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INTERCORPORATE LEASING ARRANGEMENTS
BY THE CLOSELY-HELDED CORPORATION

Before 1937, wealthy individuals sheltered their investment income from personal tax by transferring assets to holding companies and leasing back these assets. The addition of section 543(a)(6) to the Internal Revenue Code was designed to eliminate the statutory loophole by forcing distribution of certain accumulated corporate earnings to shareholders. This Note examines the workings of section 543(a)(6) in the lessee/lessor corporate context. The section has ended the use of sham personal holding companies, but has also penalized unwary taxpayers who seek to set up legitimate holding companies. This Note seeks to break the resulting judicial deadlock by proposing amendments to section 543(a)(6).

INTRODUCTION

THE PERSONAL HOLDING COMPANY provisions of the Internal Revenue Code1 (the Code) were enacted in 19342 to prevent wealthy taxpayers' use of “incorporated pocketbooks”3 to shelter their investment income from their own high personal tax brackets.4 Before the enactment of these provisions, such individuals had regularly established personal corporations to which they transferred their investment assets.5 The income earned on these investments thus accrued to the corporation, and was taxed at the much lower corporate tax rates.6 Such income was then held and

3. This descriptive phrase is commonly used in the personal holding company area to refer to the sham arrangements that the provisions were designed to eliminate. See H.R. Rep. No. 704, 73d Cong., 2d Sess. 11 (1934).
4. For the test of what is considered a personal holding company and the discussion of the Congressional Reports accompanying the 1934 provisions and subsequent additions and amendments to the personal holding company provisions, see infra text accompanying notes 112-22.
5. See H.R. Rep. No. 704, 73d Cong., 2d Sess. 11 (1934). This report accompanied the passage of the original personal holding company provision in 1934.
6. It should be noted that the Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 101(a), 95 Stat. 172, 176 [hereinafter cited as ERTA] has decreased the maximum tax rate on non-personal service income to 50%, effective for taxable years beginning subsequent to December 31, 1981. Despite the decrease in the maximum individual income tax rate from 70% to 50% provided by ERTA the personal holding company provisions continue to be vital parts of the Code. For example, the maximum 50% tax rate on individual income under ERTA is still much higher than the new lower bracket corporate tax rates established by the Act. While the present rates of tax on the first two $25,000 brackets of corporate net income are 17% and 20% respectively, I.R.C. § 11(b) (Supp. IV 1980), for a combined tax rate of 18.5% on the first $50,000 of net income, by 1983 the Act will have
accumulated by the corporation to be distributed to the taxpayer in later years when, due to any number of conditions, the individ-
lowered these rates to 15% and 18% respectively, ERTA § 231(a), for a combined rate of only 16.5% on the first $50,000 of corporate income. By 1983, moreover, the combined rate of tax on the first $100,000 of corporate net income will be only 25.75% (calculated by averaging the four surtax exemptions bracket rates)—barely more than half the maximum individual rate.

It is these lower bracket corporate tax rates, and not the maximum rate of 46%, that are the most significant in analyzing the need for the personal holding company provisions. For instance, consider that historically long term investments have returned a rate of less than 10%. Using even a historically high 10% rate of return, a $50,000 annual net income would require a full $500,000 of investment assets. One hundred thousand dollars of corporate net income, taxable at the aforementioned rate of only 25.75%, would require $1,000,000 of investment assets. Even at a present long term return rate of 15%, these annual income levels would require investment of $333,333 and $666,666, respectively. Very few individuals, even in the 50% tax bracket (representing only $109,400 annual income for a jointly-filed return, ERTA § 101(a), and $55,300 for a taxpayer filing a single return, id.), have such large amounts of investment assets. This is especially true since only individuals who may presently be earning high income but who anticipate lower income and tax brackets on retirement might, if not for the personal holding company provisions, make use of a sham investment corporation. The extremely wealthy taxpayer, who has accumulated over $1,000,000 in investment assets, is probably unlikely to ever anticipate lower tax brackets, and would thus not have tax reasons to use a personal holding company.

A second reason for the continued vitality of the personal holding company provisions is that one of the tax avoidance schemes that originally necessitated them had nothing to do with the disparity between individual and corporate income tax rates. This was the practice of transferring a pleasure asset, such as a yacht, to a corporation together with income producing assets, and then deducting the depreciation and other expenses of the yacht from the income generated by the investment property. The taxpayer could thus garner otherwise unavailable depreciation deductions, all dependent, of course, on the establishment of the pleasure asset expenses as deductible business expenses of the corporation. A more sophisticated variation on this scheme was to try to show that the fair rental value of the yacht was not equal to its depreciation and operating expenses. The taxpayer could then lease the yacht for its fair value and transfer only enough investment assets to cover the difference with his income. This variation made it easier to show that the yacht expenses were ordinary and necessary. All these potential sham devices were left unchanged by ERTA.

Finally, the personal holding company provisions are necessary to prevent taxpayers from avoiding any personal income tax on their investment income by converting it into stock appreciation that will never, by operation of I.R.C. § 1014, produce recognized income if held until death. If not for the provisions, a taxpayer could transfer his investment assets to his wholly owned corporation, where the accumulated income would increase the fair market value of his stock without producing recognized gain to the taxpayer. Upon the taxpayer's death, the stock would pass to heirs or beneficiaries with a stepped-up basis equal to its fair market value. I.R.C. § 1014(a)(1) (Supp. IV 1980). The only tax that might be paid is an estate tax, and ERTA greatly reduces the chance and magnitude of this, as well.

Congress apparently agrees that the personal holding company provisions are still necessary, having chosen to retain the provisions despite the individual tax rate reduction, while reducing the penalty tax from 70% to 50%. This reduction was made to correspond with the lowering of the maximum individual tax rate to 50%. A similar adjustment was made, from 90% to 70%, at the time the maximum individual rates were lowered to 70%.
ual's personal income tax rate would be lower. These corporations came to be known as "personal holding companies."

The personal holding company provisions of the Code force these sham corporations' accumulated earnings to be distributed to their shareholders. The mechanism used to accomplish this is a fifty percent surtax on certain specially-defined undistributed income known as "personal holding company income." The tax is imposed if at least sixty percent of the corporation's adjusted ordinary gross income for the taxable year consisted of personal holding company income, and if certain additional ownership requirements are met.

Section 543 defines personal holding company income, de-


§ 541. Imposition of personal holding company tax

In addition to other taxes imposed by this chapter, there is hereby imposed for each taxable year on the undistributed personal holding company income (as defined in section 545) of every personal holding company (as defined in section 542) a personal holding company tax equal to 50 percent of the undistributed personal holding company income.


8. I.R.C. § 542 (1976). This section reads in pertinent part:

§ 542. Definition of personal holding company

(a) General Rule

For purposes of this subtitle, the term "personal holding company" means any corporation (other than a corporation described in subsection (c)) if—

(1) Adjusted ordinary gross income requirement—At least 60 percent of its adjusted ordinary gross income (as defined in section 543(b)(2)) for the taxable year is personal holding company income (as defined in section 543(a)), and

(2) Stock ownership requirement—At any time during the last half of the taxable year more than 50 percent in value of its outstanding stock is owned, directly or indirectly, by or for not more than 5 individuals. For purposes of this paragraph, an organization described in section 401(a), 501(c)(17), or 509(a) or a portion of a trust permanently set aside or to be used exclusively for the purposes described in section 642(c) or a corresponding provision of a prior income tax law shall be considered an individual.

9. I.R.C. § 543 (1976). This section reads in pertinent part:

§ 543. Personal holding company income

(a) General rule

For purposes of this subtitle, the term "personal holding company income" means the portion of the adjusted ordinary gross income which consists of:

(6) Use of corporate property by shareholder

(A) Amounts received as compensation (however designated and from whomever received) for the use of, or the right to use, tangible property of the corporation in any case where, at any time during the taxable year, 25 percent or more in value of the outstanding stock of the corporation is owned, directly or indirectly, by or for an individual entitled to the use of the property (whether such right is obtained directly from the corporation or by means of a sublease or other arrangement).

Other subparagraphs of § 543(a) include as personal holding company income dividends, mineral, oil, and gas royalties, copyright royalties, income from film rentals constituting
lineating eight specific categories. In general, these consist of income from passive forms of investment, such as dividends, interest, and royalties. One of these categories, enumerated in section 543(a)(6), consists of amounts received by the corporation as compensation (however designated and from whomever received) for the use of, or right to use, its tangible property. Such use must occur where, at any time during the taxable year, twenty-five percent or more in value of the outstanding stock of the corporation is owned, directly or indirectly, by or for an individual entitled to the use of the property, whether such right has been obtained directly from the corporation or by means of a sublease or other arrangement. Subsection (a)(6) applies only if the corporation has personal holding company income from the other categories for the taxable year which exceeds ten percent of its ordinary gross income.

Subsection (a)(6) was added to the Code shortly after the inception of the first personal holding provisions. It was designed to address the problem of individuals who had circumvented the original provisions by transferring to their holding companies their personal assets, such as yachts and townhouses, in addition to their investment assets. Such individuals would then rent these assets from the corporation for their personal use. This rental income was not classified as personal holding company income prior to 1937. Thus, this technique would generate sufficient non-personal holding company income to prevent imposition of the surtax on the holding company's accumulated investment income because the sixty percent personal holding company income requirement of section 542(a)(1) would not be met. Section

__less than 50 percent of gross income, amounts received under personal service contracts, and amounts relating to certain estates and trusts. I.R.C. § 543(a)(1)–(5), (7)–(8) (1976 & Supp. V 1981).__

10. I.R.C. § 543(a)(6) (1976). The legislative history of § 543(a)(6) gives no indication of what type of “other arrangements” Congress may have been contemplating in the use of this language. The House reports are contradictory as to whether subsection (a)(6) was intended to be construed broadly or narrowly. See infra notes 102–22 and accompanying text.

