Volume 9 | Issue 1 Article 2

1963

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Recommended Citation

Daniel C. Knickerbocker Jr., *The Logical Difficulties of Let's-Pretend Tax Law*, 9 Vill. L. Rev. 3 (1963).
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THE LOGICAL DIFFICULTIES OF LET'S-PRETEND TAX LAW

DANIEL CANDEE KNICKERBOCKER, JR.†

LONG BEFORE Chief Justice Rolle invented the fictitious lessee and the casual ejector in aid of claimants to land,[1] lawyers had learned to escape the embarrassment of the real world by way of make-believe. Innumerable problems were solved by treating things as what they were not. The practice continues. Today's lawyer is no less adept than his professional ancestors in the creation of convenient fictions.

One can scarcely condemn a usage so ancient and so demonstrably effective. But these little inventions carry their own perils with them. We should never forget what they really are; we should remind ourselves frequently that, for all their utility, they remain figments. As such, they are fragile craft. Designed to bear single and specific cargoes, they are likely to founder if asked to carry more.

It is the purpose of this article to consider the present-day use of legal fictions and the consequence of using them too enthusiastically. The illustrations are an almost random selection of recent cases and rulings in a single field, that of the federal tax law. Nevertheless, the problems described have their counterparts in all other areas of practice.

Perhaps it will serve our purpose here if we begin with a brief enumeration of some of the recent decisions in which let's-pretend has played a part. Consider, if you will, the following hodgepodge:

> Case 1. A taxpayer who had elected to have his sole proprietorship taxed as a corporation was found to have realized, and was accordingly taxed on, a capital gain from the imaginary liquidation of his "pseudocorporation" when he transferred all of its assets to a real corporation.[2]

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1. 3 BLACKSTONE, COMMENTARIES* 202-03.

2. Estate of David Wein, 40 T.C. 454 (1963). The election referred to was one pursuant to INT. REV. CODE OF 1954 § 1361, which is available only to those proprietorships and partnerships for which capital is a material income-producing factor and at least half of whose gross income derives from trading in or the brokerage of real property, securities or commodities. It does not confer complete corporate tax status and should not be confused with the involuntary corporate characterization accorded some unincorporated organizations by virtue of the definition in § 7701(a)(3) of the Code. Section 1361 was part of an overall design to "permit . . . business to select the form of organization . . . most suitable to its operation without being influenced by Federal income-tax considerations." S. REP. No. 1622, 83d Cong., 2d Sess. 119 (1954). The design was somewhat distorted by the unexplained Conference rejection of a corresponding election by corporations to be treated as partnerships.

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Case 2. An elderly widow who had never been gainfully employed was found to be prevented from engaging in her customary substantial gainful activity and thus qualified for the expanded medical expense deduction provided in Code section 213(g).[3]

Case 3. A state income tax imposed upon a gain which was not and never could be taxed under the federal statute was held allowable as a deduction in spite of the prohibition of Code section 265 on deductions for expenses "allocable to . . . income . . . wholly exempt from" federal tax because the provision under which the gain escaped federal tax was one calling for the nonrecognition of such gain and not its exclusion from gross income.[4]

Case 4. A loan of 100,000 dollars made to a corporation by a man who was not otherwise a stockholder was held for tax purposes to be an investment in stock so that (a) interest on the loan was not deductible and (b) interest on later advances nearly two-and-a-half times as great made by the same man was deductible.[5]

Case 5. An interest in a tavern was held to be property of the same kind or class as an interest in a home and auto supply business so as to permit the exchange of the former for the latter without recognition of gain.[6]

Case 6. Federal income taxes assessed and paid in 1956 in respect of the income of a cash basis corporation for the years 1949 through 1955 were treated as if they had actually been paid in those earlier years and had therefore reduced earnings and profits sufficiently to make part of the distributions to shareholders in such years nontaxable returns of capital rather than dividends.[7]

We may contrast with the above holdings the following rejections of fiction:

Case 7. The passage of an estate by reason of intestacy to the Commonwealth of Pennsylvania was held not to be a "transfer . . . to or for the use of . . . [a] State"[8] and thus not to give rise to a charitable deduction for federal estate tax purposes.[9]

H.R. REP. No. 2543, 83d Cong., 2d Sess. 72 (1954). Subchapter S (INT. REV. CODE OF 1954 §§ 1371-77), added by the Technical Amendments Act of 1958, ch. 866, § 64, 72 Stat. 1650 (1958), now provides an election of the latter sort.

