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Ogiony v. Commissioner, 617 F.2d 14 (2d Cir. 1980)

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patentability.[119]

VI. Conclusion

Like earlier Supreme Court decisions, *Diehr* says neither yea nor nay to the underlying question of whether computer programs are patentable. Unlike previous decisions, *Diehr* leans in favor of patentability. *Diehr* establishes a new test for determining patentable subject matter under 35 U.S.C. § 101 which is much broader and more liberal than previous Court approved tests. Although the Court did not overrule *Parker v. Flook, Diehr* torpedoes *Flook's* rationale, thereby leaving *Flook* afloat but dead in the water, a derelict trap for the unwary. Under *Diehr* the key to whether a computer program related patent application defines patentable subject matter appears to reside in the skill and competency of the draftsman. If the application recites a process larger than the program itself, then the application will define patentable subject matter regardless of old or obvious aspects of the process recited.

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Taxation—Disregarding the Corporate Entity—Partners Unable to Ignore Existence of Corporation Used for Financing Purposes—*Ogiony v. Commissioner*, 617 F.2d 14 (2d Cir. 1980).

The Ogionys joined a group of investors intending to develop rental apartment projects in Cheektowaga, New York.[1] In 1966, the investors formed Garden Village Partnership (Garden Partnership) for the purpose of constructing the apartment complex, Garden Village.[2] Three years later, the building of another apartment complex, Losson Gardens, was begun through a newly organized partnership, Losson Gardens Company (Losson Partnership).[3] Financing of the projects proved difficult. Because the market interest rate for nonresidential mortgages exceeded the maximum rate that

119. *See* Gemignani, *supra* note 1, at 301-04.

1. Ogiony v. Commissioner, 38 T.C.M. (CCH) 125,126, *aff'd*, 617 F.2d 14, 80-1 U.S.T.C. ¶ 9265 (2d Cir. 1980). The group of investors comprised other individuals besides the Ogionys. Their individual claims were consolidated in trial. 38 T.C.M. at 125, n.1.

2. *Id.* at 126.

3. *Id.* at 130.

could be imposed on individual borrowers under the usury laws of New York,[4] the partners individually could not obtain adequate financing at the time construction was to begin.[5] Recognizing the dilemma faced by the partners, the lender suggested a corporation be used as a financing vehicle in order to qualify for the corporate borrower exemption to the usury laws.[6]

Accordingly, Garden Village Builders, Inc. (Garden Corporation), an inactive corporation previously created by one of the partners, was used as the financing vehicle for Garden Village.[7] Similarly, in 1969, Losson Corporation was specially formed in order to procure construction financing for Losson Gardens.[8] In order to qualify as the mortgagors of record, the partnerships in both cases conveyed to the corporations title to the property held for development.[9] Each corporation retained title of its respective property throughout most of the construction period.[10]

Reflecting the corporations' status as financing vehicles, all draws on the construction loans were transferred by the corporations to the partnerships.[11] Moreover, rentals earned on completed apartments were deposited to the partnerships' accounts. Further-

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4. 38 T.C.M. (CCH) at 126; 617 F.2d at 15, 80-1 U.S.T.C. ¶ 9265 at 83,523.

5. 617 F.2d at 15, 80-1 U.S.T.C. ¶ 9265 at 83,523. *See generally N.Y. General Obligations Law* § 5-521 (McKinney 1978).

6. 617 F.2d at 16, 80-1 U.S.T.C. ¶ 9265 at 83,523.

Garden Corporation was formed by P. Santin and A. Stangl in 1965. In 1966, Roxborough Homes Corp., in which the Ogionys were the principal shareholders and officers, acquired a one-third interest in Garden Corporation. 38 T.C.M. (CCH) at 126.

The partnership of "P. Santin, J. & E. Ogiony, A. Stangl-Joint Venture" (Garden Partnership) was also formed in 1966. *Id.* The partners conveyed their interest in the property under consideration to Garden Corporation merely for financing purposes. *Id.* at 128.