11. I.R.C. § 543(a)(6)(B) (1976). Subsection (B) was added to § 543(a)(6) in 1959. Act of April 22, 1960, Pub. L. No. 86-435, § 1(a), (b), 74 Stat. 77, 77–78. Although no reason was given in the legislative history for the addition of subsection (B), it seems to be designed to help bona fide businesses avoid the personal holding company penalty provisions.


13. H.R. REP. No. 1546, 75th Cong., 1st Sess. 6 (1937), reprinted in 1939-1 C.B. 703, 707–08 [hereinafter cited as HOUSE REPORT]. Actually, at the time of the passage of the
543(a)(6) closed this loophole simply by treating the rent paid to the corporation for the use of the personal assets by the shareholder as personal holding company income.

While section 543(a)(6) appears to have effectively eliminated this avoidance practice, it has unfortunately also served as a trap for unwary taxpayers owning corporations engaged in bona fide business operations. The owner of an operating business may often choose to create a second corporation to hold the land, buildings, and other property used by the principal business in its operations. The corporation holding the property—the "lessor" corporation—leases the property to the "lessee"—the principal corporation—for use in its operations. There are a variety of legitimate business reasons for engaging in this transaction, such as to secure legal tax advantages, or to control the underlying assets that represent the real earning power of the operating corporation, of which the individual may only be a part owner. In these arrangements, of course, both the lessor and lessee corporations often are owned by the same individual or small group of individuals. The Internal Revenue Service has thus consistently maintained that the rent paid for the use of the property by the lessee corporation represents compensation for the use of tangible personal property.

Subsection (f) includes in personal holding company income amounts received as compensation for the use of, or the right to use, the property of the corporation. However, this rule only applies where during the taxable year of the corporation, 25 percent or more in value of its outstanding stock is owned, directly or indirectly, by an individual leasing or otherwise entitled to the use of the property. It makes no difference whether the right to use the property is obtained by the individual directly from the corporation or by means of a sublease or other arrangement. Since under existing law, this type of compensation is not now included for the purposes of determining whether the corporation meets the 80 percent test, the taxpayer may fix such compensation in an amount sufficient to bring its other investment income below the 80 percent test. It has been shown to the committee that this device has been employed by taxpayers who had incorporated their yachts, city residences, or country houses and had paid sufficient rent to give the corporations enough income from their service to take them out of present section 351 [which bears no relation to the modern section 351]. By including this type of income in the definition of personal holding company income, your committee removes this method of tax avoidance.

House Report at 6, reprinted in 1939-1 C.B. at 707-08.

14. See infra notes 191-95 and accompanying text for a discussion of cases exemplifying the danger caused by § 543(a)(6) to unwary taxpayers.

sonal property of the lessor corporation from a twenty-five percent or more shareholder under section 543(a)(6). Moreover, in order to eliminate indirect rentals as an abuse of the personal holding company, the Service relies on the "other arrangement" language of subsection (a)(6). It asserts that the rental of the lessor corporation's property by the principal corporation, rather than directly by the principal corporation's shareholder, constitutes such an "other arrangement," giving the shareholder essentially the same right to use the lessor corporation's property as he would have had if he had rented the property himself. The Service regards this lessor-lessee corporation arrangement as essentially an "insulating" device used by individuals to attempt to evade section 543(a)(6) and thus avoid the sixty percent personal holding company income requirement under section 542(a)(1) for imposition of the surtax. The basic problem with the Service's position is that neither the lessor nor the lessee corporation in this arrangement is a mere sham corporation created to avoid its owner's personal taxes. Both corporations exist for legitimate business purposes exclusive of federal income tax consequences. Section 543(a)(6) thus traps unwary taxpayers who are not attempting to shelter investment income, by subjecting the accumulated earnings of their lessor corporation to the personal holding company surtax.

This Note will discuss the applicability of section 543(a)(6) to the lessor-lessee corporation arrangement. The Note will begin by examining the historical position of the courts on the applicability of section 543(a)(6) to these arrangements. The discussion will provide typical scenarios and will explore the reasoning used by courts in supporting their position. The Note also will illustrate the present stalemate of countervailing authority that has evolved from this judicial analysis. Discussion will next focus upon the

20. See infra notes 24-98 and accompanying text.
This examination includes evidence presented in the court decisions discussed in the first section of the Note. The Note will then examine the real cause of the controversy, and conclude that the present wording of section 543(a)(6) has produced a "no-win" situation, where adoption of either of the countervailing positions on the applicability of the subsection to the lessor-lessee corporation arrangement must necessarily produce some unfair results. Finally, the Note will present proposed amendments to section 543(a)(6) intended to eliminate this dilemma.

I. ILLUSTRATION AND CASE LAW HISTORY

While the Internal Revenue Service has consistently maintained that the rental income paid between corporations owned by the same person or small group of persons constitutes personal holding company income under the "other arrangement" language of section 543(a)(6), it has not been entirely successful in litigating this position. The issue is not a commonly litigated one, probably due to the wariness with which tax planners view the personal holding company provisions, and because of the overwhelmingly high percentage of tax disputes settled in the conference and appellate stages. However, judicial treatment of the issue has been inconsistent. The Tax Court has consistently sided with the taxpayer in holding that the rental income involved does not represent personal holding company income. It has re-

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21. See infra notes 99-190 and accompanying text.
22. See infra notes 191-95 and accompanying text.
23. See infra notes 196-202 and accompanying text.
25. This Note discusses all the significant court decisions to date in its examination of the judicial history of the lessor-lessee corporation issue. See infra notes 24-98 and accompanying text.
recently been joined by the First Circuit Court of Appeals.\textsuperscript{28} The
Second Circuit Court of Appeals has sided with the Commissioner,\textsuperscript{29} and the Service itself has issued a Revenue Ruling formalizing its position.\textsuperscript{30}

A. The First Litigation: Minnesota Mortuaries, Inc.

The personal holding company income issue was first litigated definitively in \textit{Minnesota Mortuaries, Inc. v. Commissioner}\textsuperscript{31} in 1944, seven years after the passage of the predecessor statute to section 543(a)(6), section 353(f).\textsuperscript{32} In \textit{Minnesota Mortuaries, Inc.}, two individuals owned all the stock of an operating company engaged in the funeral directing business.\textsuperscript{33} The same individuals were the sole shareholders of Minnesota Mortuaries, Inc., a holding company that owned all the real property used by the operating company.\textsuperscript{34} The operating company was housed in buildings owned by Minnesota Mortuaries and paid $18,000 in yearly rental payments.\textsuperscript{35} The avowed purpose of the individuals in creating this arrangement was threefold. First, they felt that it would increase the efficiency of determining individual funeral costs.\textsuperscript{36} Second, they believed that it would facilitate the operation of a profit-sharing plan for their employees, in which contributions should fairly be based on service business operations only.\textsuperscript{37} Finally, they wished to separate the risks incident to the operating company from those of the holding company which managed real estate.\textsuperscript{38}

The Tax Court held that the rental income received by Minnesota Mortuaries was not compensation for the use of corporate property by a twenty-five percent or more shareholder.\textsuperscript{39} The court identified the real issue as being whether this arrangement

\begin{itemize}
  \item \textsuperscript{28} See Silverman & Sons Realty Trust v. Commissioner, 620 F.2d 314 (1st Cir. 1980); \textit{infra} notes 86–95 and accompanying text.
  \item \textsuperscript{29} 320 E. 47th St. Corp. v. Commissioner, 243 F.2d 894 (2d Cir. 1957); \textit{infra} notes 61–67 and accompanying text.
  \item \textsuperscript{31} 4 T.C. 280 (1944), \textit{acq.}, 1945 C.B. 2, \textit{acq. withdrawn and nonacq. substituted}, 1965-2 C.B. 7; \textit{infra} note 70.
  \item \textsuperscript{32} Revenue Act of 1937, ch. 815, § 353, 50 Stat. 813, 814.
  \item \textsuperscript{33} 4 T.C. at 281.
  \item \textsuperscript{34} \textit{Id.}
  \item \textsuperscript{35} \textit{Id.}
  \item \textsuperscript{36} \textit{Id.}
  \item \textsuperscript{37} \textit{Id.}
  \item \textsuperscript{38} \textit{Id.}
  \item \textsuperscript{39} \textit{Id.} at 285.
\end{itemize}
made either stockholder an "individual entitled to the use of the property" of the corporation within the meaning of old section 353(f). In rejecting such a reading of the statute, the court first looked to the statute's legislative history. The Tax Court interpreted that history as indicating that the word "use" in the statute must portend an actual use or right to use the property, rather than a use imputed to the taxpayer merely from the acts of a corporation in which he owns stock. Reference was made to the House Report accompanying the section, which indicated a legislative purpose to reach individuals who incorporated their personal assets to evade the personal holding company provisions. The court emphasized that the rent paid was admittedly a reasonable amount, and that there were bona fide business purposes for the arrangement. This implied that there was no tax evasion motive in the arrangement. Finally, the court relied most heavily on the corporate entity concept. It emphasized the firmly recognized principle that an individual, as a stockholder of a corporation, has no right, title, interest in, or right to use, corporate property. The acts of the corporation are not deemed to be the acts of its shareholders. The court's reliance on the corporate entity concept is significant, since this represents a firmly established judicial view that has been used in all of the subsequent cases upholding the taxpayer's position.

