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# BARGAIN SALES AS TAXABLE TO THE CONTROLLING BUT NON-BENEFITING SHAREHOLDER

The ingenuity of the American taxpayer has manifested itself in attempts to receive benefits from a corporation without having to declare them on his individual income tax return. However, the Department of the Treasury and the Internal Revenue Service have enforced statutes passed by Congress and administered regulations and rulings of their own in order to make the corporate distribution of benefits taxable to individuals. Perhaps the most frequently encountered corporate distribution is the dividend, which is generally defined in section 316 of the Internal Revenue Code of 1954 as any distribution of property, to the extent of earnings and profits, made by a corporation to its shareholders.[1] Although dividends are often cash payments, formally declared by the board of directors and distributed according to ownership of common or preferred stock,[2] the Code definition is broad enough to include a wide range of non-cash corporate distributions as well.[3] These non-cash distributions include securities,[4] real estate,[5] exchanges of outstanding shares for new issues of stocks and bonds combined,[6] cancellation of indebtedness,[7] distributions of certain property by foreign corporations to corporate shareholders,[8] and transfers of property for less than fair market value.[9] Both cash and non-cash distributions are included in gross income as dividends.[10]

Perhaps nowhere have court decisions been in greater conflict than in

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[1]INT. REV. CODE OF 1954, § 316.

[2]For a general discussion of the two methods of determining earnings for dividend purposes, *see* W. CARY, CORPORATIONS 1486 (4th ed. unabr. 1969).

[3]INT. REV. CODE OF 1954, § 61(a) provides:

> Except as otherwise provided in this subtitle, gross income from whatever source derived, including (but not limited to) the following items:
>
> . . . .
>
> (7) Dividends. . . .

[4]*Id.* § 317(a) provides:

> For purposes of this part, the term "property" means money, securities, and any other property; except that such term does not include stock in the corporation making the distribution (or rights to acquire such stock).

[5]*Id.*

[6]Treas. Reg. § 1.301.1(l) (1955).

[7]*Id.* at (m).

[8]*Id.* at (n).

[9]*Id.* at (j).

[10]INT. REV. CODE OF 1954, §§ 61(a), 301(c). Section 301(c) provides:

> In the case of a distribution to which subsection (a) applies—
>
> (1) That portion of the distribution which is a dividend (as defined in section 316) shall be included in gross income.

the area of "bargain sales," the transfers of corporate property by the corporation to its shareholders for less than fair market value. The difference between the fair market value of the property and the purchase price is considered dividend income to the purchaser.[11] Bargain sale dividends are often called "constructive dividends": constructive in the sense that the shareholder does not receive cash or shares formally declared and distributed according to his holdings in the corporation, but instead realizes a benefit from acquiring property worth more than he paid for it.

Taxability on the receipt of a constructive dividend resulting from a bargain sale has been a fairly modern development in income tax law. Although the precise origins of the terms "bargain sale" and "constructive dividend" are not readily ascertainable, it is apparent that the courts repudiated early attempts by the Commissioner of Internal Revenue to tax this type of transaction.[12] However, only a few years of insulation passed before the Supreme Court noted that it would not exalt form over substance in determining whether a transaction was at arm's length or merely designed to implement a distribution of corporate earnings.[13] Soon afterwards, the Commissioner won his first case in this area. *Timberlake v. Commissioner*[14] involved the purchase by one corporation of stock from another corporation. Subsequently, the stock was resold by the purchasing corporation to its majority shareholder at less than fair market value. Since the purchasing corporation had a large surplus from which dividends could have been declared,[15] the Fourth Circuit Court of Appeals held that the transaction constituted a bargain sale and thus a constructive dividend taxable to the shareholder.

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[11]Treas. Reg. § 1.301-i(j) (1955) governs these transactions and reads in part:

> If property is transferred by a corporation to a shareholder which is not a corporation for an amount less its fair market value in a sale or exchange, such shareholder shall be treated as having received a distribution to which section 301 applies. In such case, the amount of the distribution shall be the difference between the amount paid for the property and its fair market value.

[12]*See* Commissioner v. Van Vorst, 59 F.2d 677 (9th Cir. 1932); Taplin v. Commissioner, 41 F.2d 454 (6th Cir. 1930), *rev'g* 12 B.T.A. 1264 (1928). Taplin and Van Vorst, both majority shareholders, bought stock and real estate, respectively, from their corporations at substantially less than half the fair market value. The courts of appeals, in both cases, held that the mere interest of the shareholder in the corporation does not convert a bargain purchase into taxable income.

[13]Palmer v. Commissioner, 302 U.S. 63 (1937). But the Court held that the exercise of stock option rights at a substantial discount from fair market value was not a constructive dividend, since the options had been issued when their exercise price approximated their fair market value. *Id.* at 73.

[14]132 F.2d 259 (4th Cir. 1942).

[15]The court emphasized the importance of an earned surplus from which dividends could have been paid by distinguishing the instant case from Taplin v. Commissioner, 41 F.2d 454 (6th Cir. 1930). 132 F.2d 261-62.