Losson Gardens Co. (Losson Partnership) was a joint venture involving P. Santin Construction Co., Inc., Roxborough Homes Corp. and J. & J. Nasca. These partners organized Losson Corporation in 1969 "solely to satisfy bank requirements for obtaining a loan." *Id.* at 130.

7. 617 F.2d at 16, 80-1 U.S.T.C. ¶ 9265 at 83,523, n.3. Garden Corporation agreed to finance the construction of Garden Village on the condition that the property to be used in the project be conveyed to the corporation solely for the purpose of obtaining a mortgage on the project. Garden Corporation agreed to reconvey the project, encumbered with a permanent mortgage, to Garden Partnership upon receipt of the final draw on the construction mortgage. 38 T.C.M. at 127. "[O]n two occasions Garden Corporation transferred title . . . back to the Partners." *Id.* at 127-28. Losson Partnership conveyed land to Losson Corporation so that the corporation could execute a mortgage on the project. *Id.* at 130. Losson Corporation retained title. *Id.* at 131.

8. 38 T.C.M. (CCH) at 130; 617 F.2d 16, n.3, 80-1 U.S.T.C. ¶ 9265 at 83,523, n.3.

9. 617 F.2d at 16, 80-1 U.S.T.C. ¶ 9265 at 83,523.

10. *Id.*

11. 38 T.C.M. (CCH) at 128, 131.

more, the partnerships covered project expenses[12] and Garden Partnership was listed as the lessor in leasing agreements entered into with tenants.[13]

The partnerships reported both income and expense items relating to the apartment projects on their partnership information returns.[14] The partners then claimed their respective distributive shares of the partnerships' reported operating losses on their individual federal tax returns.[15] The Commissioner of Internal Revenue (Commissioner) disallowed the claimed loss deductions on the ground that the losses were properly deductible only by the corporations.[16]

The taxpayers petitioned the Tax Court, contending that the corporations should have been ignored for tax purposes.[17] The arguments advanced in support of their position were that *Strong v. Commissioner*,[18] a case relied upon by the Commissioner, had been wrongly decided;[19] that the corporations were in fact agents or nominees of the partnerships; and that the partners were entitled to claim their respective shares of the net operating losses because revenues and expenses generated by the projects were received and paid by the partnerships rather than the corporations.[20] The Commissioner argued in opposition that *Strong* had been correctly decided and should be followed because of similarities between the two cases.[21] Thus, the corporations would be recognized as owners of the property conveyed to them and consequently entitled to claim the loss deductions.[22]

The Tax Court held for the Commissioner.[23] It refused to reap-

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12. *Id.*
13. 38 T.C.M. (CCH) at 128.
14. *Id.* at 131. Garden Corporation reported no income but it claimed deductions for expenses. *Id.* at 130.
15. 617 F.2d at 16, 80-1 U.S.T.C. ¶ 9265 at 83,523. With regards to Garden Partnership, the claims were made for 1967 through 1971. 38 T.C.M. (CCH) at 130. The Losson Partnership loss claim was made in 1971. *Id.* at 131.
16. 617 F.2d at 16, 80-1 U.S.T.C. ¶ 9265 at 83,523.
17. 38 T.C.M. (CCH) at 131. For purposes of trial and opinion, the claims of the individual partners were consolidated. 38 T.C.M. (CCH) at 125, n.1.
18. 66 T.C. 12 (1976), *aff'd without published opinion*, 553 F.2d 94, 77-1 U.S.T.C. ¶ 9240 (2d Cir. 1977).
19. *See generally* Kurtz & Kopp, *Taxability of Straw Corporations in Real Estate Transactions*, 22 TAX LAW. 647 (1969) and Kronovet, *Straw Corporations: When Will They be Recognized; What Can and Should be Done*, 39 J. TAX. 54 (1973).
20. 38 T.C.M. (CCH) at 132.
21. *See* text accompanying note 68 *infra*.
22. 38 T.C.M. (CCH) at 131.
23. *Id.* at 132-33.