40. Id. at 284.
41. Id. The House Report accompanying the statute evinced a legislative purpose to reach the individuals who incorporated personal possessions such as yachts, boats, and residences in order to evade the personal holding company provisions. See House Report, supra note 13, at 6, 1939-1 C.B. at 708. This report, quoting the committee report of the Joint Committee on Tax Evasion and Avoidance, is quoted and discussed infra at notes 112-22 and accompanying text. For a general discussion of the statute's legislative history, see infra notes 99-122 and accompanying text.
42. 4 T.C. at 285.
43. Id.; see supra text accompanying notes 36-38.
44. Id.
45. Id.
46. Id. The corporate entity concept and its strength as a legal doctrine are discussed infra at text accompanying notes 133-48.
47. See, e.g., Silverman & Sons Realty Trust v. Commissioner, 620 F.2d 314 (1st Cir. 1980); 320 E. 47th St. Corp. v. Commissioner, 26 T.C. 545 (1956), rev'd, 243 F.2d 894 (2d Cir. 1957). More recently, in Allied Indus. Cartage Co. v. Commissioner, 647 F.2d 713 (6th Cir. 1981), the court rejected the rationale of 320 E. 47th St. in favor of that of Silverman & Sons, which distinguished rents paid for tax evasion purposes from rents paid for bona fide commercial enterprises. See infra discussion at notes 86-95.
B. Growing Divergence of Authority: 320 East 47th Street

Twelve years passed after Minnesota Mortuaries, Inc. before any court again considered whether rent paid in the lessor-lessee arrangement for the use of corporate property constituted personal holding company income under section 543(a)(6). In the interim, the old section 353(f) was recodified as section 502(f).

320 East 47th Street Corp. v. Commissioner displayed an ownership and rental situation very similar to that in Minnesota Mortuaries, Inc. This case also upheld the taxpayer's position, but differed significantly from Minnesota Mortuaries, Inc. in both its reasoning and conclusion.

The stock of 320 East 47th Street Corporation was wholly owned by two unrelated individuals. In 1948, it received $6000 in rentals from another corporation owned by these same individuals. The company also received $20,000 in interest on a condemnation award from New York City. The primary issue before the court was whether the interest should be treated as personal holding company income to the corporation; the court ruled affirmatively.

Thus, the rental income was a secondary issue raised by the taxpayers. Ironically, the taxpayers, not the Service, claimed that the rental income should qualify under section 502(f). They noted that in 1950 Congress passed section 223 of the Code, which specifically provided that section 502(f) would not apply to rents received by the corporation from another bona fide business enterprise during the years 1945 through 1950. Therefore, if the individuals could show that the rent received in 1948 was section 502(f) income, it would not be treated as personal holding company income. Given the $20,000 of personal holding company income involved, the $6000 of regular income would defeat the

49. Revenue Act of 1938, ch. 289, § 403, 52 Stat. 447, 558 (codifying the provision under this section number as part of the Internal Revenue Code of 1939).
50. 26 T.C. at 546.
51. Id. at 546-47.
52. Id.
53. Id. at 548.
55. 26 T.C. at 548.
then-existing eighty percent requirement.\textsuperscript{56}

The Tax Court summarily rejected the taxpayers' argument.\textsuperscript{57} It relied exclusively on the corporate entity concept, maintaining that a corporation was a separate entity apart from its shareholders, who could not be deemed to be individual lessees of the property in the corporation's place.\textsuperscript{58} The court further held that a corporation was not itself an "individual" within the meaning of section 502(f).\textsuperscript{59} Therefore, the lessor-lessee arrangement did not qualify under section 502(f), and the taxpayers could not rely upon section 223 to avoid the personal holding company surtax. The rent received was instead held to be rent within the meaning of section 502(g), which would allow the taxpayers a temporary exemption.\textsuperscript{60}

The Court of Appeals for the Second Circuit reversed, disagreeing with the Tax Court's conclusion regarding the applicability of sections 502(f) and 223.\textsuperscript{61} The court concluded that the Tax Court's decision would allow taxpayers to use section 502(f) to create a second corporation to lease their own property.\textsuperscript{62} This would allow taxpayers to escape the personal holding company tax and frustrate the congressional intent in enacting section 502(f).\textsuperscript{63} Such a scheme would provide the investing corporation with enough nonpersonal holding company income to avoid the

\textsuperscript{56} \textit{Id.} at 548-49. The total income of the corporation would thus equal $26,000 ($20,000 + $6000). Without treating the $6000 rental as personal holding company income, only 20/26, or 76.9\%, of the corporation's income would qualify—not enough to meet the 80\% requirement.

\textsuperscript{57} \textit{Id.}

\textsuperscript{58} \textit{Id.} at 549.

\textsuperscript{59} \textit{Id.}

\textsuperscript{60} \textit{Id.; see supra} note 9 for the modern version of § 543(a)(2). One might wonder why "compensation for the use of corporate property" under § 502(f) would not also constitute "rent" under § 502(g), so that the compensation would be covered by both subsections. While on the face of the statute the subsections do not appear to be mutually exclusive, the House Report accompanying the bill enacting both of the subsections provided specifically that "rents" under subsection (g) did not include compensation for the use of property covered by subsection (f). \textit{House Report, supra} note 13, at 6, 1939-1 C.B. at 708; \textit{see infra} note 119; \textit{see also} the discussion of this report \textit{infra} in the text accompanying notes 112-22.

\textsuperscript{61} 320 E. 47th St. Corp. v. Commissioner, 243 F.2d 894 (2d Cir. 1957).

\textsuperscript{62} \textit{Id.} at 899.

\textsuperscript{63} \textit{Id.} The Tax Court position announced in \textit{Minnesota Mortuaries, Inc.} and \textit{320 E. 47th St.}—holding that § 543(a)(6) will not apply to the lessor-lessee arrangement in any circumstances due to the corporate entity concept—is arbitrary and \textit{would} allow even taxpayers with a purely tax avoidance purpose to thwart the personal holding company provisions by merely creating a second sham corporation to rent the property in their place. \textit{See infra} text accompanying notes 194-95.
sixty percent requirement, just as if the taxpayer had rented the assets directly. It would, in effect, allow the taxpayer to engage in the very practice which section 502(f) was designed to prevent. The Second Circuit believed that while it was true that including the lessor-lessee arrangement under section 502(f) might otherwise penalize businessmen using the arrangement for valid business purposes, Congress had provided for their relief (at least temporarily) by enacting section 223.64

The court found that the lessor-lessee arrangement came within the "other arrangement" language of section 502(f).65 Therefore, it was not necessary to find that the lessee corporation itself was an "individual" under section 502(f) as the Tax Court had concluded, or that its individual shareholders be deemed the lessees of the property in the corporation's place.66 The important question, rather, was whether the arrangement indirectly gave the two shareholders of the lessee corporation the "use of, or right to use, property of the [lessor] corporation . . . ."67 The Second Circuit's approach was to look at the practical net effect of the arrangement and to minimize the detrimental effect to future taxpayers using the arrangement for bona fide business purposes upon the expiration of section 223.68

Relatively little controversy arose concerning the application of section 543(a)(6) to the lessor-lessee arrangement in the period following the 320 East 47th Street decision. That holding was expressly followed in Hilldun Corp. v. Commissioner,69 another Second Circuit decision which merely cited 320 East 47th Street without discussion. The Second Circuit's position was subsequently acquiesced to by the Internal Revenue Service in Revenue Ruling 65-259.70 This Ruling cited 320 East 47th Street, using its facts as an example of the type of situation in which section 543(a)(6) was to be applied.71

64. 243 F.2d at 899.
65. Id. The wording of § 502(f) was substantially identical to that of the present § 543(a)(6).
66. 243 F.2d at 899.
67. Id.; see supra note 9.
68. As discussed supra at notes 123–28 and accompanying text, § 223 was a temporary provision expiring in 1953.
69. 408 F.2d 1117 (2d Cir. 1969).
70. 1965-2 C.B. 174. In the same ruling, the Commissioner withdrew his former acquiescence to Minnesota Mortuaries, Inc. and substituted a nonacquiescence therefore. See 1965-2 C.B. 7, 8 n.25.
C. The Rebirth of Judicial Controversy: Allied Industrial Cartage\textsuperscript{72} and Silverman & Sons\textsuperscript{73}

In 1979, the Tax Court rekindled the judicial controversy, first in \textit{Allied Industrial Cartage Co. v. Commissioner,}\textsuperscript{74} and again in \textit{Silverman & Sons Realty Trust v. Commissioner.}\textsuperscript{75} The Tax Court held in both cases—under fact patterns substantially identical to those in \textit{Minnesota Mortuaries, Inc.}\textsuperscript{76} and \textit{320 East 47th Street\textsuperscript{77}}—that section 543(a)(6) did not apply to the intercorporate leasing arrangement.