3. Rev. Rul. 63-101, 1963 INT. REV. BULL. No. 22, at 11.

4. Commissioner v. McDonald, 12 Am. Fed. Tax R. 2d 5162 (5th Cir. 1963), *affirming* 36 T.C. 1108 (1961).

5. The Motel Co., 22 CCH Tax Ct. Mem. 825 (1963).

6. Miller v. United States, 12 Am. Fed. Tax R. 2d 5244 (S.D. Ind. 1963).

7. Demmon v. United States, 12 Am. Fed. Tax R. 2d 5371 (7th Cir. 1963).

8. INT. REV. CODE OF 1954 § 2055c(1).

9. Senft v. United States, CCH EST. & GIFT TAX REP. (437-18 U. S. Tax Cas.) ¶ 12, 158 (3d Cir. June 29, 1963), *affirming* 202 F. Supp. 838 (M.D. Pa. 1962).

Case 8. A father entitled under state law to his sons' earnings could not claim dependency deductions for children supported by him in large part with such earnings.[10]

Case 9. A change from corporation to partnership tax treatment accorded an unincorporated association, which change arose solely by reason of a revision in Treasury regulations, was held not to have constituted a liquidation of the organization or a taxable distribution to its associates.[11]

Case 10. An estate whose income was payable to charitable beneficiaries could not be allowed a charitable deduction for an amount included in its income where such amount represented a consent dividend deemed to have been, but not actually received, from a personal holding company.[12]

Case 11. A couple domiciled in a community property state were not entitled to treat earnings of the husband during a period of foreign residence as having been earned half by him and half by the wife in order to exempt 40,000 dollars rather than 20,000 dollars of the income from United States tax.[13]

In considering these decisions and rulings, we are not concerned with their soundness as expositions of the law, nor with whether they may be relied on as precedents. We are not even, in this context, interested in discovering what they tell us of the need for law reform. Rather our interest in them is for what they disclose with respect to the administrative and judicial process.

It is submitted that our test cases are notable chiefly for a sense of overriding equity. In spite of their citations of authority and air of formal logic, these determinations suggest a greater concern for people than for principles. Fictions are invoked in order to defeat smart tax avoidance schemes or to give comfort to those whose positions are personally appealing; fact is rigidly adhered to if it will provide escape from a dilemma that is not of the taxpayer's own making.

This approach, for example, explains the seemingly tortuous logic of the gain that arose when the imaginary corporation became a real one. To be sure, the result was in accord with Treasury regulations[14] and was doubtless a permissible inference from the statute. But the problem was presented by a taxpayer who had made his election of

10. Dick v. United States, 11 Am. Fed. Tax R. 2d 1651 (E.D. Wis. 1963).
11. Rev. Rul. 63-107, 1963 INT. REV. BULL. No. 23, at 10.
12. Estate of Joseph R. Esposito, 40 T.C. 459 (1963).
13. Renoir v. Commissioner, 12 Am. Fed. Tax R. 2d 5402 (9th Cir. 1963), *affirming* 37 T.C. 1180 (1961).
14. Treas. Reg. § 1.1361-5(b) (1960). It should be noted that this regulation was not proposed until four years after the taxpayer in the *Wein* case had made his § 1361 election and his subsequent transfer of assets to a real corporation. 24 Fed. Reg. 2681 (1959).