praise the *Strong* rationale, stating simply that "*Strong* is a reviewed opinion which was approved without dissent."[24] The court adopted the position that the partners would be unable to "evade the tax consequences" of employing corporations simply by characterizing them as their agents when they had economically benefited from their use. The corporations' alternate characterization as nominees was also rejected under authority of *Strong*.[25] The court dispensed with the taxpayer's last argument by concluding that any excess out-of-pocket payments made on behalf of the projects by the partnerships were not to be treated as losses but rather as a "contribution to the capital of the corporations."[26]

On appeal, the Second Circuit affirmed after determining that *Strong* applied.[27] In a concise opinion, the court held that " 'income from property must be taxed to the corporate owner,' " unless the corporation served merely as a "passive dummy" or was used solely to avoid taxation.[28] With little discussion, these exceptions were found inapplicable to the taxpayers.[29]

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24. *Id.* at 132.

25. *Id.*

26. *Id.*

27. 617 F.2d 14, 16, 17, 80-1 U.S.T.C. ¶ 9265 at 83,523-24 (1980). The court affirmed the Tax Court decision *except* with respect to certain calculations relating to allowed deductions. Those parts of the decision relating to these deductions were *remanded* so the Tax Court could amend its calculations. *Id.* at 17. The error related to a mistake made in calculating "Garden Partnership's share of the interest on the purchase obligation paid in 1967 to Sereth Properties, Inc., the seller of the real estate on which" Garden Village was built. The appropriate deduction was $4,520.82 instead of the $2,728.42 figure computed by the Tax Court. *Id.*

28. *Id.* at 16, 80-1 U.S.T.C. ¶ 9265 at 83,523 (quoting *Strong*, 66 T.C. at 22).

29. *Id.* at 16, 80-1 U.S.T.C. ¶ 9265 at 83,523. The court also addressed other arguments raised by the taxpayer. In particular, the court rejected the taxpayer's assertion that the Commissioner had acted capriciously and arbitrarily in applying section 482 of the Internal Revenue Code (Code) (first raised in the Tax Court at 38 T.C.M. (CCH) at 132). The court simply noted that the record was devoid of any indication that the Commissioner had even invoked section 482 with his statutory notices of deficiency. 617 F.2d at 16-17, 80-1 U.S.T.C. ¶ 9265 at 83,523-24. Section 482 authorizes the Commissioner to reallocate gross income, deductions, credits, or other allowances of related taxpayers in order to more accurately reflect income and avoid the distortion of tax liability. It is designed to apply to artificial transactions which distort income. Treas. Reg. § 1.482-1(c) (1980).

The taxpayers also asserted they were entitled to rely on private letter rulings issued other taxpayers and covering scenarios similar to the one at bar in the Tax Court. 38 T.C.M. (CCH) at 133. The Tax Court summarily dismissed that contention and stated that it was well settled law that private letter rulings have no precedential value. *Id.* Judge Oakes, in his concurring opinion, was the only member of the court on appeal to address this issue. 617 F.2d at 17, 80-1 U.S.T.C. ¶ 9265 at 83,524. Recognizing the merit of the taxpayer's argument, he suggested that private letter rulings did indeed possess precedential value. Judge Oakes relied on Hanover Bank v. Commissioner, 369 U.S. 672 (1962), and stated that the Commissioner would be well-advised to consistently and uniformly treat taxpayers simi-

To fully appreciate *Ogiony v. Commissioner*,[30] the evolution of this field of the tax law must be investigated. In light of recent developments and especially with the unquestioned adoption of *Strong*, *Ogiony* falls within the natural progression of cases following the landmark decision rendered in *Moline Properties, Inc. v. Commissioner*.[31] Whether this progression is justified and desirable is another question entirely.