In \textit{Allied Industrial Cartage}, the Tax Court, in an opinion subsequently affirmed by the Court of Appeals for the Sixth Circuit, again relied heavily on the corporate entity concept and refused to impute the acts of the corporation to its shareholders.\textsuperscript{78} The court also insisted that section 543(a)(6) was enacted with personal, nonbusiness use of corporate property by a shareholder in mind and had not contemplated the rental of productive corporate assets by a lessee for use in its corporate business.\textsuperscript{79} This latter situation is potentially much more expansive since it could apply to

\textit{Id.}\textsuperscript{72} Allied Indus. Cartage Co. v. Commissioner, 72 T.C. 515 (1979), aff'd per curiam, 647 F.2d 713 (6th Cir. 1981).

\textit{Id.}\textsuperscript{73} Silverman & Sons Realty Trust v. Commissioner, T.C.M. (P-H) ¶ 79,404 (1979), aff'd, 620 F.2d 314 (1st Cir. 1980).

\textit{Id.}\textsuperscript{74} 72 T.C. 515 (1979).

\textit{Id.}\textsuperscript{75} T.C.M. (P-H) ¶ 79,404 (1979).

\textit{Id.}\textsuperscript{76} 4 T.C. 280 (1944), acq., 1945 C.B. 2, acq. withdrawn and nonacq. substituted, 1965-2 C.B. 7; see \textit{supra} notes 34-47 and accompanying text.

\textit{Id.}\textsuperscript{77} 26 T.C. 545 (1956), rev'd, 243 F.2d 894 (2d Cir. 1957); see \textit{supra} notes 48-67 and accompanying text.

\textit{Id.}\textsuperscript{78} 72 T.C. at 518.

\textit{Id.}\textsuperscript{79} at 520. The court stated: "It is manifest from the legislative history quoted above [the 1937 House Report], and duplicated in section 1.543-1(b)(9), Income Tax Regs.,
even *individual* twenty-five percent or more shareholders who lease the corporate assets, so long as the assets are business assets used by the shareholder for purely business purposes.

The court expressly rejected *320 East 47th Street* without discussion, simply stating its decision to reaffirm its holding in *Minnesota Mortuaries, Inc.* 80 The court did, however, suggest that the section 543(a)(6) discussion in *320 East 47th Street* could be construed as mere dicta.81 The court did not attempt to support this suggestion, and it is difficult to see how such an argument could be made when the holding regarding section 543(a)(6)'s applicability formed the basis of the Second Circuit's reversal of the lower court decision. In any event, the dicta issue was not the basis of the Tax Court's rejection of the *320 East 47th Street* position.82

The Tax Court shortly thereafter reaffirmed its *Allied Industrial Cartage* holding in a memorandum decision in *Silverman & Sons Realty Trust v. Commissioner.*83 The court simply cited *Allied Industrial Cartage* as a reaffirmation of its *Minnesota Mortuaries, Inc.* holding, and followed *Minnesota Mortuaries, Inc.* without elaboration.84 The *Silverman & Sons* court also discussed the previous refusal in *Allied Industrial Cartage* to follow *320 East 47th Street* and again asserted that the holding in *320 East 47th Street* regarding the applicability of section 543(a)(6) was merely dicta, or at best an alternative holding.85 Once again, the Tax Court failed to support this contention.

The Tax Court's short memorandum decision on review in *Silverman & Sons* gave rise to a thoroughly reasoned and highly significant opinion by the First Circuit Court of Appeals.86 After reviewing the previously discussed section 543(a)(6) decisions, the First Circuit chose to affirm the Tax Court and adopt the *Minne-

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80. *Id.*
81. *Id.*
82. The court's decision was based upon *Minnesota Mortuaries, Inc.*'s view of the corporate entity concept, as well as the asserted intent of the statute to apply to the rental of nonbusiness property. The court referred to the dicta issue in *320 E. 47th St.* as follows: "It can be argued that the language on which respondent relies constitutes dicta in the Second Circuit's opinion. However, no matter what its characterization, we respectfully decline to follow it." 72 T.C. at 520 (emphasis added). This language indicates that the dicta issue was not the basis of the court's rejection of *320 E. 47th Street.*
83. T.C.M. (P-H) ¶ 79,404 (1979), aff'd, 620 F.2d 314 (1st Cir. 1980).
84. *Id.*
85. *Id.*
86. *Silverman & Sons Realty Trust v. Commissioner,* 620 F.2d 314 (1st Cir. 1980).
sota Mortuaries, Inc. line of reasoning, placing itself at odds with the Second Circuit and producing a stalemate of judicial authority.

The Commissioner’s argument on appeal closely paralleled the Second Circuit’s decision in 320 East 47th Street. The Commissioner insisted that the lessor-lessee arrangement could properly fit within the “other arrangement” provision of section 543(a)(6), and that to hold otherwise would enable scheming taxpayers to avoid section 543(a)(6) and the personal holding company penalty tax merely by interposing a second sham corporation as the ostensibly lessee.

In rejecting the Commissioner’s argument, the First Circuit applied an approach not presented in the Minnesota Mortuaries, Inc. line of cases. It placed primary emphasis on the presence or absence of a tax avoidance purpose. The court stated that if the lessee corporation has been established solely for the purpose of avoiding section 543(a)(6), that fact should be readily ascertainable and appropriate measures may be taken, including piercing the corporate veil, to insure that the personal holding company provisions are not frustrated. This will plainly be the case where the leased property consists of personal or recreational property or in other instances where the property is being placed at the disposal of the individual shareholders for their personal use. However, the court held that a bona fide lessor-lessee corporation arrangement set up for valid business purposes, such as those present in Minnesota Mortuaries, Inc. is not the equivalent of an “other arrangement” under section 543(a)(6). The court emphasized that while a “sublease or other arrangement” might legally authorize personal use of leased property, a corporation qua corporation does not provide such authorization. Furthermore, the shareholders of a corporation have no legal right to reach the corporation’s property for their own personal use.  

87. Id. at 318; see supra text accompanying notes 61–67.
88. See supra text accompanying note 63 and infra notes 194–95.
89. 620 F.2d at 318–19.
90. Here the court suggests two factors which should be considered as part of the examination to ascertain the existence of a tax evasion purpose: The type of property involved—business or nonbusiness—and whether the individual shareholder has in fact acquired any right to personal use of the property. Guidelines such as these would be helpful in the administration of the proposed test. Id. at 316.
91. Id. at 318.
92. Id. This is merely the statement of the corporate entity concept relied upon heavily in the Tax Court decisions. See supra notes 46–47 & 58 and accompanying text.
The decision of the First Circuit thus turned upon the issue of whether section 543(a)(6) should be construed to impute to individual shareholders the property rights possessed by their corporation. To do so would contradict the well-established corporate entity concept referred to in the Minnesota Mortuaries, Inc. line of decisions. Therefore, the courts should be reluctant to take such a step. However, that step may be appropriate when necessary to prevent a known tax avoidance scheme. In the First Circuit's view, therefore, the inquiry should focus on the presence or absence of a tax avoidance purpose.

The decision of the First Circuit in Silverman & Sons and the Sixth Circuit's following of the First Circuit in Allied Industrial Cartage, therefore, are at loggerheads with the position of the Second Circuit regarding the applicability of section 543(a)(6) to the lessor-lessee corporate arrangement. The First and Sixth Circuits adopt the longstanding position of the Tax Court, beginning with Minnesota Mortuaries, Inc. that this relationship does not constitute an "other arrangement" within the purview of section 543(a)(6). The position of the Second Circuit, supported by the Internal Revenue Service in Revenue Ruling 65-259, is that section 543(a)(6) controls the lessor-lessee arrangement. To evaluate the relative merits of these countervailing positions, this Note will proceed to examine the authority relied upon to support the two approaches and to examine additional sources of authority or analogy not previously employed.

II. EXAMINATION OF AUTHORITY RELIED UPON BY THE COURTS

The courts have relied upon various authorities in formulating their positions on the personal holding company income issue. These authorities include legislative histories, general tax principles, and related case law.

93. See infra notes 133-48 and accompanying text.
94. 620 F.2d at 319.
95. Id. at 318-19.
97. 1965-2 C.B. 174; see supra note 71 for the relevant text of the Revenue Ruling.
98. 320 E. 47th St. Corp. v. Commissioner, 243 F.2d 894 (2d Cir. 1957); see supra text accompanying notes 61-67.
A. Legislative History of Section 543(a)(6)

An examination into the legislative history of a statute is the first step in gaining an insight into its intended application. The legislative history of section 543(a)(6) indicates at least two relevant areas of congressional concern—ease of administration, and fairness to bona fide lease arrangements. These arose at the time of the initial enactment of the personal holding company provisions in 1934,99 and again when the statutory predecessor to section 543(a)(6) was enacted in 1937.100 Section 543(a)(6) has changed little since its original enactment. The only significant alteration has been the addition of a requirement that the corporation also have other forms of personal holding company income comprising at least ten percent of its ordinary gross income in order to trigger application of the section.101

1. Old Section 351

The personal holding company penalty tax was created by the Revenue Act of 1934.102 At that time it consisted of only a single and now defunct provision, (section 351, which should not be confused with the present section 351), which labeled royalties, dividends, interest, annuities, and capital gains as personal holding company income.103 The House report accompanying the bill enunciated an intent to prevent the use of "incorporated pocket-books"—the sham corporations used to shelter the investment income of high tax bracket individuals now commonly known as personal holding companies.104 Old section 351, the personal holding company provision, was created by splitting the currently existing section 104 into two parts.105 Section 104 was the equivalent of the modern excess accumulated profits tax provision,106 which places a fifty percent tax penalty on the excessive accumulation of profits by any corporation when such accumulation is for the purpose of avoiding high shareholder tax brackets. Section 104 had long been available to prevent these incorporated

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103. Id.
104. See supra note 3.
pocketbooks, but had been largely ineffective due to the necessity of proving a tax avoidance purpose. Thus, it became necessary for Congress to enact a separate provision to specifically address this tax avoidance scheme. The major change from section 104 was the elimination of the “tax avoidance” language. The House report explained the operation of the newly enacted section 351 as follows:

The effect of this system recommended by your committee is to provide for a tax which will be automatically levied upon the holding company without any necessity for proving a purpose of avoiding surtaxes. It is believed that the majority of these corporations are in fact formed for the sole purpose of avoiding the imposition of the surtax upon the stockholders.