pseudocorporate status on February 25th and had transferred his business to a real corporation on April 1st. The February election was a method—and the only one then possible—of insulating the earnings of the business for the prior calendar year from tax at the rate applicable to individuals. The subsequent actual incorporation suggests that the election was an attempt to incorporate *nunc pro tunc.* And this is what it would have been if the formation of the real corporation had not triggered a liquidation of its fictitious predecessor. In the words of Judge Forrester:

> Presumably the individual rates would have been higher [than the corporate], else the 1361(a) election would never have been made. Petitioner . . . would have us ignore this fact . . . and treat the exchange as . . . a tax-deferred corporate organization under section 351.
>
> . . . [T]he net earnings of the pseudocorporation . . . for Federal income tax purposes . . . belonged to the pseudocorporation. David Wein could have gotten them . . . by a distribution under section 1361(k), but then they would have been taxed to him at ordinary rates as a dividend. Respondent seeks less by his assertion of the principles of a liquidating distribution. . . .[15]

The desire to strike down the merely clever seems likewise to have informed the court's view of the father who claimed dependency deductions on the strength of his children's earnings. The layman may find the mere fact that such an argument could have been made a little startling. But once one accepts the basic premise imposed by local law that what the child earns belongs to his parent, the taxpayer's position begins to look plausible. Indeed strict logic might require an acceptance of the argument coupled, however, with a holding that the earnings used by the taxpayer in discharging his support obligations were includible in his income. This, however, seems precluded by the statutory provision making children's earnings their income and not that of their parents (even though they are not "received" by the children) and expenditures therefrom expenditures by the children.[16] Conceivably, one might argue that the provision is directed only to the income tax treatment of children's earnings where the only ground for taxing them to the parent is a state law similar to that invoked in the *Dick*[17] case. On this theory the parent who not only had a legal right to his son's

15. Estate of David Wein, 40 T.C. 454, 457-58 (1963).

16. INT. REV. CODE OF 1954 § 73. This provision was added to the tax law by Individual Income Tax Act of 1944, ch. 210, § 7, 58 Stat. 235 (1944), adding a new subsection (m) to Int. Rev. Code of 1939, § 22.

17. Dick v. United States, 11 Am. Fed. Tax R. 2d 1651 (E.D. Wis. 1963).

Knickerbocker: The Logical Difficulties of Let's-Pretend Tax Law

wages, but actually used them to meet his own obligations would be required to include them (to the extent of such use) in his own income.[18]

In *Esposito*[19] the claim that an imaginary receipt could have been paid to a charity and thus given rise to a perfectly genuine deduction was not as far-fetched as it seems and as the court found it. The court in its opinion relied heavily on the fact that the Executors' account filed with the New York County Surrogate showed no income of the personal holding company as having been either received or distributed.[20] But the absence of these items should not have been dispositive of the issue. There are many differences between income for fiduciary accounting purposes and income in the contemplation of the tax law.[21] If the amount of the consent dividend was included in any item accounted for as principal (for example, the stock of the corporation or the proceeds of its liquidation) and, if such item was permanently set aside for or paid to the charitable legatees, it should have been allowed as a deduction under Code section 642(c). In its distaste for what seemed a barefaced quibble, the court may have overlooked an underlying reality.

The rejection of M. and Mme. Renoir's ingenious argument in support of increasing the exempt portion of their foreign income suggests more an impatience with all arguments resting on the community property concept than any special scorn for this one.[22]

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18. An argument very like that offered by Mr. Dick was similarly rejected in James R. Dunning, 22 CCH Tax Ct. Mem. 648 (1963). In that case a father who was required by a divorce decree to pay $15 a week for the support of his minor son took the position that this entitled him to a dependency deduction because state law made a father solely responsible for the support of his children. The court held that in the absence of proof that he had actually provided more than half his son's support the taxpayer could not avail himself of the deduction. These eminently reasonable decisions should be compared with the holding in Charles P. Ide, 40 T.C. 721 (1963). In 1958 the taxpayers had provided between $1,500 and $2,000 for the support of their son, a student at Cornell. As a member of the Naval R.O.T.C., the son during the same year had received from the Navy (and admittedly used in supporting himself) a little over $900. In addition, the Navy had paid out $1,500 to cover the cost of his tuition and books at the University. The court found this last amount represented a scholarship which was expressly removed from the support equation by INT. REV. CODE OF 1954 § 151(e)(4). Accordingly, taxpayers' claimed dependency deduction was sustained.