Prior to 1943, the year in which the Supreme Court decided *Moline*, the courts generally recognized that a corporation might be employed for reasons devoid of tax considerations.[32] Taxpayers frequently utilized corporations for a number of reasons; among these is a desire to escape mortgage liability, to enjoy anonymous ownership, to limit tort and contract liability, to escape disruption of management in case of premature death or withdrawal of a partner or owner, to simplify conveyancing, to avoid personal liability, to gain advantage under the law of the state of incorporation, or to increase the taxpayer's borrowing capacity.[33] Historically, the beneficial owner in these arrangements—the taxpayer—sought to disregard the corporation's separate existence by arguing its activities were insufficient to give it a separate taxable identity.[34] The effect of this argument would be to treat the taxpayer as the sole owner of a project even though a corporation had been used in one or more transactions during the construction period.[35]

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larly situated. 617 F.2d at 17-18, 80-1 U.S.T.C. ¶ 9265 at 83,524-25. Nevertheless, such incitefulness did not help the taxpayers since Judge Oakes found that they had not established sufficient doubt concerning the Commissioner's action in order to trigger further judicial scrutiny. 617 F.2d at 18, 80-1 U.S.T.C. ¶ 9265 at 83,525.

The Tax Court concluded that the *Strong* decision controlled. 38 T.C.M. (CCH) at 132. The Second Circuit agreed and cited Judge Hall of the Tax Court who noted "that the instant case is virtually indistinguishable from *Strong*," 617 F.2d at 16, 80-1 U.S.T.C. ¶ 9265 at 83,523.

30. 617 F.2d at 14, 80-1 U.S.T.C. ¶ 9265 (1980).

31. 319 U.S. 436 (1943).

32. *See* Baker & Rothman, *Nominee and Agency Corporations: Grasping for Straws*, 33 N.Y.U. INST. ON FED. TAX. 1255, 1262-63 (1975).

33. *See generally*, Baker & Rothman, *supra* note 32, at 1257-63; Hoffman, *Straw or Nominee Corps. Must be as Passive as Possible to Protect Investors Deductions*, 5 TAX FOR LAW. 10 (1976); Kronovet, *supra* note 19, at 54; Palcar Real Estate Co. v. Commissioner, 131 F.2d 210 (8th Cir. 1942); Texas-Empire Pipe Line Co. v. Commissioner, 127 F.2d 220 (10th Cir. 1942); Watson v. Commissioner, 124 F.2d 437 (2d Cir. 1942); Sheldon Bldg. Corp. v. Commissioner, 118 F.2d 835 (7th Cir. 1941); Bond v. Commissioner, 14 T.C. 478 (1950).

34. 6 FED. TAX COORDINATOR 2D ¶ D-1200 at 18,028 (1980). Normally, it is the Internal Revenue Service which seeks to ignore the corporation in order to impose a higher tax rate on a shareholder's income.

35. *See* Stogel & Jones, *Straw and Nominee Corporations in Real Estate Tax Shelter Transactions*, 1976 WASH. UNIV. L. Q. 403, 406. Internal Revenue Code, section 761(a), de-

On the other hand, the Internal Revenue Service (Service) promoted the corporation's separate taxable identity. By successfully emphasizing the active role played by the corporation during the construction of the project, several significant tax consequences befell the taxpayer. The taxpayer's income might increase due to a reallocation of a claimed loss to the corporation, and any corporate distributions might be recharacterized as "dividend income, return of capital or gain from the sale or exchange of property."[36] Thus, the stakes being high, the battle could be fierce.

In recent times, however, the taxpayer has frequently lost the battle. With the exception of subchapter-S elections,[37] the taxpayer is rarely extended the privilege to freely disregard his corporation's existence at his convenience.[38] This restraint is predicated upon recognition of the corporation as a separate jural personality or entity[39] in order to protect the integrity of the corporate income tax.[40]

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fines a partnership as including "a syndicate, group, pool, joint venture, or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on." Section 761(b) defines the partner as a member of the partnership. *See also* I.R.C. § 7701(a)(3), which defines a corporation to include "associations, joint-stock companies, and insurance companies."