Bargain sale and constructive dividend principles have been expanded since the *Timberlake* decision to include transactions which might seem outside the traditional scope of their application.[16] One expansion of these principles has been into situations where the shareholder himself does not directly receive the benefit of the sale or distribution, but instead diverts the benefit to a member of his family or to another legal entity[17] controlled by him. Thus, the word "constructive" in the term constructive dividend seems to have taken on another meaning: constructive not only in the sense that it is not a cash or stock dividend, but also in the sense the shareholder benefits only indirectly. The rationale for applying bargain sale and constructive dividend principles to transactions where the shareholder does not benefit directly seems to flow from the broader theory of taxability of an assignor. Under this theory, income is realized because the assignor controls the disposition of that which he could have received for himself.[18] Upon application of this theory to a case involving a bargain sale transaction, the shareholder would be taxed as having received a constructive dividend if, by his control over the corporate decision as to where the dividend goes, he is able to divert that to which he is entitled to someone else.[19] Thus, control over the business affairs of the corporation is the threshold determination in bargain sale transactions where the benefit inures, in the absence of an assignment, to some-

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[16]For example, in George Staab, 20 T.C. 834 (1953), bargain sale principles were applied to the reverse of the orthodox bargain sale transaction. Two partners sold property, their partnership assets, at an inflated price to a corporation in which they were the sole shareholders. The Tax Court held that a bargain sale had occurred and that the partners had realized a constructive dividend from the corporation in the amount received in excess of the fair market value of the assets.

In Stanley V. Waldheim, 25 T.C. 829 (1956), *aff'd*, 244 F.2d 1 (7th Cir. 1957), the acquisition by a shareholder of additional shares in the corporation at less than fair market value constituted a constructive dividend. The Tax Court rejected the restriction previously imposed upon the application of bargain sale and constructive dividend principles, *i.e.*, that there must be retained earnings or surplus from which dividends could have been formally declared. *See* Timberlake v. Commissioner, 132 F.2d 259 (4th Cir. 1942). Even though the corporation had been operating at a deficit, the court found that there were sufficient earnings and profits in the year of sale to cover the difference between the fair market value of the shares purchased and the purchase price.

[17]*See, e.g.*, Worcester v. Commissioner, 370 F.2d 713 (1st Cir. 1966) (to a corporation); Strake Trust, 1 T.C. 1131 (1943) (to a trust).

[18]*See* Helvering v. Horst, 311 U.S. 112 (1940), in which the Supreme Court stated:

> [I]ncome is "realized" by the assignor because he, who owns or controls the source of income, also controls the disposition of that which he could have received himself and diverts the payment from himself to others as the means of procuring the satisfaction of his wants.

*Id.* at 116-17.

[19]Commissioner v. Gordon, 391 U.S. 83 (1968); Sammons v. United States, 433 F.2d 728 (5th Cir. 1970), *cert. denied*, 402 U.S. 945 (1971); Byers v. Commissioner, 199 F.2d 273 (8th Cir. 1952), *cert. denied*, 345 U.S. 907 (1953).

one other than the shareholder. Since control is a word of relative meanings, it would seem to be of crucial importance to specify as nearly as possible the degree of the shareholder's control sufficient to justify the imposition of tax liability upon him.

The recent decision of the Fifth Circuit Court of Appeals in *Green v. United States*[20] broached the issue of degree of control for the first time. In that case, taxpayer Green was the owner of 7.9% of the outstanding shares of Central Oil Company (Central). Central was a closely held corporation with a three-member board of directors and twenty-two shareholders, many of whom were related by blood, although the kinship was often distant. Green was both a director and the president of Central when the company sold portions of its mineral interests. The sales were made first to shareholders and then to nonshareholders for a total combined consideration of $210,000. However, the jury determined the fair market value of the interests to be $585,000, thereby rendering the transaction a bargain sale dividend to shareholders accepting the offer. Green was offered an opportunity to buy a portion of the mineral interests equal to the percentage of shares which he held in Central. He declined the offer but suggested that it be made to his adult son and to two trusts established for the benefit of his minor children, none of which were shareholders. They accepted the offers and the Commissioner determined that the transaction was a bargain sale dividend since the fair market value of the corporate property sold was greater than the consideration received.[21] Green was assessed even though he had purchased nothing and had made no formal assignment of his option.

The Fifth Circuit held that Green was taxable on the bargain sales made to his adult son and the two trusts. The court cited the well established principles that: (1) a dividend does not escape taxation to the shareholder merely because the shareholder diverts it to others;[22] and (2) a distribution is taxable to a would-be dividend assignor who has such a controlling interest in the corporation that he is able to direct corporate wealth to another without routing it through his own hands.[23] The court

[20]460 F.2d 412 (5th Cir. 1972).

[21]The method of valuation was also in dispute. The court remanded the case and ordered that the trier of fact first determine, pursuant toTreas. Reg. § 1.611-2 (1960), if methods of valuation other than the analytical method might be used, and second, to determine the value in accordance with the method chosen. 460 F.2d at 415-19.

[22]Sammons v. United States, 433 F.2d 728 (5th Cir. 1970), *cert. denied*, 402 U.S. 945 (1971); Alex Silverman, 28 T.C. 1061 (1957), *aff'd*, 253 F.2d 849 (8th Cir. 1958); Frances B. Hodgkins, 34 P-H Tax Ct. Mem. Dec. 225 (1965).