19. Estate of Joseph R. Esposito, 40 T.C. 459 (1963).

20. *Id.* at 460.

21. The most obvious area of difference is in the treatment of capital gains which, although part of taxable income, are almost always principal for fiduciary accounting purposes. See Treas. Reg. § 1.662(c)-4 (1956) which, by way of example, shows the differences between tax and fiduciary accounting, and the definition of "income" in the INT. REV. CODE OF 1954 § 643(b), from which we may infer a statutory recognition of these differences.

22. Local rules of property have always made for difficulty in the federal tax law, and of these the community property concept has perhaps occasioned the greatest difficulty of all. The Supreme Court's declaration that "State law may control only when the operation of the Federal taxing act, by express language or necessary implication, makes its operation dependent upon State law" [Burnet v. Harmel, 287 U.S. 103, 110, 53 S.Ct. 74, 77 (1932)], is not altogether dispositive of the issue. Other recent decisions in which community property has created difficulty include

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Disallowing an estate tax deduction for the late Mr. Senft's unintended gift to his state of residence may have seemed the more reasonable because no one in particular was going to bear the burden of the federal exaction. However one might regard the matter in the abstract, the fact was that Pennsylvania was ahead no matter what it got from this estate.[23]

The case of the little old lady who was allowed to deduct all of her medical expenses appeals to the heart. We can picture her, propped up in her hospital bed, wan and worn and patiently suffering. Even a tax collector must do what he can to help such a one as this.[24]

The partnership that used to be and no longer is a corporation for tax purposes is aided because—and only because, as the ruling is careful to say—its change in character was forced upon it by the tax authorities themselves. Its form of organization, its method of doing business remains the same. But for 1961 and later years these had a different meaning from what they had had before. To make this shift in meaning a taxable event would seem a shocking injustice.

To a degree, the same desire to avoid penalizing the innocent seems inherent in the curious treatment of earnings and profits in the *Demmon*[25] case. The "corporation" was in fact organized as a trust and had been filing fiduciary returns. It took the Tax Court and the Sixth Circuit[26] to make certain of the existence of a corporation in contemplation of the tax law. Moreover, the taxpayers were honest. One of the most revealing parts of the opinion of Judge Grant is his contrast between

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Estate of Lillian B. Gregory, 39 T.C. 1012 (1963), and Rev. Rul. 62-115, 1962-2 CUM. BULL. 23. Much special tax learning made necessary by the community property rules became obsolete with the enactment of the income splitting and marital deducton provisions of the Revenue Act of 1948. Int. Rev. Code of 1939 §§ 12, 812, 1004(a), as amended, 62 Stat. 114, 117, 125 (1948) (now INT. REV. CODE OF 1954 §§ 2, 2056, 2523).

23. The problem was rather more difficult in Cox v. Commissioner, 297 F. 2d 36 (2d Cir. 1961), *affirming* 19 CCH Tax Ct. Mem. 1470 (1960). There decedent had willed a portion of her residuary estate to her son, a Jesuit priest, knowing that he could not acquire property except for his Order and that her bequest therefore had the effect of a gift to the Society of Jesus. The courts nevertheless held that this knowledge was not sufficient to make the bequest one "to or for the use of" a charity.

24. The problem here is that of reconciling the statutory equivalence of a disability that gives rise to the tax benefit to inability "to engage in any substantial gainful activity by reason of any medically determinable . . . impairment," even though it seems patent that Congress did not intend to confine the benefit to those prevented from earning a living. In point of fact, the regulations had laid the foundation for the most recent ruling by stating that in the contemplation of § 213(g) "housekeeping shall be considered the substantial gainful activity of an individual whose primary activity is housekeeping." Treas. Reg. § 1.213-2(c)(1)(1960). Suppose, however, the case of a very rich woman whose housekeeping has consisted of enjoying the ministrations of a large staff of servants, or that of a spinster who has always lived in a hotel and whose housekeeping never amounted to more than occasional moves to other hotels.