Because of the Code's broad definition of a corporation, the courts have applied six corporate characteristics when distinguishing a corporate entity from other entities. Although not exclusive, the characteristics are: (1) the presence of associates; (2) a purpose to carry on business and divide gain; (3) continuity of life; (4) centralized management; (5) limited liability; and (6) the free transferability of interests. Treas. Reg. § 301.7701-2(a)-(e) (1980).

Normally each partner in a partnership is required to report his distributive share of the partnership income or loss. For a more complete discussion of partnership income and the partner's distributive share, *see* Cowan, *Partnerships—Taxable Income and Distributive Shares*, 282 TAX MANAGEMENT PORTFOLIOS (Silverstein ed. 1978); Spada, *Partnerships—Statutory Outline and Definition*, 161-2nd TAX MANAGEMENT PORTFOLIOS, (Silverstein ed. 1978).

36. *See supra* note 35, at 405.

37. An election to become a sub-chapter S corporation may effectively destroy a nominee status argument. *See* Howell v. Commissioner, 57 T.C. 546 (1972); Hooper v. Commissioner, 33 T.C.M. (CCH) 759 (1974). There may also be problems relating to the code section 1372 (e)(5) restriction with regard to passive investment income. For a discussion of sub-chapter S elections as an alternative to conduit corporations, see Baker & Rothman, *supra* note 32, at 1310.

38. *See* United States v. Rexach, 185 F.Supp. 465 (Dist. Ct. P.R. 1960); Strong v. Commissioner, 66 T.C. 12 (1976), *aff'd without published opinion*, 553 F.2d 94, 77-1 U.S.T.C. ¶ 9240 (2d Cir. 1977). *See* I.R.C. §§ 1371-1379 (1980). *See generally* Kinzer & Marzehi, *Sub-Chapter S Operations* 60-6th TAX MANAGEMENT PORTFOLIOS, (Silverstein ed. 1980); 7 MERTEN'S LAW OF FED. INCOME TAX. §§ 41B.01-41B.44 (1976).

39. *See* Flint v. Stone Tracy Co., 220 U.S. 107 (1911), in which the Court recognized congressional power to tax corporations as separate entities.

40. *See* Carver v. United States, 412 F.2d 233 (Ct. Cl. 1969). *See also* Judge Tannewald's comments on the two tier tax structure in the *Strong* opinion which reflects the fear that

Nevertheless, with regard to cases in which a corporation held title to property for the convenience of the beneficial owner, early decisions rendered before *Moline* favored imposing the tax burden on the beneficiary. Relying on an equitable ownership theory, the courts inquired into the extent to which the owner benefited from the property and to what degree control was exercised over the property taxed.[41] The judiciary's attention was not directed as much at "refinements of title" as it was at benefit and control.[42] Because benefit and control were the determinative factors, arrangements could be planned whereby control was exercised through a legal interest as long as real authority and benefit remained with the taxpayer.[43] As a result, the corporation was frequently disregarded, and the beneficial owner was recognized as the real party in interest. The practical consequence of this state of affairs was that any income or loss could be attributed to a shareholder-owner when the corporation could, with minimal independent activity, hold title to property for the convenience of that shareholder-owner.[44] Unfortunately, no clear definitional standard was provided under this approach. Consequently, the question remained: To what extent would corporate activity satisfying the taxpayer's business objectives contemporaneously qualify as minimal independent activity for tax purposes?

Addressing this uncertainty, the Supreme Court in *Moline* formulated a disjunctive test.[45] In that case, a corporation was employed as a security device for additional financing with respect to Florida realty. Title to the property was in the corporation's name. The corporation's qualifying shares were transferred to a trustee appointed by the creditor. Upon repayment of the loan, the shares were returned to the taxpayer and sole shareholder of the corporation. The corporation subsequently leased and sold some real estate, and its sole shareholder reported the sales on his individual

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lenient disregard of corporate entities may encourage taxpayers to employ a corporation merely to avoid the higher tax rates applicable to their personal income. Hence, a taxpayer in a high tax bracket could conceivably benefit from such an arrangement. Problems of double taxation with regard to dividend income among other problems with such an arrangement might dissuade taxpayers from following such a scheme "en masse." 66 T.C. at 12, 24 (1976).