[23]Commissioner v. Gordon, 391 U.S. 83 (1968); Byers v. Commissioner, 199 F.2d 273 (8th Cir. 1952), *cert. denied*, 345 U.S. 907 (1953). Of course, if Green had accepted the offer to purchase, his subsequent assignment of it to the trusts and his adult son would not have relieved him from tax liability because of the theory of Helvering v. Horst, 311 U.S. 112 (1940), quoted in note 18 *supra*. Green, however, was only a "would-be dividend assignor,"

reasoned that controlling interest must mean something less than "absolute legal control":[24] "To conclude otherwise would invite an epidemic of intracorporate logrolling."[25] The Fifth Circuit then formulated the test for determining controlling interest in the corporation for the purpose of tax liability on a bargain sale where the shareholder receives no direct benefit. The crucial determination was held to be "whether the taxpayer has exercised *substantial influence* over the corporate action whose tax consequences are at issue."[26] The court held that this determination was for the trier of fact and that consideration should be given to all the circumstances surrounding the transaction, including but not limited to: (1) the extent of the taxpayer's shareholdings in the corporation; (2) the taxpayer's relation to the corporation; (3) the identity of the recipient of the corporate benefit, the recipient's relation to the corporation and any other circumstances which would reveal a link from the corporation through the taxpayer to be recipient; (4) evidence of the origins of the transaction; and (5) the general favorability of consequences of the transaction for the taxpayer personally or for his immediate family.[27]

The Fifth Circuit was not without precedent for formulating a test which emphasizes the consideration of surrounding circumstances in determining taxability.[28] Furthermore, each of the individual circumstances enunciated by the court has been considered an important factor of taxpayer liability for receipt of a constructive dividend in previous cases. Thus, it is necessary to examine some of these previous cases, singling out the circumstances upon which the decisions relied and analyzing the facts of *Green* to determine the extent to which these circumstances were present.

The extent of the taxpayer's shareholdings in the corporation frequently has been considered an important index of control over corporate action. In *Walter Lacy*,[29] the sole shareholder[30] of a bank purchased

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*i.e.*, he would have been a dividend assignor if the dividend had come directly to him in the first place.

[24]The court did not define "absolute legal control." 460 F.2d at 420. However, it seems reasonable to infer that the court was referring to ownership of a majority of the outstanding voting shares.

[25]460 F.2d at 420.

[26]*Id.* (emphasis added).

[27]*Id.* at 420-21.

[28]*See, e.g.*, Palmer v. Commissioner, 302 U.S. 63 (1937); Timberlake v. Commissioner, 132 F.2d 259 (4th Cir. 1942). In *Palmer*, the Court stated that in determining whether a transaction is an arm's length sale or a constructive dividend:

> [T]he corporate action which results in one or the other must be scrutinized in the light of circumstances at the time when the action is taken, and of the conditions under which in practice it must be taken.

302 U.S. at 72.

[29]39 T.C. 1100 (1963).

[30]Lacy apparently held all the shares of the bank. *Id.* at 1102.

property worth $133,000 from the bank for $33,000 after having replaced the bank's board of directors with his own men. The Tax Court held that he had received a constructive dividend resulting from a bargain sale and was taxable on the $100,000 difference. *Donald J. Flamm*[31] involved a taxpayer who was the sole shareholder of a realty company. The taxpayer purchased land and sold it for cost to the company. Later, after the property had appreciated in value, he purchased it from the company for less than one-seventh of its fair market value and resold it to a governmental park commission at its market value. His constructive dividend was held to be the difference between the fair market value of the property and the price for which he purchased it from his realty company. Both *Lacy* and *Flamm* involved taxpayers who, by their 100% shareholdings, held absolute voting control of their corporations and thereby had power to effect and direct a distribution. However, these two cases would appear inapposite as authority for the imposition of tax liability in *Green*, since they involved the receipt of the distribution by the taxpayers themselves. Thus, it may be said that the extent of shareholdings, although an index of control, was not determinative of taxability in *Lacy* and *Flamm* since the shareholders were taxed because of their receipt of a corporate benefit and not, as in *Green*, because of their control over the direction in which the benefit was channeled.

A case more closely analogous to *Green*, because of its focus on control by a non-benefiting shareholder, is *Frances B. Hodgkins*,[32] in which the taxpayer owned 44% of the outstanding shares of the corporation. The corporation paid compensation to her adult, married daughter and twenty year-old son which apparently exceeded the fair market value of the services rendered. The Tax Court held the taxpayer exempt from taxation on the constructive dividend, despite the large percentage of her shareholdings. By contrast, taxpayer Green held only 7.9% of the outstanding shares of Central and yet was held liable for tax on the receipt of a constructive dividend.

Although the decisions in *Hodgkins* and *Green* were concerned with other considerations in addition to the extent of shareholdings, the general difference between the percentage of shareholdings in the two cases and the opposite conclusions therein, give rise to an inference that the courts, in fact, gave little weight to the extent of shareholdings in determining the tax liability of the minority shareholders. Thus, although the extent of Green's shareholdings in Central was determinative of the pro rata portion of the offer he received,[33] it may not have been important in ascertaining the degree of control which he exercised over the business

[31] 38 P-H Tax Ct. Mem. Dec. 287 (1969).