25. Demmon v. United States, 12 Am. Fed. Tax R. 2d 5371 (7th Cir. 1963).

26. Estate of Levi T. Scofield, 25 T.C. 774 (1956), *aff'd*, 266 F. 2d 154 (6th Cir. 1959).

Knickerbocker: The Logical Difficulties of Let's-Pretend Tax Law

this and two earlier cases where "the taxpayers were embezzlers and black market operators who knew they were diverting corporate funds and who knew they were evading 95% wartime excess profits tax" and even so were "allowed to accrue . . . unpaid deficiencies, in determining how much of their illegal gains constituted taxable dividends."[27] The present plaintiffs on the other hand were guilty of no wrongful intent. "Reason and authority,"[28] as Judge Grant insisted, doubtless supported the plaintiffs' claims for refund. But may we not surmise that those claims derived additional strength because they seemed some slight compensation for the pain the plaintiffs had suffered when they saw their trust relieved of 420,000 dollars in unexpected corporate taxes?

The case of the non-stockholder debts seems at the outset to have less of an *ad hominem* flavor than these other decisions. It flows into the channel of a tolerably ancient authority and swells it in apparent concord.[29] Upon closer inspection, however, we find the decision rather less than an objective ruling derived from unequivocal facts.

The thin incorporation doctrine is a special application of the principle that the substance of a transaction and not its form will determine its tax effects. It requires that if any part of a corporation's debt capital is in substance stock, it will be treated as stock for tax purposes. In consequence, interest on it will not be allowed as a deduction; its repayment will constitute a distribution subject to the provisions of Code subchapter C and, if it becomes uncollectible, its holder will have suffered a worthless security loss and not a bad debt. There is more than a hint in the case law that these unhappy results are penalties imposed upon investors who have failed to supply their corporations with enough equity capital to make them go. To the extent that they are rooted in this quantitative concept the decisions lie philosophically in the same tradition as Deep Rock.[30]

A more rewarding analysis will take us beneath the figures and into the operation of the business. If we discover that the use to which capital is being put is one for which debt financing is appropriate, it should not matter that a larger stock issue would have made the debt unnecessary or even that, in comparison with the amount of debt, the stock interest is relatively nominal. On the other hand, when capital is

27. Demmon v. United States, 12 Am. Fed. Tax R. 2d 5371, 5373 (7th Cir. 1963).
28. *Ibid.*
29. The beginnings of the underlying doctrine are traced in Schlesinger, *"Thin" Incorporations: Income Tax Advantages and Pitfalls,* 61 HARV. L. REV. 50 (1947). An outline of the case law appears in 2 P-H 1963 FED. TAX SERV. ¶ 13096.
30. Taylor v. Standard Gas. Co., 306 U. S. 307, 59 S. Ct. 543 (1939), holding that, in a reorganization under § 77B of the Bankruptcy Act, [ch. 204 § 77(b), 47 Stat. 1467 (1933)] preferred stockholders of a subsidiary corporation could not be subordinated to the creditor position of the corporation's parent where it appeared that the subsidiary had been insufficiently capitalized.

used in a manner that makes its recovery entirely dependent on the success of the enterprise, that capital is equity and should be treated as such for tax purposes. Here again both the size of the stock issue and its relationship to the size of the debt are irrelevant.

Judged in these terms, the debts in *The Motel Co.*[31] were, it is believed, properly characterized, the earlier as stock, the later as true debt. But these were not the terms of the court's view. Once more the examination was subjective, the test, the parties' deserving natures. The close relationship between the creditor and the corporation's president and principal stockholder, even more, the great disparity between the aggregates of debt and equity capital: these were the facts stressed in support of Judge Pierce's conclusion with respect to the initial debt. And to buttress his opinion that the later advance was true debt, the Judge pointed to the conservative debt-stock ratio that then obtained, a ratio made all the more conservative by the court's decision on the status of the initial debt.