The language of the 1934 House report seems to support the view of the Second Circuit in 320 East 47th Street which holds that a tax avoidance purpose in corporate formulation is irrelevant to the issue of applicability of the personal holding company tax. The House report suggests that one of the reasons for the creation of these provisions was to eliminate the need for showing a tax avoidance purpose. This impliedly tends to refute the First Circuit’s position which found the presence or absence of tax avoidance purpose determinative.

2. Revenue Act of 1937 Additions

Congress appointed a Joint Committee on Tax Evasion and Avoidance in 1937 to investigate methods of evasion and avoidance of income, estate, and gift taxes, and to recommend statutory resolutions to eliminate the loopholes discovered. The recommendations of this committee were later included in identical House and Senate reports accompanying the resulting statutory proposals. As part of its scheme of statutory proposals to eliminate perceived means of tax evasion, the committee recommended that the list of enumerated forms of personal holding company income be amended to include two additional categories: rents, and com-

108. Id.
109. Id. at 12 (emphasis added).
110. See 243 F.2d 894, 899 (2d Cir. 1957); supra notes 61-67 and accompanying text.
111. Silverman & Sons Realty Trust v. Commissioner, 620 F.2d 314, 318-19 (1st Cir. 1980); see supra notes 89-95 and accompanying text.
compensation for the use of corporate property by a twenty-five per-
cent or more shareholder.\(^{114}\) The recommendations were
subsequently enacted as part of the Revenue Act of 1937.\(^{115}\)

The joint committee's analysis of the proposal to add the cate-
gory of compensation for the use of corporate property first dis-
cussed the tax evasion scheme that necessitated its proposal: the
practice of transferring an individual's personal assets to a per-
sonal holding company. The report cites as an example the lease-
back of an individual's yacht, city residence, and country house in
order to provide the holding company with sufficient nonpersonal
holding company income to escape the penalty tax.\(^{116}\) The com-
mittee concluded that "by including this type of income in the
definition of personal holding company income, your committee
removes this method of tax avoidance."\(^{117}\) The language of the
report thus indicates that the abuse to be curtailed was limited to
the scheme involving tax evasion motives and personal or non-
business types of assets, and did not include the bona fide business
corporation arrangements described earlier. The report also re-
peatedly refers to the leasing of corporate assets by an individual.\(^{118}\) Finally, the report expresses the desire "not to interfere
with bona fide and legitimate operating companies, whose busi-
ness consisted of ownership and operation of office buildings,
apartment houses, etc."\(^{119}\) It is significant that the leased property
in 320 East 47th Street, the major case supporting the position of

\(^{114}\) House Report, supra note 13, at 5–6, reprinted in 1939–1 C.B. at 707–08.


\(^{116}\) See House Report, supra note 13, at 6, reprinted in 1939–1 C.B. at 708. For an
examination of the present 60% personal holding company income requirement, see supra
note 8.

\(^{117}\) See House Report, supra note 13, at 6, reprinted in 1939–1 C.B. at 708.

\(^{118}\) Id.

\(^{119}\) Id. When using this language, the report discusses the proposed addition of sub-
section (g)—Rents, not subsection (f)—Compensation for the use of corporate property.
However, the words still indicate Congress' intent to spare bona fide business operations
from the personal holding company tax penalties. Subsections (g) and (f) were enacted
concurrently to prevent the avoidance of the personal holding company provisions by the
incorporation of personal assets. The report states in pertinent part:

Subsection (g) includes as personal holding company income, rents which do not
constitute 50 percent or more of the gross income. For this purpose, rents are
defined as compensation, however designated for the use of, or right to use, prop-
erty. But rents do not include compensation received for the use of property cov-
ered by subsection (f) (rent of yachts, airplanes, etc., to shareholders). Under
existing law, rents are excluded from the 80-percent classification. This was done
principally so as not to interfere with bona-fide and legitimate operating compa-
nies, whose business consisted of the ownership and operation of office buildings,
apartment houses, etc.

\(^{117}\) Id.
the Commissioner, was, in fact, an office building.\textsuperscript{120}

The 1937 committee report, in contrast to the earlier 1934 committee reports, is consistent with the position of the First and Sixth Circuits. Its reference to the examples of personal and non-business types of property used in the leasing schemes supports the validity of the First Circuit's position in \textit{Silverman \\& Sons}.\textsuperscript{121} The \textit{Silverman \\& Sons} test provides in part that the type of property leased under the arrangement is an important consideration in determining whether section 543(a)(6) should be invoked. The later congressional intention not to interfere with bona fide and legitimate operating companies is significant not only because it upholds the taxpayers position, but also because it nearly diametrically conflicts with the position expressed in the 1934 House report.\textsuperscript{122} This dichotomy suggests the simultaneous existence of two countervailing congressional purposes. First, a rule was sought which could be easy to administer and difficult to evade, by eliminating the requirement that the Commissioner prove a tax avoidance purpose in the establishment of a personal holding company. Second, bona fide business operations were to be protected from arbitrary tax penalties. The simultaneous existence of these two motives has understandably contributed to the confusion in the resulting statutory schemes.

\textbf{B. Section 223}

Section 223 of the Code was a temporary provision enacted by the Revenue Act of 1950.\textsuperscript{123} Significantly, it was enacted primarily in response to the situations arising in the cases discussed earlier.\textsuperscript{124} The application of section 223 was originally limited to taxable years ending between 1945 and 1950, but was later ex-

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\item \textsuperscript{120} 320 E. 47th St. Corp. v. Commissioner, 243 F.2d 894, 895 (2d Cir. 1957).
\item \textsuperscript{121} 620 F.2d 314 (1st Cir. 1980); \textit{see supra} notes 89–95 and accompanying text.
\item \textsuperscript{122} H.R. Rep. No. 704, 73d Cong., 2d Sess. 12 (1934). The House report expressly rejected any need to examine the motive or purpose in creating the leasing arrangement. \textit{Id.} For a discussion of the 1934 House report, \textit{see supra} notes 102–11 and accompanying text.
\item \textsuperscript{123} Revenue Act of 1950, ch. 994, § 223, 64 Stat. 906, 947, \textit{as amended by} Act of August 11, 1955, ch. 808, § 223, 69 Stat. 693, 693. Section 223 reads as follows:

\textbf{SEC. 223. PERSONAL HOLDING COMPANY INCOME.} Section 502(f) of the Internal Revenue Code (relating to use of corporation property by a shareholder) shall not apply with respect to rents received during taxable years ending after December 31, 1945, and before January 1, 1950, if such rents were received for the use by the lessee, in the operation of a bona fide commercial, industrial, or mining enterprise, of property of the taxpayer.

\item \textsuperscript{124} For a representative fact situation, \textit{see supra} notes 31–38 and accompanying text.
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tended to include taxable years through 1953.\textsuperscript{125} A consideration of section 223 and its legislative history is useful in evaluating the application of section 543(a)(6) to the lessor-lessee corporation arrangement.\textsuperscript{126}

Section 223 provided that section 502(f), the then-existing counterpart of current section 543(a)(6), would not apply to rents received during the taxable years ending between 1945 and 1950 if such rents were received for the use of the corporation’s property by the lessee “in the operation of a bona fide commercial, industrial or mining enterprise.”\textsuperscript{127} These bona fide business lease arrangements would otherwise have qualified under section 502(f). Section 223 was not limited to lease arrangements involving corporate lessees, but relieved all types of bona fide lease arrangements from application of the penalty tax.\textsuperscript{128}

The Senate report accompanying the Revenue Act of 1950\textsuperscript{129} states unequivocally that the statute was a specific response to problems arising under the lessor-lessee arrangement:

The attention of your committee has been called to examples where, through a set of fortuitous circumstances, corporations have become closely held and also have rented most of their assets for use in the operation of businesses to the individuals holding the stock of the companies. Thus, unwittingly the corporations have become personal holding companies and subject to the penalty tax.