[32] 34 P-H Tax Ct. Mem. Dec. 225 (1965).

[33] 460 F.2d at 415.

affairs of the corporation. It would seem, therefore, that the Fifth Circuit's designation of the extent of the taxpayer's shareholdings as a circumstance to consider in all cases may lead to non-uniform application of the "substantial influence" test. Other courts attempting to apply that test might infer, by comparing the facts of *Green* with those of other cases, either that the extent of minority shareholders' holdings is unimportant or, by relying on the facts of *Green* alone, that any percentage of shareholdings, however small, would indicate some quantified measure of control.

The court in *Green* simply did not make it clear if, or how, the extent of the taxpayer's shareholdings figured into its decision. The percentage of holdings of other shareholders was not given, and thus there is no opportunity to compare Green's relative voting strength in the corporation. Certainly, he did not have voting control of the corporation. Moreover, it would seem that if Green had holdings in excess of other shareholders, the court would have mentioned this as an indication of his ability to influence the corporate decision-making process. Although the only mention of the *extent* of Green's holdings was that it established the portion of the offer which he received, it would seem unlikely that the Fifth Circuit was asserting that the extent of shareholdings is an important circumstance to consider only when it is determinative of the amount of property sold. It is more probable that the court, by its lack of discussion of this circumstance, meant to imply that the extent of shareholdings is not important in assessing tax liability in every case. In any event, it would appear that the court promulgated a test involving the consideration of a circumstance, *i.e.*, the extent of the taxpayer's shareholdings, which it failed to relate adequately to the facts of the case. Clearly, the extent of the taxpayer's shareholdings is an important circumstance to consider even where the taxpayer does not have voting control of the corporation; a minority shareholder can exercise substantial influence over corporate affairs when he holds a large percentage of shares in relation to his fellow shareholders. However, the Fifth Circuit might have avoided the confusion almost certain to arise when courts attempt to interpret the extent of shareholdings, by relating this circumstance to the facts of *Green*, and by reconciling *Green* with, or distinguishing it from, other cases such as *Hodgkins*.

If a shareholder holds 51% or more of the voting shares, a prima facie case of substantial influence can be made. As the Fifth Circuit stated in *Green*:

> Only in the most extraordinary circumstances . . . would it be possible to conclude that a controlling shareholder of a corporation had not exercised substantial influence in causing a diversion

of corporate assets in his own favor or in favor of a member of his family.[34]

However, even this presumption of substantial influence exercised by the controlling shareholder conceivably has limitations. For example, a controlling shareholder may be interested only in receiving dividends from his shares and not in controlling the business affairs of the corporation. Under these unusual but not necessarily "extraordinary" circumstances, the directors of the corporation, unbeknown to the shareholder, might sell corporate property to a relative of the shareholder at a bargain price. Nothing in the above quoted language of the court would appear to absolve the shareholder from tax liability.

It may be argued that a controlling shareholder, under such circumstances, should bear the consequences of having waived the voting rights by which he could exercise control over the board of directors. Nevertheless, it should be realized that tax liability may work a real hardship on a controlling shareholder when he is held accountable for a sale by the directors to a member of his family, especially if he is unable or unqualified to oversee the business, and relies on the prompt receipt of dividend checks as his only guide to sound business management. It would seem, then, that the Fifth Circuit's designation of the extent of shareholdings as a circumstance to consider has yet another limitation: the presumption of substantial influence which attaches to the holder of a majority of voting shares is phrased in such broad terms as to provide potential for the inequitable application of bargain sale and constructive dividend principles.

The second circumstance for consideration noted by the court in *Green* was the taxpayer's relation to the corporation. In *Alex Silverman*,[35] the taxpayer's position as officer, director and shareholder was an important factor in the court's determination that payments of $3,204.41 by the corporation for his wife's expenses while accompanying him on a business trip were not a gift. Instead, the court held that the payments were taxable to Silverman either as compensation to an employee or as a constructive dividend to a shareholder. Green was also an officer, director and shareholder of the corporation, but the *Silverman* case shows a closer relationship between the taxpayer and the corporation in several ways. First, Silverman's brother was president, director and majority shareholder of the corporation and apparently was solely responsible for authorizing payment of the expenses. No authorization for the transaction was given by the full board of directors as in the *Green* case. Second, although Silverman, like Green, was a minority shareholder, he, together with his brother and his brother's immediate family,

[34] *Id.* at 421.

[35] 28 T.C. 1061 (1957), *aff'd*, 253 F.2d 849 (8th Cir. 1958).

controlled all the shares of the corporation. There were not twenty-two distantly related or unrelated shareholders as in *Green*. By his close blood relationship to the majority shareholder and president, who apparently exercised complete control over the business affairs of the corporation, Silverman was, in effect, more closely related to the corporation than was Green. Whereas Green could count only on his own persuasiveness and vote among those to whom he was not closely related, Silverman might rely on the additional advantage of a brother's generosity in effecting a corporate distribution. Although the formal structure of the taxpayer/corporation relationship is present in *Green*, the substantive elements that were present in *Silverman* seem to be lacking. It is, therefore, difficult to surmise what features of the relationship the Fifth Circuit found relevant to the evaluation of Green's substantial influence.