41. *See* United States v. Brager Bldg. & Land Corp., 124 F.2d 349, 351 (4th Cir. 1941). *See also* Griffiths v. Commissioner, 308 U.S. 355 (1939); Corliss v. Bowers, 281 U.S. 376 (1930).

42. 124 F.2d at 351-52.

43. *Id.* at 352.

44. *Id.* at 351; North Jersey Title Ins. Co. v. Commissioner, 84 F.2d 898 (3rd Cir. 1936).

45. 319 U.S. 436 (1943).

returns.[46] The question addressed by the Court concerned who should be taxed on the sales.[47]

The Supreme Court held the corporation to be the appropriate taxpayer and recognized it as a viable separate taxable entity.[48] In an attempt to define the scope of the relevant inquiry more precisely, the Court espoused the view that:

> The doctrine of corporate entity fills a useful purpose in business life. Whether the purpose be to gain an advantage under the law of the state of incorporation or to avoid or to comply with the demands of creditors or to serve the creator's personal or undisclosed convenience, so long as that purpose is the equivalent of business activity or is followed by the carrying on of business by the corporation, the corporation remains a separate taxable entity.[49]

The disjunctive test thus laid down by the Court assessed the extent to which the corporation's purpose "is the equivalent of business activity" or "is followed by the carrying on of business." Although prior to *Moline* courts tended to focus on the actual significance of the benefit to the beneficiary,[50] the Supreme Court nevertheless dispensed with any requirement that in order to qualify as a taxable entity the corporation retain beneficial as well as legal ownership of property. Under its new test, corporate retention merely of legal title could be sufficient to warrant recognition of the corporation's existence.[51] The purpose achieved by the corporation's creation and the degree of business activity engaged in therefore became relevant inquiries under the two alternate prongs of the *Moline* test. Unfortunately, the Court did not specify what business activity or the quantum of activity necessary to satisfy the second prong of the test. The practical consequence of this failure was to leave it to other courts to decide what activity would qualify under the test.

Later court decisions have played a critical role in refining how the test is to be applied. Generally, the courts have emphasized the second prong of the disjunctive test; i.e., the extent of business ac-

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46. *Id.* at 437-38.
47. *Id.* at 438.
48. *Id.* at 438-40.
49. *Id.* at 438-39 (footnotes omitted).
50. *See* Bertane, *Tax Problems of the Straw Corporation*, 20 VILLA. L. REV. 735, 741 (1975).
51. *Id.* at 742.

tivity.[52] Hence, cases construing the *Moline* decision have interpreted the test to mean that "a corporation must engage in commercial, industrial, or some other activity besides tax-avoidance to retain its corporate identity."[53] The level of activity required is not great. Where a corporation was required to join in the execution of all commercial and financial documents relating to the enterprise, the test was met.[54] Even where the owner made all decisions regarding corporate actions, the corporation was still considered a viable separate entity within the meaning of the test because the corporation shared in expenses, disposed of income, entered management contracts, filed tax returns, and so forth.[55]

The refining process took a new turn in the early seventies. In applying the *Moline* test, the Tax Court in *Bolger v. Commissioner*[56] and *Rogers v. Commissioner*,[57] and the Court of Claims in *Harrison Property Management Co. v. United States*[58] emphasized the business purpose prong of the test, even though the Supreme Court in *Moline* laid down the test as a disjunctive one, and subsequent decisions construing its application favored the second prong.[59] Nevertheless, decisions such as *Bolger, Harrison,* and *Rogers* focused on the reasons justifying the creation and activity of the corporation.