While your committee recognizes that such arrangements could result in tax avoidance, and, therefore, does not permit such practices in the future, it believes that relief for past years should be given where such arrangements have been unwittingly entered into with no thought of tax avoidance.\textsuperscript{130}

This statement indicates the congressional awareness of, and sympathy for, the entrapment of bona fide business lessors in situations like the lessor-lessee arrangement. Despite such apparent sympathy for the taxpayer, however, the report also reveals that Congress deliberately chose to limit its relief to the prescribed period.\textsuperscript{131}

\textsuperscript{125} Act of August 11, 1955, ch. 808, 69 Stat. 693. No reason was given for the extension of the period of applicability of § 223.
\textsuperscript{126} S. REP. NO. 2375, 81st Cong., 2d Sess. 65 (1950). For pertinent language from the report, see \textit{supra} text accompanying note 130.
\textsuperscript{128} See S. REP. NO. 2375, 81st Cong., 2d Sess. 65 (1950).
\textsuperscript{129} Id.
\textsuperscript{130} Id. at 65.
\textsuperscript{131} Id. In spite of the statement that the committee “does not permit such practices in
Section 223 and its legislative history must be viewed as supporting the position of the Internal Revenue Service. The Senate report shows a congressional recognition of the unfairness caused by the application of section 543(a)(6) to bona fide business lease arrangements. It also indicates that the use by section 223 of a bona fide business purpose test in determining the applicability of section 502(f) supports the workability of the First Circuit's position in Silverman & Sons. Nevertheless, the report appears to unequivocally evince a congressional intent to disallow the presence of a bona fide business purpose to prevent the applicability of the statute to present lessor-lessee corporate arrangements.

C. The Corporate Entity Concept

The concept of the corporate entity—that the corporation is an entity separate and distinct from its shareholders, with the shareholders having no right to personal use of the assets of the corporation—has been at the heart of every court decision upholding the taxpayer's position that section 543(a)(6) should not apply to the lessor-lessee corporate arrangement. The pro-taxpayer decisions relying on it read the corporate entity concept as an established, black letter rule of law. The existence of such a strongly established entity concept obviously would lend great support to the taxpayer's position by indicating that the mere rental of the lessor corporation's property by the shareholder's corporation does not give that shareholder an indirect right to use the property personally, as in the "other arrangement" provision of section 543(a)(6). The resulting question, therefore, is whether the corporate entity concept is indeed as firmly established as the First Circuit and the Tax Court believe it to be.

Substantial authority supports the corporate entity concept. The United States Supreme Court has held that a corporation is a separate entity for federal income taxation purposes—a view

the future," § 223 was amended five years later to have its application extended through 1953. See supra note 125.

132. 620 F.2d 314 (1st Cir. 1980).


134. For the text of I.R.C. § 543(a)(6), see supra note 9.

adopted regularly by both courts and commentators.\textsuperscript{136} It has been broadly stated that "a stockholder as such has no title, legal or equitable, to the corporation's property."\textsuperscript{137} The case law plainly upholds the First Circuit's statement in \textit{Silverman & Sons} that "[a] bona fide corporation is not the equivalent of a 'sublease or other arrangement' for the simple reason that whereas the latter would legally authorize personal use, the former does not."\textsuperscript{138} Thus, the corporate entity concept appears to be a firmly entrenched judicial doctrine.

The corporate entity concept has not, however, gone unchallenged. The doctrine has been questioned with respect to the stock attribution provisions of the Internal Revenue Code found in section 318.\textsuperscript{139} This section provides that under certain conditions the stock owned by a corporation will be considered owned by its fifty percent or more shareholder.\textsuperscript{140} However, the personal holding company provisions are not among the sections to which the section 318 attribution rules apply. Section 318 applies only when activated by another Code section to stock transfer or redemption transactions.\textsuperscript{141} Additionally, section 318 is limited to attributing ownership of the corporation's stock assets only to fifty percent or more shareholders.\textsuperscript{142} These limitations indicate that section 318 is to be interpreted narrowly, and cannot be used to suggest a general rejection of the corporate entity concept.

A more powerful argument for rejecting the corporate entity concept arises under Code section 544.\textsuperscript{143} Section 544 also contains attribution rules but is both part of the personal holding company provisions and expressly applicable to section 543(a)(6). Section 544 provides that for purposes of section 543(a)(6), \textit{stock} owned by a corporation will be considered as being owned pro-

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\item \textsuperscript{137} Howell Turpentine Co. v. Commissioner, 162 F.2d 319, 322 (5th Cir. 1947) (although they could contract to sell it, shareholders of a corporation could not themselves convey the corporation's property short of liquidation).
\item \textsuperscript{138} Silverman & Sons Realty Trust v. Commissioner, 620 F.2d 314, 318 (1st Cir. 1980) (emphasis added); \textit{see supra} notes 91–95 and accompanying text.
\item \textsuperscript{139} I.R.C. § 318 (1976).
\item \textsuperscript{140} \textit{Id.} § 318(a)(2)(C) (1976).
\item \textsuperscript{141} \textit{Id.} § 318(a) (1976). Examples of Code sections invoking the application of § 318 are I.R.C. §§ 302 (distributions in redemption of stock), 306 (dispositions of certain types of preferred stock), and 334 (basis provision for property received in certain liquidations).
\item \textsuperscript{142} \textit{Id.} § 318(a)(2)(C).
\item \textsuperscript{143} \textit{Id.} § 544.
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portionately by its shareholders. At least with respect to shares of stock in other companies held by the corporation, this section suspends the protection of the corporate entity concept in section 543(a)(6) applications. Since section 544 is made expressly applicable to section 543(a)(6), one can argue that attribution to shareholders should be made of other property rights of the corporation, including the indirect right to reach the corporation's property for personal use. This might constitute an "other arrangement" within the definition of section 543(a)(6).

The validity of such a construction, however, seems remote. The provisions are limited to attributing ownership of shares of stock only; they do not attribute ownership of general corporate assets. The authority supporting the corporate entity concept and its general application for federal income tax purposes is overwhelming. Even the Second Circuit, which refused in 320 East 47th Street to employ the doctrine to protect the lessor-lessee corporate arrangement, was forced to acknowledge the general application of the entity concept in federal tax matters. The court stated that "while it is true that under [New Colonial Ice Co. v. Helvering] the corporation is an entity for the purpose of the imposition of taxes, the two sole shareholders of a corporation indirectly do have the use of its leased property." The Second Circuit then applied section 543(a)(6) to the arrangement while recognizing the validity of the corporate entity concept. Despite this judicial legerdemain, the court's inability to offer any authority for rejecting the application of the corporate entity concept demonstrates the strength of the doctrine.

D. The Partnership Context

In contrast to the sharp division of opinion characterizing adjudication of the applicability of section 543(a)(6) to lease arrangements where the lessee is another corporation having shareholders identical to those of the lessor corporation, no such division exists in the partnership area. The courts have univer-

144. Id. § 544(a)(1).
146. 320 E. 47th St. Corp. v. Commissioner, 243 F.2d 894 (2d Cir. 1957); see supra text accompanying notes 61–67.
148. 243 F.2d at 898; see supra text accompanying notes 66–67.
sally agreed that section 543(a)(6) will apply where the lessee is a partnership whose partners comprise substantially all of the shareholders of the lessor corporation.\textsuperscript{149} The basis for this distinction is the absence of any similar entity concept in partnership law.\textsuperscript{150} A partnership has not generally been recognized in the law as an entity distinct from its individual partners for federal tax purposes.\textsuperscript{151} Thus, the primary reason cited by the courts in upholding the taxpayer's position in the corporate-lessee cases—that the shareholder does not by the arrangement gain a right to personal use of the leased assets—is unavailable in the partnership context. The prevailing rule there is quite apposite: "A partner is a co-owner with his partners of specific partnership property, holding as a tenant in partnership."\textsuperscript{152}

The partnership-lessee cases have broadly insisted on the application of section 543(a)(6) to the lease arrangements, and courts have refused to stay the application of the section even in a case where local state law held that a partnership was an entity separate and apart from its partners.\textsuperscript{153} The court ruled that the federal revenue statutes have their own criteria independent of local law.\textsuperscript{154}

The contrast between the partnership-lessee decisions favoring the Commissioner's position and the pro-taxpayer corporate-lessee decisions is reconcilable. The absence of the corporate entity concept in the partnership cases distinguishes these from the former cases. In fact, the partnership cases tend to support the

\textsuperscript{149} See, e.g., Randolph Prods. Co. v. Manning, 176 F.2d 190 (3d Cir. 1949); Hafffried, Inc. v. Commissioner, 162 F.2d 628 (3d Cir. 1947); Walnut St. Co. v. Glenn, 83 F. Supp. 945 (D. Ky. 1948); Western Transmission Corp. v. Commissioner, 18 T.C. 818 (1952); Furniture Fin. Corp., 46 B.T.A. 240 (1942).

\textsuperscript{150} See, e.g., Western Transmission Corp. v. Commissioner, 18 T.C. 818 (1952). The court noted the differences in holdings between the partnership cases (citing Randolph Prods. Co. and Walnut St. Co.), and the holding in Minnesota Mortuaries, Inc. v. Commissioner, 4 T.C. 280 (1944), acq., 1945 C.B. 2, acq. withdrawn and nonacq. substituted, 1965-2 C.B. 7. See supra notes 31-47 and accompanying text. The court attributed the difference in holdings to the presence of the corporate entity concept in Minnesota Mortuaries, Inc.

\textsuperscript{151} See Randolph Prods. Co. v. Manning, 176 F.2d 190 (3d Cir. 1949); Jennings v. Commissioner, 110 F.2d 945, 946 (5th Cir. 1945); I.R.C. §§ 701, 702 (1976).

\textsuperscript{152} Commissioner v. Whitney, 169 F.2d 562, 567 (2d Cir.), cert. denied, 335 U.S. 892 (1948) (quoting N.Y. Partnership Law § 51 (Consol. 1948); see also Uniform Partnership Act § 25 (1914). In a limited partnership, the limited partners do not hold as tenants in partnership with the general partners.