The relationships between the distributing corporation, the shareholder, and the recipient of the distribution have been the basis of decision in several cases. In *V.U. Young*,[36] the taxpayer and a partner had approximately equal shareholdings totaling 97.7% of the outstanding shares of Young-Wolf Corporation. Young-Wolf Corporation held practically all the shares of Gary Theatre Company, which sold stock that it owned at less than fair market value. The purchasers of the shares were nine recently established trusts, four for the benefit of the taxpayer's family and five for the benefit of his partner's family. The taxpayer was held taxable on his pro rata portion of a constructive dividend received from the bargain purchase on the theory that, although the sale was between Gary Theatre Company and the trusts, it was effected by the intent of Young and Wolf to distribute the profits of that company to persons of their choice. The transfer was treated as a two step transaction made possible by the effective voting control of Young and Wolf in both corporations. Thus, Young-Wolf Corporation, as a shareholder of Gary Theatre Company, was held taxable on the entire amount of the constructive dividend; and Young, as a shareholder of Young-Wolf Corporation was assessed on that portion which was attributable to the sales to the four trusts. Furthermore, Young was also held taxable on the income from the shares to the trusts because of the great power which he retained over distribution of the trust assets as trustee.[37]

Although both *Young* and *Green* concern bargain sales made by corporations to trusts without directing the property through the hands of the shareholder, *Young* involved a slightly stronger corporation-shareholder-recipient relationship than *Green*. Whereas both Young and Green were undoubtedly key factors in bringing together the parties to the bargain sale, Young had a greater proportion of voting control over

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[36] 5 T.C. 1251 (1945).

[37] *See* Helvering v. Clifford, 309 U.S. 331 (1940).

his corporation than Green, thus indicating greater power to effect a bargain sale. As evidenced by the fact that the trusts were set up by Wolf at approximately the same time as the transactions, there was from the beginning an apparent complicity between the partners to effect the distribution that was neither apparent nor proven in *Green*. Furthermore, there was no evidence in *Young* that the sales were made to any persons other than the trusts in which the taxpayer or his partner had an interest, whereas in *Green*, other children of the shareholders bought interests.[38] More important than any of these minor distinctions, however, is the fact that Young retained powers as trustee of the purchasing trusts. This indicates a much closer relationship between the shareholder and the recipient than in *Green*, where no mention was made of any trusteeship by the shareholder. Thus, although the formal structure of the tripartite relationship is similar in *Young* and *Green*, the substantive elements that make the relationship relevant and consequential received virtually no comment in *Green*. The Fifth Circuit seems to have identified form without elaborating upon substance and it is difficult to evaluate the extent to which the tripartite relationship figured into the decision.

The fourth circumstance for consideration urged by the Fifth Circuit in *Green* was evidence of the origins of the transaction whose tax consequences are at issue. The origins of the transaction seem to have been suspect, and thus significant, in assessing tax liability in *Byers v. Commissioner*,[39] where the controlling shareholder in a closely held corporation was responsible for the establishment of a partnership by his two children, aged sixteen and eighteen. It was alleged, but never proved, that each of the children contributed five hundred dollars to the partnership. Subsequently, the corporation purchased gasoline from the partnership at a price of two cents per gallon more than it had been paying to its former gasoline suppliers. The court found that the transactions originated from the formation of the partnership as a device whereby the shareholder was able to drain off earnings of the corporation for the benefit of his children. The court held that the excess two cents per gallon multiplied by the number of gallons purchased was a constructive dividend and includible in the gross income of the shareholder.[40]

It may be said that the origins of the transaction in *Green* are suspect since the two trusts were created by Green shortly before their purchase of the mineral interests[41] and each contained only one hundred dollars at

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[38]460 F.2d at 420 n.8.

[39]199 F.2d 273 (8th Cir. 1952), *cert. denied*, 345 U.S. 907 (1953).

[40]The type of transaction involved in *Byers*, *i.e.*, the sale of property to a corporation at an inflated price, is another example of the reversed application of bargain sale principles discussed in note 16 *supra*.

[41]Record at 36.

the time of the purchase.[42] Thus, it may be alleged that the *Green* trusts, like the *Byers* partnership, were mere agents of the shareholder for acquiring the corporate distribution for the benefit of his children. However, the *Green* trusts, unlike the *Byers* partnership, were proved to have been funded originally with an amount of money, albeit small. This fact provides evidence, although not compelling, that the trusts were set up for a purpose unrelated to any attempt to originate a bargain sale. Furthermore, Byers himself apparently retained considerable control over the partnership business. He apparently signed the first checks payable to the distributor which supplied the partnership filling station. In addition, he arranged to have a third party actually operate the filling station and, at least in the early stages of the partnership business, to have his own corporation's bookkeeper maintain the partnership records. By contrast, it was not alleged that Green retained any ties with the trusts after their creation or that he exercised any control over the actions of the trustees. Even if subterfuge of this sort had been alleged and proved, it would not justify holding Green liable for taxes on that portion of the bargain sale made to his independent adult son. Therefore, it would appear that taxpayer Byers took many more steps in originating the bargain sale transaction than did taxpayer Green, who only voted for the sale in his capacity as one of three directors and later made a suggestion that the pro rata offer to him be made to others.