Bolger involved the corporate acquisition of property subsequently leased and the securing of negotiable notes issued to an institutional lender. The property was then conveyed to the shareholders subject to contractual encumbrances. These transactions transpired within one day. The court determined the corporations were taxable entities because their purpose was avoidance of state

52. Rogers v. Commissioner, 34 T.C.M. (CCH) 1254, 1256 (1975).

53. National Investors Corp. v. Hoey, 144 F.2d 466, 468 (2d Cir. 1944). *See* Greer v. Commissioner, 334 F.2d 20 (5th Cir. 1965); Strasburger v. Commissioner, 327 F.2d 236 (6th Cir. 1964); Tomlinson v. Miles, 316 F.2d 710 (5th Cir.), *cert. denied*, 375 U.S. 828, *rehearing denied*, 375 U.S. 926 (1963); Given v. Commissioner, 238 F.2d 579 (8th Cir. 1956); Whitfield's Estate v. Commissioner, 192 F.2d 494 (5th Cir. 1951).

54. Britt v. United States, 431 F.2d 227, 230, 237 (5th Cir. 1970).

55. Bass v. Commissioner, 50 T.C. 595 (1968). For further examples, *see generally* Bateman v. United States, 490 F.2d 549 (9th Cir. 1973); Republic Petroleum Corp. v. United States, 397 F. Supp. 900 (E.D. La. 1975); Kessler v. Commissioner, 36 T.C.M. (CCH) 514 (1977); Gettler v. Commissioner, 34 T.C.M. (CCH) 442 (1975); Harbour Prop., Inc. v. Commissioner, 32 T.C.M. (CCH) 580 (1973); Little Carnegie Realty Corp. v. Commissioner, 29 T.C.M. (CCH) 647 (1970).

56. 59 T.C. 760 (1973).

57. 34 T.C.M. (CCH) 1254 (1975).

58. 475 F.2d 623 (Ct. Cl. 1973), *cert. denied*, 414 U.S. 1130, *rehearing denied*, 415 U.S. 952 (1973).

59. 34 T.C.M. (CCH) at 1256.

usury laws and because they engaged in business activity by leasing property, issuing notes, and executing mortgages.[60]

Shortly thereafter, the Court of Claims in *Harrison* also refused to ignore the corporation's existence.[61] The court concluded the corporation could not be disregarded because it performed several business functions in fulfilling the purpose served by its formation. Although the corporation existed solely for the convenience of shareholders, directors, and officers, because it entered into leases, granted right-of-ways, and sold property, the corporation would not be disregarded.[62]

In *Rogers,* the Tax Court, in a memorandum decision, went further by characterizing the *Moline* test as a two-pronged test establishing alternative criteria.[63] Satisfaction of either alternative, business purpose or business activity, required recognition of the corporation as a separate taxable entity.[64] Although the court relied upon the business purpose prong in reaching its decision, it also noted that the corporation had carried on enough business activity to satisfy the business activity prong of the test.[65]

The court's emphasis on purpose may explain the Tax Court's adoption of an overly mechanical and simplistic analysis in *Strong v. Commissioner,*[66] a case very similar to *Ogiony.* In *Strong,* a corporation was also utilized to obtain mortgages for the construction of an apartment complex.[67] The taxpayers wanted to disregard the corporation. They argued that it "was merely a sham or device used for the purpose of avoiding the New York usury statute, that it performed no acts other than those essential to that function, and that to treat it as the actual owner of property would be to exalt form over substance."[68]

The Tax Court was not persuaded by this argument. Reading *Moline* narrowly, it concluded that the quantum of business activity required under the test was minimal and that avoidance of state usury laws was a business purpose as contemplated under the test.[69]

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60. 59 T.C. at 766-67.
61. 475 F.2d at 627.
62. *Id.* at 629.
63. 34 T.C.M. (CCH) at 1256.
64. *Id.*
65. *Id.* at 1257.
66. 66 T.C. at 12.
67. *Id.* at 21.
68. *Id.*
69. *Id.* at 24-26.