\textsuperscript{153} See, e.g., Western Transmission Corp. v. Commissioner, 18 T.C. 818 (1952).

\textsuperscript{154} Id. at 822-23. The court stated that "such a distinction [provided by the peculiar Michigan law] is immaterial for the reason that the Federal revenue statutes have their own criteria, and their applicability is not dependent upon local Michigan law." Id.
position of the corporate-lessee situation because they demonstrate by negative implication the power of the corporate entity doctrine as a valid device to remove a business lease arrangement from the reach of section 543(a)(6). Thus, the most significant contribution of the partnership-lessee decisions, for the purposes of this Note, is their emphasis of the crucial role played by the corporate entity concept in the First and Sixth Circuits and in the Tax Court.

E. Tax Avoidance Purpose

The relevance of a tax avoidance purpose in creating the lessor-lessee corporation arrangement in determining applicability of section 543(a)(6) has been essential in the reasoning used by both sides in the controversy. The Tax Court and the First Circuit Court of Appeals both assert that the absence of a tax avoidance purpose is a relevant consideration in determining the applicability of the section. Accordingly, both courts have tended to excuse the taxpayer when the leasing arrangement appears to have been created merely for a reason independent of avoiding the applicability of section 543(a)(6). This consideration was especially important in Silverman & Sons, in which the First Circuit prescribed a test for the application of section 543(a)(6) based primarily on an examination of tax avoidance purpose. The Second

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155. For a reference to the distinctive power of the corporate entity concept to prevent the application of § 543(a)(6) to a business lease arrangement, see Western Transmission Corp. v. Commissioner, 18 T.C. 818, 822 (1952).


160. See supra notes 86-95 and accompanying text.

161. 620 F.2d 314. The court stated its views on tax avoidance purpose as follows: The Commissioner argues that the Tax Court, in reaching its decision, mistakenly relied on a distinction between those rental arrangements having a business purpose and those having only a tax-related purpose. This distinction, it is argued, is a false one, because the statute has long been interpreted as reaching both
Circuit in *320 East 47th Street* declared unequivocally that the absence of a tax avoidance purpose in formation of the lessee corporation could have no effect on the issue. Hence, section 543(a)(6) was applicable.

What is the proper role of a tax avoidance purpose in deciding the application of section 543(a)(6)? There is no statutory or case law mandate either demanding or prohibiting the examination into tax avoidance purpose. Certain tax statutes are applied mechanically, due to established judicial practice or because of statutory language or history. Other statutes, such as the excess accumulated earnings tax provisions, specifically incorporate references to tax avoidance purpose and thus statutorily demand an investigation into this issue.

One of the main reasons advanced for establishing the special personal holding company provisions in 1934 was the difficulty in enforcing the excess accumulated earnings tax provisions because of the need to prove a tax avoidance motive. The House report accompanying the 1934 Act stated that the holding company provisions would be “automatically levied upon the company without any necessity for proving a purpose of avoiding surtaxes.” The Second Circuit has relied heavily on this state-

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types of arrangements where the lease is to an individual or partnership. . . . Whatever the force of this argument in other contexts, we do not think it answers the question before us. The issue is whether the statute is to be construed so as to impute to individuals the property rights of a corporation in which they own stock. Absent explicit Congressional guidance, this is a step any court should be reluctant to take. . . . We agree with the Tax Court that a relevant consideration is whether the step is necessary to prevent a scheme of tax avoidance. Where, as here, there is no showing the arrangement is other than a bona fide business transaction, we see no necessary implication that Congress intended to impose a personal holding company tax on the lessor corporation.

Id. at 319.


163. 243 F.2d at 899; see supra text accompanying notes 61–66.

164. See, e.g., United States v. Davis, 397 U.S. 301 (1970), holding business purpose irrelevant to the determination of dividend equivalence. Further examples of mechanical application are the retirement and pension plan provisions of the Code—§§ 401–418, under which a tax avoidance motive is ignored when testing pension or profit sharing plan qualification in terms of vesting, participation, or funding. Finally, I.R.C. § 2035 was amended in 1976 so as to replace its rebuttable presumption with a provision which automatically includes in the gross estate gifts by a decedent within the three years preceding his or her death.


166. See supra notes 99–122 and accompanying text.


168. Id. at 12; see supra text accompanying note 109.
ment in support of its position that the lack of a tax avoidance purpose is not a relevant consideration. The position of the Second Circuit rests upon its earlier decision in *O'Sullivan Rubber Co. v. Commissioner*, which also involved the application of the personal holding company provisions, and which determined that the absence of tax avoidance purpose was irrelevant. In that case, the court stated that "[i]n enacting the very section being applied here, Congress was attempting to foreclose the defense, available under [the excess earnings tax provisions], that the accumulation of profits was responsive to a legitimate business need." The court then quoted the same language from the 1934 House report included above and continued:

> Having before us indisputable proof from the exactitude of section 351 itself, reinforced by the Committee reports, that Congress wished to establish objective criteria for imposition of the tax, we cannot, by probing into corporate motives, undertake to relieve from the alleged harshness of a particular application of the statute.

*O'Sullivan Rubber* and the 1934 House report both demonstrate a secondary ground of support for the Second Circuit position—the problem of practical administration. As indicated, the great difficulty in enforcing excess earnings tax provisions had been the primary reason for the creation of the special holding company provisions in 1934. The need to prove a tax avoidance purpose had created too much of a barrier to successful enforcement, thus warranting an objective test. To readopt the consideration of a tax avoidance purpose in gauging the applicability of the personal holding company tax might revive the difficulties formerly experienced, thus allowing offenders to escape the penalty provisions by fraudulently concealing their tax avoidance

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169. 320 E. 47th St. Corp. v. Commissioner, 243 F.2d 894 (2d Cir. 1957); see supra text accompanying notes 61–68.
170. 120 F.2d 845 (2d Cir. 1941).
171. *Id.* at 847. The court observed:
> It is . . . abundantly clear that Congress, in correcting an evil, is not narrowly confined to the specific instances which suggested the remedy. Of course, all personal holding companies were not conceived in sin—many were organized for legitimate personal or business reasons; but Congress has made little distinction between the goats and the sheep.

172. 120 F.2d at 848.
173. *See supra* note 99 and accompanying text.
The proposed First Circuit tax avoidance test, however, would not likely provoke the same administrative difficulties as were experienced with the old excess earnings tax provisions. The more flexible First Circuit test allows the court to decide for itself whether a tax avoidance purpose is present, based on an overall subjective review of the evidence. It need not find actual proof of the existence of a tax avoidance purpose. Nevertheless, administration of the section under this test could not equal the ease of application offered by the Second Circuit position.

The pro-taxpayer decisions of the Tax Court and First Circuit all cited *Gregory v. Helvering*—a Supreme Court decision dealing with a corporate reorganization question—to support their assertion that the absence of a tax avoidance purpose was a relevant consideration. In *Gregory*, the Supreme Court approved of an inquiry into the taxpayer’s motives which had produced a finding that the taxpayer was motivated by a tax avoidance purpose. The Court observed that “[t]he rule which excludes from consideration the motive of tax avoidance is not pertinent to the situation, because the transaction upon its face lies outside the plain intent of the statute.” The statute involved was section 112 of the Revenue Act of 1928, which permitted the shareholder of a corpo-

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174. See the discussion of the rationale of *O’Sullivan Rubber Co.* in the text accompanying notes 61–67 *supra*.


177. 293 U.S. 465 (1935).


179. 293 U.S. at 469–70. The Court explained its view of the arrangement in *Gregory* as follows:

Simply an operation having no business or corporate purpose—a mere device which put on the form of a corporate reorganization as a disguise for concealing its real character, and the sole object and accomplishment of which was the consumption of a preconceived plan, not to reorganize a business or any part of a business, but to transfer a parcel of corporate shares to the petitioner. No doubt, a new and valid corporation was created. But that corporation was nothing more than a contrivance to the end last described. . . . The whole undertaking, though conducted according to the terms of subdivision (B), was in fact an elaborate and devious form of conveyance masquerading as a corporate reorganization, and nothing else.

*Id.*

180. *Id.* at 470.

ration undergoing a reorganization to receive a tax-free partial distribution of the assets.

The taxpayer in Gregory wanted to remove assets from a corporation she controlled without incurring dividend treatment. Toward that end, she formed a second sham corporation to receive the assets from the original corporation, which would then "reorganize" under section 112, distributing the assets to the taxpayer. The scheme was obviously a ruse to avoid tax liability. This situation thus differed significantly from that which typically arises with respect to section 543(a)(6). As the Court stated, to permit the Gregory sham would be "to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose." The obviousness of the tax avoidance scheme in Gregory suggests that the case is of doubtful support for the position of the Tax Court and the First and Sixth Circuits. Section 112 contained no legislative history similar to that of the holding company provision (which indicated that the statute was to be applied without reference to the presence of tax avoidance purpose), and the Gregory court could hardly have allowed this overt abuse of section 112 to circumvent the tax on dividend income.

The most direct support for the position that the absence of a tax avoidance purpose should be considered in deciding whether to apply section 543(a)(6) comes not from case law, but from the previously discussed report of the Joint Committee on Tax Evasion and Avoidance which accompanied the 1937 Act. The report expressed a desire on the part of Congress not to interfere

(g) Distribution of stock on reorganization.—If there is distributed, in pursuance of a plan of reorganization, to a shareholder in a corporation a party to the reorganization, stock or securities in such corporation or in another corporation a party to the reorganization, without the surrender by such shareholder of stock or securities in such a corporation, no gain to the distributee from the receipt of such stock or securities shall be recognized.