The general favorability of the consequences of the transaction for the taxpayer and his immediate family was the last circumstance urged by the Fifth Circuit for consideration in determining whether the taxpayer exercised substantial influence over the bargain sale transaction. Favorable consequences are necessarily a result of every bargain sale and constructive dividend. The only question can be whether the favorability accrued to the taxpayer or his immediate family. Unless this question is answered in the affirmative, there is no need to consider the other circumstances which are based on the assumption that favorability to the taxpayer or his immediate family has been found. Accordingly, it would seem more appropriate to remove this circumstance from the list where it stands pari passu with other circumstances and set it apart as a threshold requirement. It seems clear that the requirement was met in *Green*, since the consequences of the corporate action were favorable to the members of the taxpayer's immediate family.[43] This requirement having been met, consideration would then be given to the other circumstances

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[42]*Id.*

[43]In fact, the taxpayer's wife, Eleanor T. Green, was also a bargain purchaser since she held 2.8% of the outstanding shares in Central and purchased the same percentage of the mineral interests. There was no question of her tax liability, except for the amount thereof as determined by the proper method of valuation. 460 F.2d at 415.

in order to determine whether Green, as opposed to the family member who actually enjoyed the favorable consequences, should be taxed.

The foregoing examination of the circumstances to be considered in determining substantial influence, and of cases in which those circumstances have been considered of prime importance, is not intended to imply that the test for controlling interest as given by the Fifth Circuit is of little value. Rather, the analysis is intended to suggest that no decision to date appears to have extended taxability on bargain sales as far as *Green*. Green was a shareholder, officer and director of the corporation, and the transaction did result in favorable consequences to members of his family. However, unlike the taxpayers in the representative cases, Green held a small percentage of the shares outstanding in a fairly large, closely held corporation, was only one of three directors whose votes effected the bargain sale, received only an offer, and exercised no proven control over the recipients of the corporate benefit.

The *Green* decision also seems to imply that a shareholder may not escape tax liability by refusing an offer and subsequently suggesting that the same offer be made to someone else, however independent in status. This implication arises from the imposition of tax liability on Green for that part of the offer accepted by his adult son in control of his own business affairs. Except for the fortuitous blood relationship, the evidence showed no greater connection between father and son than the shareholder might have had with a friend or neighbor. Green raised this issue by suggesting that if the shareholder requested that the offer be made to someone with whom he had no legal connection, there would be no attempt by the Commissioner to tax the shareholder.[44] However, it would appear illogical to apply a different standard to a shareholder who suggests that the offer be made, for example, to a neighbor or friend, since the shareholder would be equally instrumental in directing the offer whether a relative or an unrelated person receives it. The Fifth Circuit probably did not intend to imply that Green had no right to refuse the offer. However, the decision might have been clearer as to whether Green, having refused the offer, could have suggested that it be made to anyone without incurring tax liability himself.

Thus, in determining controlling interest, the "substantial influence" test, with its circumstances to be considered, appears to be inconclusive when applied to borderline fact situations such as that in *Green*. Another serious obstacle to the feasibility of the "substantial influence" test seems to be its apparent failure to reflect adequately the theoretical basis for imposing any tax at all on the non-recipient of a corporate benefit, *i.e.*, the shareholder is taxed because of his control over the disposition of a

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[44]Reply Brief for Cross Appellants at 6, Green v. United States, 460 F.2d 412 (5th Cir. 1972).

benefit which he could have received.[45] In *Frances B. Hodgkins*,[46] by contrast, the Tax Court seemed to have had that basic theory in mind in deciding in favor of the taxpayer. In that case, the son and daughter of the taxpayer mother had included the compensation paid by the corporation for their services in their own gross incomes. The Commissioner was seeking to attribute the compensation to the income of the mother, who held 44% of the shares of the corporation, because the compensation appeared to be far in excess of the value of the services.

The Tax Court found that it was just as likely that the controlling shareholder-father, who had been divorced from the mother for sixteen years and who alone managed the corporation, had effected the distribution.[47] The court further reasoned that to adopt the Commissioner's approach by assessing the mother would be to turn every corporate distribution into a pro rata dividend distribution.[48] The decision in favor of the taxpayer seems sensitive to the distinction between: (1) the power, through influence over the board of directors, to create the right to a benefit; (2) the right to a benefit once it has been created; and (3) the power to divert the benefit elsewhere. It was not proven that Mrs. Hodgkins had sufficient power to create a right to the benefit. Moreover, the court apparently felt that she had no right to the benefit once created, since the benefit arose from a contractual agreement between the recipients and the corporation. Not having the power to create the benefit, or the right to it once it was created, Mrs. Hodgkins could hardly have exercised power over the disposition of the benefit. Thus, the basic requirements of the theory of imposing tax liability on a non-recipient of a corporate distribution were not met, and the taxpayer was not liable.