The weakness in such an attack on a tax problem is not its mechanistic character or even its air of vindictiveness. Indeed, if this is the sort of thing tax lawyers may expect, their duty to anticipate adverse results and avoid them through appropriate action is probably considerably simplified. But taxes are not the only problem with which business must deal, and it should be possible to find the solutions for nontax problems without more than passing reference to tax consequences. If, in the instant case, it had been sound financial practice to capitalize the corporation with twenty-five times more debt than stock, no purely tax rule should make it unsound. But the latter effect is precisely what results when we set ourselves to reviewing a taxpayer's conduct in moral terms.

The element of human appeal is obscured in the formal enumeration of facts judicially found. Nevertheless, one may infer that the unexpressed determinant that made Mr. Norman Miller's tavern partnership the same thing as his new interest in an auto supply business was the fact that the trade was just a cozy family arrangement. Norman and his two brothers, Donald and Robert, were partners in the supply store; Norman and Robert ran the tavern. It was agreed—we are not told why—that Robert would leave the former and Norman the latter. They made their trade, and Robert became sole owner of the tavern while Norman took over Robert's interest in the supply store, becoming the owner of half of it. No cash changed hands. Whether there had been a change in their respective economic worths or whether in a technical sense either brother had realized gain or loss, it can hardly

31. The Motel Co., 22 CCH Tax Ct. Mem. 825 (1963).

Knickerbocker: The Logical Difficulties of Let's-Pretend Tax Law

be supposed that either of them considered himself richer or poorer by reason of the transaction. From their point of view, therefore, the tax assessed against Norman must have seemed a wholly unreasonable exaction.

It is possible, of course, that Norman's position in both businesses was merely that of an investor. In this event there would have been the sort of equivalence between the partnership interests which permits nonrecognition of gain upon an exchange. As the regulations point out, two otherwise qualified properties will be regarded as being of "like kind" if they have the same nature or character.[32] There is doubtless a considerable difference between one partnership interest that sets one to drawing beer and mixing martinis and another that requires a knowledge of tires, batteries and spark plugs. The taxpayer who seldom sees the inside of either establishment and is concerned only with his share of the profits may very well regard the two—and expect the courts to regard them—as one and the same thing.

We come finally to the Fifth Circuit's decision in *Commissioner v. McDonald.*[33] Taxpayer was the transferee of a corporation which had adopted a plan of complete liquidation, sold its principal property, distributed all of its assets to its stockholders, and dissolved. The corporation's gain on the property sale (amounting to nearly 600,000 dollars) was not recognized (by reason of Code section 337) for federal income tax purposes, but it was subject to Louisiana state income tax. In computing its federal taxable income for its final year of operation, the corporation accrued and deducted this state levy. The Commissioner disallowed the deduction on the ground that the tax represented an expense allocable to income wholly exempt from federal income tax and was, as such, subject to the proscription of Code section 265(1). The Tax Court reversed this determination,[34] and the instant decision constitutes the Fifth Circuit's affirmance of that action.

The Commissioner's view of this case, and of several others that arose about the same time,[35] seems in essence to be this: that there is no difference in substance between those realizations which the statute

32. Treas. Reg. § 1.1031(a)-1 (1956). Another recent case applying these rules is Coastal Terminals Inc. v. United States, 12 Am. Fed. Tax R. 2d 5247 (4th Cir., 1963), *affirming* 207 F. Supp. 560 (E.D.S.D. 1962).

