript{336} Additionally, the government can resort to statutory tax avoidance rules such as those contained in sections 269\textsuperscript{337} and 482\textsuperscript{338} of the Internal Revenue Code. Commissioner v. Court Holding Co.\textsuperscript{339} exemplifies the use of

\textsuperscript{330} See, e.g., Smalley v. Commissioner, 32 T.C.M. (CCH) 373 (1973) (transfer by shareholder not a sham when done for valid business reasons).

\textsuperscript{331} Commissioner v. Court Holding Co., 324 U.S. 331, 334 (1945); see, e.g., Stewart v. Commissioner, 714 F.2d 977, 987-89, 992 (9th Cir. 1983) (affirmed Tax Court's holding that corporation was mere conduit for appreciated securities); O'Hare v. Commissioner, 641 F.2d 83, 85 (2d Cir.) (shareholder conduit where transfer requirement of loan transaction), cert. denied, 454 U.S. 829 (1981); Waltham Netoco Theatres, Inc. v. Commissioner, 401 F.2d 333, 334-35 (1st Cir. 1968); General Guar. Mortgage Co. v. Tomlinson, 335 F.2d 518, 520 (5th Cir. 1964) (substance of transaction, sale by corporation, not to be disguised by formalisms).

\textsuperscript{332} See, e.g., O'Hare v. Commissioner, 641 F.2d 83, 84-85 (2d Cir.) (stockholder given title to property but income upon subsequent sale attributable to corporation), cert. denied, 454 U.S. 829 (1981); Williamson v. United States, 292 F.2d 524, 526 (Ct. Cl. 1961) (shareholder given accounts receivable but income still attributable to corporation).

\textsuperscript{333} See, e.g., Kimberl v. Commissioner, 371 F.2d 897, 902 (5th Cir. 1967) (corporation depository or donee of income).

\textsuperscript{334} See, e.g., Lowndes v. United States, 384 F.2d 635, 637 (4th Cir. 1967) (government urged court to disregard transfers as being "mere formalisms").

\textsuperscript{335} See, e.g., Foglesong v. Commissioner, 621 F.2d 865, 869 (7th Cir. 1980) (assignment of income doctrine inappropriate where corporation not pure tax avoidance vehicle); Keller v. Commissioner, 77 T.C. 1014, 1021 (1981) (taxpayer's assignment of income set aside when arbitrary and capricious), aff'd, 723 F.2d 58 (10th Cir. 1983).

\textsuperscript{336} See, e.g., Stewart v. Commissioner, 714 F.2d 977, 987-89 (9th Cir. 1983) ("substance over form" case arises when transaction structured to satisfy formal code requirements to minimize tax liability); Commissioner v. Sansome, 60 F.2d 931, 933 (2d Cir.) (courts seek recourse in vague "form" and "substance" alternative), cert. denied, 287 U.S. 667 (1932).

\textsuperscript{337} I.R.C. § 269A (1982); see, e.g., Siegel v. Commissioner, 45 T.C. 566, 577-78 (1966) (government's reliance on § 264 held untenable).

\textsuperscript{338} I.R.C. § 482 (1982); see, e.g., Foglesong v. Commissioner, 691 F.2d 848, 850 (7th Cir. 1982) (section 482 held inapplicable); Keller v. Commissioner, 77 T.C. 1014, 1021-22 (1981) (section 482 prevented evasion of taxes), aff'd, 723 F.2d 58 (10th Cir. 1983); see also B. BRITTKER & J. EUSTICE, supra note 96, ¶ 3.17, at 3-66 (section 482 permits reallocation to "clearly reflect income"); Berger, Gilman & Stapleton, Section 482 and the Nonrecognition Provisions: An Analysis of the Boundary Lines, 26 Tax Law 523, 527-31 (1973) (section 482 may override any specific code provision with which it comes into conflict).

\textsuperscript{339} 324 U.S. 331 (1945).
virtually all of these common-law tax principles to recast the terms of a particular transaction. In Court Holding, a corporation agreed to sell its sole asset to an unrelated third party.\textsuperscript{340} At the first scheduled closing, the corporation’s attorney instructed the corporation not to execute the closing documents because the sale would have resulted in a large taxable gain to the corporation.\textsuperscript{341} At the direction of the attorney, the parties reconvened the next day, when the corporation distributed the asset to the shareholders in a liquidation, and they in turn sold the asset to the unrelated third party.\textsuperscript{342} According to the revised structure of transaction, the only recognized gain was that of the shareholders for receipt of the liquidating distribution. (The sale to the third party was a taxable event, but the amount realized matched the shareholders’ basis). The Supreme Court used the substance-over-form and step-transaction doctrines, along with agency principles, to recast the sale as one made by the corporation with its shareholders acting as its agent.\textsuperscript{343} Because the corporation was deemed to be the seller, it had to recognize a taxable gain on the sale.\textsuperscript{344}

One final incidence of disregarding the corporate entity is worthy of note. Close corporations are notoriously undercapitalized. They often own insufficient assets with which to pay a final judgment.\textsuperscript{345} Consequently, when the government has reduced a claim for taxes to a final judgment, it sometimes encounters difficulties in collecting on its judgment. As would any other judgment creditor in such circumstances, the government is likely to request the court to “pierce the corporate veil,” that is, to make the shareholders personally liable.\textsuperscript{346} The arguments and issues in these cases

\begin{footnotes}
\item \textsuperscript{340} Id. at 332-33.
\item \textsuperscript{341} Id. at 333.
\item \textsuperscript{342} Id.
\item \textsuperscript{343} Id. at 334.
\item \textsuperscript{344} Id.
\item \textsuperscript{346} See, e.g., Kalb v. United States, 506 F.2d 506, 508 (2d Cir. 1974) (government sought
closely track common-law principles developed in state courts.\textsuperscript{347}

CONCLUSION

Although corporations and other business organizations each have certain clearly defined characteristics, the line of demarcation often blurs when attempting to define corporations for federal tax purposes. The Internal Revenue Code and the Kintner Regulations promulgated thereunder offer little guidance, particularly in classifying borderline cases. State law is of no additional value, even when federal tax regulations permit the state to have a voice in classification.

Amidst these murky waters, the owners of closely held business enterprises struggle to have their corporations considered or not considered distinct taxable entities. In addition to the two traditional and evolving arguments that the corporation should be disregarded under \textit{Moline Properties}, or that the corporation is a mere agent or nominee under \textit{National Carbide}, taxpayers are taking advantage of the emerging doctrine of beneficial ownership or turning to S Corporation status. The government is not unarmed, however, and has itself successfully used numerous doctrines to convince courts to disregard corporate entities. The growing strength of the government’s arguments for disregarding corporate entities is particularly evident when courts recognize undercapitalization as a means of “piercing the corporate veil.”

\textsuperscript{347} \textit{See} H. \textsc{Henn} \& J. \textsc{Alexander}, \textit{ supra} note 122, at § 147; F.H. \textsc{O’Neal}, \textit{ supra} note 24, at § 1.09.