The *Green* decision, on the other hand, dealt only in an oblique manner with the shareholder's power to effect a distribution, right to receive the distribution, and power to divert it. In speaking of control over corporate action, the court asserted: "It must mean something less than a shareholder having the legal 'right' to purchase corporate property at a reduced price or to compel the payment of income to himself or to another."[49] By these words, the Fifth Circuit Court of Appeals appears to have conceded that Green did not have a right, arising by operation of law because of his shareholdings, to purchase the property from the corporation, nor the right[50] to compel any sale. The implication seems to

[45]*See* Helvering v. Horst, 311 U.S. 112, 116 (1940), quoted in part at note 18 *supra*.

[46]34 P-H Tax Ct. Mem. Dec. 225 (1965).

[47]*Id.* at 228.

[48]*Id.*

[49]460 F.2d at 420.

[50]Here the court probably meant "power," since even a majority shareholder seldom has a right to compel the corporation to pay dividends, a matter usually left to the discretion of the board of directors. *See* W. CARY, CORPORATIONS 1486 (4th ed. unabr. 1969).

be that even without the right to receive a benefit, or the power to create that right, the non-benefiting shareholder may somehow be seen as having exercised sufficient control over the corporate action resulting in a bargain sale to be held taxable. This implication runs counter to the basic theory of imposing tax liability on non-recipients, as applied in *Hodgkins*, which requires either the right to a benefit or the power to create that right, *plus* the power to divert the benefit, before imposing tax liability. The Fifth Circuit seems to have ignored the coordinate nature of these requirements and based its decision on the power to divert the benefit alone, a nonexistent power unless derived from one of the other requirements.

The court cited *Sammons v. United States*,[51] *Byers v. Commissioner*,[52] and *Commissioner v. Gordon*[53] in support of its position that a dividend may be taxed to a shareholder even though it does not pass through his hands, if he has effective power to divert the flow of corporate wealth. However, the facts of these three cases are difficult to reconcile with the facts of *Green* and thus do not provide a clear precedent. In *Sammons* and *Byers*, as in *Green*, there was no right of the shareholders to any distribution. However, both Sammons and Byers, by their voting control of their corporations and consequential ability to elect a board of directors to do their bidding, had power not only to divert the flow of corporate wealth but also to initiate that flow. Thus, the holding of those two cases may have been based implicitly on the assumption of a controlling interest by the shareholder, a circumstance not found in *Green*.

In *Gordon*, since the taxpayer was a minority shareholder like Green, he did not have the power to cause the stock purchase rights to be issued. However, upon their issuance, he did have the right to insist upon receipt of his pro rata portion of rights since he owned stock upon which the

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[51]433 F.2d 728 (5th Cir. 1970), *cert. denied*, 402 U.S. 945 (1971). *Sammons* involved the transfer of assets from a group of five corporations to another corporation at $500,000 less than fair market value at a time when the taxpayer held the controlling shares of all corporations. The $500,000 was held to be a constructive dividend to the taxpayer.

[52]199 F.2d 273 (8th Cir. 1952), *cert. denied*, 345 U.S. 907 (1953). Text accompanying note 39 *supra*.

[53]391 U.S. 83 (1968). Gordon was a shareholder and recipient of rights to purchase shares at ten dollars per share less than fair market value. He was held taxable on the amount of ten dollars multiplied by the number of shares purchased. The only reference in the *Gordon* opinion to the idea that a shareholder may be taxed even though the dividend does not pass through his own hands came when the Supreme Court stated:

> [I]t is clear that when a corporation sells corporate property to stockholders *or their assignees* at less than its fair market value, thus diminishing the net worth of the corporation, it is engaging in a "distribution of property" as that term is used in § 316.

*Id.* at 89 (emphasis added).

distribution of rights was based. In other words, Gordon's receipt of stock purchase rights, valuable on the open market even if unexercised, was not optional either with him or with the issuing company, but was a distribution to which he was automatically entitled by virtue of his shareholdings.[54] Green, on the other hand, received only an offer, and his only "right" to the property arose by the grace of the entire board of directors which had the option of making the offer to anyone. It should be recalled that the offer was, in fact, made to shareholders and nonshareholders alike.

The Fifth Circuit failed to analyze the facts in *Green* in light of the theoretical basis of imposing tax liability on the non-recipient of a corporate benefit and to reflect this analysis in its substantial influence test. By blurring the distinctions between the power to create the right to a benefit, the right to receive the benefit once created, and the power to divert the benefit, the court deprived its test of the clearly defined background against which it should be applied. These distinctions were not clarified, as they might have been, by a detailed comparison of the facts of *Green* with those of the cases on which the court relied for authority. Thus, other courts, in order to apply the substantial influence test consistently, will be required to supply the missing background unreflected in the test.

Finally, the Fifth Circuit's substantial influence test seems to have been cast in somewhat ambiguous terms insofar as it does not make it clear over what substantial influence must be exercised. To be sure, the substantial influence is said to be exercised "over the corporate action whose tax consequences are at issue."[55] However, the opinion does not elaborate further on the meaning of "corporate action." It would seem that the term could refer to two possible actions by the board of directors: (1) the decision to make the bargain sale; and (2) the decision to divert the offer at the taxpayer's behest after his refusal. It would appear that the taxpayer in *Green* was in a position to, and did, exercise substantial influence over both of these decisions. However, because the facts in *Green* are subject to this analysis, it is unclear whether the Fifth Circuit was considering the term "corporate action" as necessarily embracing both decisions. The distinction is more than semantic, and it is necessary to elicit the precise decision with which the court was concerned in order to insure consistent application of the test.