33. Commissioner v. McDonald, 12 Am. Fed. Tax R. 2d 5162 (5th Cir. 1963), *affirming* 36 T.C. 1108 (1961).

34. Commissioner v. McDonald, 36 T.C. 1108 (1961).

35. Commissioner v. Universal Leaf Tobacco Co., 11 Am. Fed. Tax R. 2d 1614 (4th Cir. 1963), *affirming* 21 CCH Tax Ct. Mem. 992 (1962); Hawaiian Trust Co. v. United States, 291 F. 2d 761 (9th Cir. 1961), *reversing* 178 F. Supp. 637 (D. Hawaii 1959); Rushton v. Patterson, 12 Am. Fed. Tax R. 2d 5443 (N.D. Ala. 1963); City Bank of Washington, 38 T.C. 713 (1962); Cotton States Fertilizer Co., 28 T.C. 1169 (1959). The Service now has announced its concession of defeat in these cases and will no longer litigate the issue, Rev. Rul. 60-236, 1960-2. CUM. BULL. 109 will be "revised." Tech. Inf. Rel. No. 510 (Sept. 25, 1963).

decrees "shall not be included in gross income"[36] and at least some of those which shall not be "recognized." And this is a position that in logic is difficult to challenge. The usual distinction between these two escapes from tax incidence is that between the accretion to wealth which will never be taxable and the one on which we have chosen to defer tax until the happening of some future event. The classic example of the latter is the exchange of properties or securities that takes place in a corporate reorganization. The stockholder of Company *A* who turns in his *A* shares and gets back shares of *B* into which *A* has been merged realizes, in the contemplation of the tax law, just as much gain or loss as he would if he had sold his *A* stock for cash. But Congress has deemed it inappropriate to tax the gain or allow a loss deduction at this point.[37] Instead, the basis for the *A* stock is transferred to the *B* and the tax or deduction will arise when, if ever, the *B* is disposed of in a taxable transaction.[38] In this context, the distinction between nonrecognition of gain and its exclusion from gross income is a meaningful difference. But what if there can be no future taxable disposition? A corporation buys shares of its own stock in the open market and later sells them for more than they cost. The statute says this sale is a transaction in which no gain or loss shall be recognized.[39] Nevertheless, this involves no tax deferral. The corporation takes cash for the shares and spends it and that is the end of the tax road. No finespun theory can hide the economic reality that makes the income here realized wholly exempt from federal income tax.

The unrecognized gain of the *McDonald* case was of a similar nature. Once the corporate property had been sold and the proceeds distributed to shareholders, the 600,000 dollar gain appeared to evaporate. To be sure, there would be taxes payable in respect of the shareholders' own gains. But these gains were measured upon bases wholly different from that of the corporation for its property and bore no necessary relationship to the corporation's own gain.

How then can we explain the Tax Court's and Fifth Circuit's refusal to accept the Commissioner's reasoning? We may be able to find our answer in history. For years, perhaps ever since the adoption of the Sixteenth Amendment, no issue has generated more heat than the controversy over "double taxation" at corporate and shareholder

36. Hawaiian Trust Co. v. United States, 291 F. 2d 761, 772 (9th Cir. 1961).

37. INT. REV. CODE OF 1954 § 354.

38. INT. REV. CODE OF 1954 § 358.

39. INT. REV. CODE OF 1954 § 1032. An interesting problem arising as a result of this non-recognition of a gain was considered in Rev. Rul. 62-217, 1962-2 CUM. BULL. 59, which held that a corporation that paid part of the compensation of its employees in shares of its own stock was entitled, in the year of payment, to a deduction measured by the fair market value of such stock.

levels.[40] And to those who fairly quiver in rage over the idea, there was double taxation in its most virulent form when, as part of a plan of liquidation, a corporation sold property at a gain and distributed the proceeds to its shareholders.[41] Code section 337 provided a route for avoiding the corporation's tax on such a transaction.[42] To the self-styled advocates of tax equity, this was not the creation of a new exemption, but merely a reduction in tax to a more desirable level.

It is this interpretation of section 337 that is implicit in the *McDonald* case and other decisions, and permits the courts in the face of the facts to tell us that gain that can never be taxed is not tax exempt. Here the appeal is not in the taxpayer's *beaux yeux* but in the ideology his cause supports. It is just as compelling as the little old lady's anxious smile—perhaps more so, for men will die for their faiths—and no less discouraging to the seeker of guiding principles.