(i) Definition of reorganization.—As used in this section . . .

(1) The term "reorganization" means . . . (B) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor or its stockholders or both are in control of the corporation to which the assets are transferred . . . ."

Id. 293 U.S. at 467.

Id. at 470.

See supra notes 99–122 and accompanying text.

H.R. Misc. Doc. No. 337, 75th Cong., 1st Sess. 10 (1937). The recommendations of the joint committee were concurred in by the House Ways and Means Committee and made part of its report to the Congress. House Report, supra note 13, reprinted in 1939-1 (Part 2) C.B. 708. For a discussion of the report, see supra notes 112–22 and accompanying text.
with bona fide and legitimate operating companies. Because there is no general rule regarding the examination of avoidance purpose in the tax area, the indications provided by the legislative history of a statute become almost determinative. In this area, however, even the legislative history itself provides no clear resolution. Nevertheless, Congress did state at the time of the original enactment of the personal holding company provisions that they were created to avoid the need to prove a tax avoidance purpose in enforcement—and that statement may be considered supportive for the Second Circuit position.

That section 223 legislative history would provide relief from section 543(a)(6) for bona fide business leases in the past but would “not permit such practices in the future” also buttresses the Second Circuit’s view. Nevertheless, the very creation of section 223 evidences a congressional awareness of the pitfalls for innocent taxpayers that have been created by section 543(a)(6) and its desire not to see bona fide business operations inflicted with the tax penalty.

III. A Suggested Solution

This Note has attempted to detail the conflicts regarding the application of section 543(a)(6) to the lessor-lessee corporation, and to examine the evidence supporting each position. Both positions have strong supporting authority; both are subject to strong countervailing considerations. Neither is entirely satisfactory. The present form of section 543(a)(6) has created a no-win situation and the adoption of either position must necessarily produce some undesirable results.

The position of the Internal Revenue Service and the Second Circuit, which would apply section 543(a)(6) objectively to all lessor-lessee corporate relationships while simply ignoring both

186. See supra notes 112–22 and accompanying text.
192. See supra text accompanying notes 61–68.
the corporate entity concept and the issue of tax avoidance purpose, means that all such arrangements will receive personal holding company treatment. Thus, the use of section 543(a)(6) to avoid the penalty surtax by creation of a second sham corporation to lease the corporate assets would be foreclosed. Unfortunately, such an approach will also impose the penalty tax upon valid business arrangements by innocent taxpayers merely trying to secure nontax organizational advantages of the type seen in Minnesota Mortuaries, Inc. 193

The Tax Court position is that, because of the corporate entity concept, section 543(a)(6) can never be applied to lessor-lessee corporation arrangements.194 The obvious problem with this approach was explained by the Second Circuit in 320 East 47th Street.195 It would allow even bad faith taxpayers seeking to evade taxes to escape section 543(a)(6) and to frustrate the personal holding company provisions merely by creating a second sham corporation to rent their personal assets from the first, instead of doing so directly.

The adoption of either of these positions will yield some form of undesirable consequences. A possible solution is to amend section 543(a)(6) to include "tax avoidance purpose" language—that is, language requiring that an avoidance purpose be present before the statute can be applied. Additionally, the statute should be amended to provide that such a purpose will be presumed, with the burden of proof on the taxpayer to rebut such presumption.196

193. 4 T.C. 280 (1944), acq., 1945 C.B. 2, acq. withdrawn and nonacq. substituted, 1965-2 C.B. 7; see supra text accompanying note 38.
195. 320 E. 47th St. Corp. v. Commissioner, 243 F.2d 894 (2d Cir. 1957); see supra text accompanying notes 61-68.
196. The "conditions for the presumption of tax avoidance purpose" would be the same statutory requirements found in § 543(a)(6) for its application now. The proposed amendment to § 543(a)(6) might read as follows:

(C). Subparagraph (A) shall apply only if, in addition to the requirement of subparagraph (B), the compensation received by the corporation was not received as part of an arrangement created merely for the purpose of avoiding the personal holding company tax provided in section 541 of this chapter.

Burden of Proof:

If the conditions of subparagraphs (A), (B), and (D) have been met, the taxpayer shall bear the burden of proof of showing that the arrangement providing the corporation with compensation for the use of its assets was not entered into merely for the purpose of avoiding the personal holding company tax.

The present subparagraph (C) would be reclassified as subparagraph (D).
Adoption of this scheme would allow the courts to excuse the taxpayer when it is clear that the arrangement is not being used as part of a tax avoidance scheme, but would enable the courts to impose section 543(a)(6) treatment where they deem it appropriate without the need to find actual proof of a tax avoidance purpose. Such a provision would not return the courts to the same situation they faced before the adoption of the personal holding company provisions. Under the old accumulated earnings tax provisions, the government, not the taxpayer, had to bear the burden of proof. It should be noted that the modern accumulated earnings tax provisions have adopted the same statutory scheme as is presented here.

Acceptance of the suggested statutory amendments would be in effect an adoption of the proposed First Circuit test in *Silverman & Sons*, which mandated an inquiry into the existence of a tax avoidance purpose, and a piercing of the corporate veil with a section 543(a)(6) application for any such purpose discovered. The First Circuit attempted to establish some objective factors to be

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197. *See supra* notes 102–09 and accompanying text.


(a) Unreasonable accumulation determinative of purpose

For purposes of section 532, the fact that the earnings and profits of a corporation are permitted to accumulate beyond the reasonable needs of the business shall be determinative of the purpose to avoid the income tax with respect to the shareholders, unless the corporation by a preponderance of the evidence shall prove to the contrary.


Section 543(c) provides for the taxpayer to file a response statement upon notification from the Secretary that earnings and profits have allegedly been permitted to accumulate beyond the reasonable needs of the business. This statement would set forth "the grounds (together with facts sufficient to show the basis thereof) on which taxpayer relies to establish that all or any part of the earnings and profits have not been permitted to accumulate beyond the reasonable needs of the business."

The language "bona fide business purpose" and "purpose to avoid federal income taxes" is also found in other sections of the Code. Section 357, relating to tax-free assumption of liability in corporate organizations and reorganizations, contains an essentially similar scheme as that found in § 533 and suggested here for § 543. Subsection (c) provides for the non-application of the benefits of § 357 when "it appears" that the "principal purpose" of the taxpayer in arranging for the assumption of the liabilities was either a purpose to avoid federal income tax or was otherwise not a bona fide business purpose. The subsection then states that a burden of proof on the taxpayer to prove that the transaction should qualify for § 357 treatment is not met unless "taxpayer sustains such burden by the clear preponderance of the evidence."

Other Code sections employing somewhat similar language are §§ 302(c) and 355(a)(1)(D).

199. *Silverman & Sons Realty Trust v. Commissioner*, 620 F.2d 314 (1st Cir. 1980); *see supra* notes 89–95 and accompanying text.
considered in the examination. These same factors might also be useful in administering the proposed amended section 543(a)(6). One factor was an inquiry into the nature of the assets being leased—whether they are business assets, or personal or recreational type property. The latter is indicative of a non-business arrangement. A second factor was whether the leased property was actually being placed at the disposal of the individual shareholder for his personal use. The presence of this factor also would indicate a tax avoidance scheme.

This proposed amendment to section 543(a)(6) would provide a valuable and efficient administrative tool enabling the courts and the Service to apply section 543(a)(6) to lease arrangements without the need to find proof of a tax avoidance purpose when, from their review of all relevant facts, they deem such action appropriate. Taxpayers engaged in bona fide leasing arrangements for business purposes could be excused. The result would be a readily administrable statute protecting the interests of both taxpayer and government.

IV. CONCLUSION

Barring the adoption of amendments to section 543(a)(6) such as those proposed, the present stalemate regarding the application of section 543(a)(6) to lessor-lessee corporation arrangements will continue until the Supreme Court chooses to settle the issue permanently. Under the present circumstances, many bona fide corporate lease arrangements face the possibility of unexpectedly triggering the surtax penalty. Wealthy taxpayers can often use personal holding companies to escape high taxes on their investment income by transferring their personal assets to the holding company and then leasing them back via a second sham corporation, yet still providing the holding corporation with suffi-

200. See supra notes 61–67 and accompanying text.
201. Recall that the House report accompanying the bill enacting the original version of § 543(a)(6) indicated that this subsection had been added to address the problem of individuals who had previously circumvented the provisions by transferring to their holding companies their personal assets, such as yachts and townhouses, in addition to their investment assets. These individuals would then rent these assets from the corporation in order to give the company sufficient non-personal holding company income to avoid the § 542 60% personal holding company requirement, thus preventing the imposition of the 70% surtax on the company's accumulated investment income. See supra note 13 and accompanying text.
202. See supra notes 196–201 and accompanying text.
203. See supra notes 96–98 and accompanying text.
cient non-personal holding company income to avoid the sixty percent requirement. Both positions on this issue thus present unfair and unwanted consequences. Congress has the power to cure this dilemma by adopting an amendment to section 543(a)(6) that would permit taxpayers to be excused from its application where they can prove an absence of tax avoidance purpose. In the interest of sparing innocent taxpayers from an unwarranted tax penalty, while still accomplishing the intended purpose of the section, Congress should consider adopting such an amendment.

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204. See supra note 63 and accompanying text.