It would seem that it was the decision to divert the offer following Green's refusal that constituted the corporate action over which the court found substantial influence, and that substantial influence over the corporate decision to make a bargain sale is immaterial. Substantial influence over the mere threshold decision to declare a dividend, constructive or

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[54]*See* Choate v. Commissioner, 129 F.2d 684 (2d Cir. 1942), for another case concerning the tax liability of a minority shareholder who received stock purchase rights.

[55]460 F.2d at 420.

otherwise, does not appear to supply any basis for imposing tax liability, since the taxpayer cannot divert that to which he is not entitled. Other shareholders are entitled to their portion of the dividend by virtue of their own status, irrespective of the taxpayer's substantial influence over a decision to declare the dividend. Thus, there is no diversion of the benefit. The same cannot be said of the alternative decision.

The corporate decision to divert the offer at Green's behest after his refusal appears to be the decision at which the court was looking for substantial influence. This is implicit in the court's analysis although not formulated in terms that sufficiently expose the rationale. Once Green refused the offer, he was still able to determine, or substantially influence, to whom it would be made. Thus, the refusal of the offer was a mere formality, leaving Green with no diminished capacity to control its disposition. This analysis is consistent with the court's characterization of Green as a would-be dividend assignor since the dividend came from the corporation in form only; in substance it came from the recipient Green.

The value of the test laid down by the Fifth Circuit in *Green* ultimately will lie in its utility to the courts which will attempt to apply it to diverse fact situations. Only future decisions will disclose whether the substantial influence test provides a basis for uniformity in the application of income tax law concerning bargain sales and constructive dividends. However, even uniformity should not be substituted for soundness of theory. In large measure, the income tax structure is built upon the foundation of the taxpayer's receipt of a benefit, or at least the right to receive a benefit.[56] Unless this fundamental theory is somehow reflected and standardized in the Fifth Circuit's guidelines, considerable injustice may be done in some cases where, because of differing views of that theory, bargain sale and constructive dividend proceeds are taxes to the wrong person.

Changes which may be suggested to make the substantial influence test more workable are:

(1) Consideration of the general favorability of the consequences of the corporate distribution transaction to the taxpayer personally or to his immediate family as a threshold question, independent of other circumstances. Unless this general favorability is found, there is no need to consider the other circumstances in regard to the taxpayer.

(2) A more detailed definition of the term "corporate transaction" in order to give the trier of fact a clearer idea of its scope.

(3) Greater specificity in analyzing the triangular relationship between corporation, taxpayer, and recipient of the corporate benefit, including, but not limited to, these factors:

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[56]Helvering v. Horst, 311 U.S. 112 (1940); Corliss v. Bowers, 281 U.S. 376 (1930).

(a) the taxpayer's implied contractual right to receive a corporate benefit, *e.g.*, the right to receive stock purchase rights declared on the basis of shares already owned, as in *Gordon*;[57]
(b) the taxpayer's legal or practical ability to cause a corporate distribution, *e.g.*, whether the shareholder has voting control of the corporation whereby he can elect the board of directors and thereby maintain dominant influence over their decisions, as the facts revealed in *Walter Lacy*;[58] and, whether the shareholder in fact exercises personal control over the decision making process;[59]
(c) the extent to which the taxpayer is related, personally and legally, to the recipients of the corporate benefit, *e.g.*, whether the recipients are minor children under the legal guardianship of the taxpayer as in *Byers*;[60] or instead, are adult children in control of their own affairs, as in *Frances B. Hodgkins*.[61]

The above examples are not intended to be exhaustive, but are designed to focus attention on whether the taxpayer actually received a direct or indirect benefit, or the right thereto. Care must be taken not to rely upon absolutes, such as controlling shareholdings, as the sole basis for assessing tax liability for the receipt of constructive dividends from bargain sales. The substantial influence test given by the Fifth Circuit in *Green* may be helpful to a trier of fact in determining what is a controlling interest. Time may well prove, however, that blind reliance on the incomplete and somewhat misleading list of circumstances enumerated by the Fifth Circuit, without consideration of the facts relating to benefit, is worse than having no list at all.

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[57]Commissioner v. Gordon, 391 U.S. 83 (1968).

[58]39 T.C. 1100 (1963). However, the finding of tax liability was not based upon these facts, but rather upon the fact that the taxpayer himself received the benefit. Text accompanying note 29 *supra*.

[59]At this point, considerations may be made of the shareholder's business personality; his influence over shareholder or board of director meetings; his apparent reasons for having acquired the shares and the extent to which he retains control over them; and any other personal factors which may tend to indicate control.

[60]Byers v. Commissioner, 199 F.2d 273 (8th Cir. 1952), *cert. denied*, 345 U.S. 907 (1953).

[61]34 P-H Tax Ct. Mem. Dec. 225 (1965).