Back in 1882, Sir Frederick Pollock published a collection of essays which included one entitled "The Science of Case Law."[43] Those were days when men thought science quite as important as they do now and had a good deal more faith in the ability of science to answer all questions. Sir Frederick was reasonably persuasive in his proof that the operations of judges and lawyers "have a truly scientific character, and that English case-law may fairly claim kindred with the inductive sciences."[44]

The decisions in the eleven recent tax cases here examined were based, it is believed, not on science or logic but on emotion. We found the Tax Court holding that a fictitious corporation must be treated as a real one because to do otherwise would be to give aid and comfort to an obvious tax-avoidance device; we found the Internal Revenue Service refusing to engage in a like process because its own regulations, rather than the machinations of the taxpayer, had created the difficulty. The literal wording of a statute was ignored in the medical expense case because to do otherwise would have added to the financial burdens of one for whom chivalry decrees protection. In

40. *E.g.,* compare the various statements with respect to the proposed repeal of the individual dividend exclusion and credit provisions of the Code in *Hearings on the President's 1963 Tax Message Before the House Committee on Ways and Means,* 88th Cong., 1st Sess., 51, 1406, 1970 (1963).

41. This problem was made acute but was certainly not created by the decisions in Commissioner v. Court Holding Co., 324 U.S. 331, 65 S. Ct. 707 (1945), and United States v. Cumberland Pub. Serv. Co., 338 U.S. 451, 70 S. Ct. 280 (1950). The enactment of INT. REV. CODE OF 1954 § 337 was intended only as a remedy for the uncertainties resulting from these cases. S. REP. No. 1622, 83d Cong., 2d Sess. 258 (1954); H.R. REP. No. 1337, 83d Cong. 2d Sess. A106 (1954).

42. For a general discussion of the effect and limitations of this provision, see Note, 76 HARV. L. REV. 780 (1963).

43. POLLOCK, *The Science of Case Law,* in JURISPRUDENCE AND LEGAL ESSAYS 169 (Goodhart ed. 1961).

44. *Ibid.*

Villanova Law Review, Vol. 9, Iss. 1 [1963], Art. 2

the section 337 liquidation instance, a deduction of what was pretty clearly nondeductible was allowed because of a commitment to the slogan, "Down with double taxation." The purity of the taxpayers' motives, their freedom from designs of tax avoidance, persuaded the courts to make believe that the taxable dividends of a former trust were less than they had actually been, and that a tavern partnership was the same thing as one in the auto supply business. The lack of such purity turned the loans of the motel investor into stock purchases, but made a similar alchemy unavailable to the couple who attempted to avail themselves of community property concepts to increase their nontaxable foreign income. Let's-pretend was denied for the same reason to the estate that claimed it had given its make-believe dividend to charity and the father who wanted dependency deductions on the strength of his use of his children's earnings. Finally, in the case of the Pennsylvania intestate we found that judges are like all the rest of us when we look at government: it is so big, so impersonal, that we don't mind in the least taking money away from it.[45]

Two conclusions are inescapable. The first is that the courts neither follow the law's fictions blindly nor reject them out of hand. The second is that whether a court or the Service will accept or refuse to accept a fiction in a particular case depends on the merits of that case determined in purely subjective terms. Here arguments of law are not persuasive. The taxpayer who seems to be doing his harried best to pay what he owes fares better than the one advised by expensive counsel. If there is an implacable science that dictates such results, its precepts remain to be formulated.

These conclusions are probably equally valid outside the tax field. To us who make our living telling others what the courts are going to do, it may be a little chilling to think that the decisions are actuated by emotion. But further reflection leads us to suspect that we have always known this and have unconsciously taken it into account when we made our predictions. This perhaps is the part of a legal opinion that is based on nothing more tangible than the feeling in the tips of the lawyer's fingers.

45. *Cf.* CAHN, THE MORAL DECISION 171 (1955).