> The fact remains, however, that the corporation did exist and did perform the function intended of it until the permanent loan was consummated. It was more than a business convenience, it was a business necessity to . . . [the taxpayer's] . . . enterprise. As such, it came into being. As such, it served the purpose of its creation.[70]

Prodded by the one-dimensional concept enumerated in *Bolger, Harrison,* and *Rogers,* and cognizant of the practical difficulties inherent in differentiating between a dummy corporation and a viable separate tax entity, the court in *Strong* directed its attention to the taxpayer's motives underlying the creation of the corporation.[71]

A legitimate concern that the court read *Moline* too narrowly arises. There is an obvious lack of reason and justice in a rule which recognizes a corporation existing in form only and bases significant substantive results thereon. The decision may simply reveal an overriding concern that liberal judicial disposition will lead to intolerable abuses of the tax system. In order to avoid this situation, the *Strong* court sought to withhold invoking the activity prong of the test by focusing on the purpose for which the corporation was formed and used.

More ominous perhaps, in ruling against the taxpayer the court espoused that "income from property must be taxed to the corporate owner."[72] Has the court created a presumption of sorts whereby the corporation holding title to property is charged with any income derived from the property regardless of the results of an inquiry into purpose or activity? This would be a bold leap indeed in light of earlier interpretations attributed to the Supreme Court's holding in *Moline.* Prior to *Rogers* and *Strong,* at least, the *Moline* dual concern with purpose *and* activity flavored the more mechanical inquiry which is evolving. Although both extremes might be advocated—some arguing that a corporation's existence should be taken as conclusive proof of its separate existence as a tax entity, and others saying that a corporation's mere existence should mean nothing absent relevant, compelling proof to the contrary—neither extreme should prevail. Rather, a sound formula of

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70. *Id.* at 26 (quoting Collins v. United States, 386 F. Supp. 17, 21 (S.D. Ga. 1974), *aff'd per curiam,* 514 F.2d 1282 (5th Cir. 1975)).

71. The *Strong* court focused on the purpose for which a corporation was used. It related the corporation's existence to some taxpayer motivation to accomplish either a tax or nontax aim. *Id.* at 24.

72. *Id.* at 22.

compromise should exist whereby facts and circumstances are explored in order to ascertain the true state of affairs existing between the corporation and those seeking to have it disregarded. Arguably, this formula received authoritative expression in *Moline*. But, *Strong* adopts a purely mechanical orientation which systematically favors the mere existence of the corporation as the dispositive factor—in effect form triumphs over substance.

Before considering *Ogiony* more fully, the simultaneous development of another aspect of the problem should be addressed. The *Moline* court explicitly recognized an agency perspective to the problem. The leading case of *National Carbide Corp. v. Commissioner*[73] provided the Supreme Court with the first opportunity after *Moline* to consider a case firmly grounded on an agency theory. In *National Carbide,* the parent company had entered into an agreement with three of its subsidiaries whereby it agreed to provide certain assets to the subsidiaries and give managerial and financial help in return for all subsidiary profits exceeding a stated amount.[74] The Supreme Court held that the subsidiaries were corporate entities in their own right and rejected the parent company's assertion that an agency relationship existed.[75]

The Court noted, however, the following:

> What we have said does not foreclose a full corporate agent or trustee from handling the property and income of its owner-principal without being taxable therefor . . . . If the corporation is a true agent, its relations with its principal must not be dependent upon the fact that it is owned by the principal, if such is the case. Its business purpose must be the carrying on of the normal duties of an agent.[76]

In considering what are the normal duties of an agent, the Court listed a number of factors: (1) the agent operate in the name and for the account of the principal; (2) the principal be bound by the agent's acts; (3) the agent transmit any money received to the principal; and (4) the receipt of income be attributable to the services of employees of the principal and to the assets belonging to the principal.[77]

Compliance with these factors is crucial since the Service and

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73. 336 U.S. 422 (1949).
74. *Id.* at 425.
75. *Id.* at 437-38.
76. *Id.*
77. *Id.*

the courts have required convincing proof that an agency relationship in fact exists before a corporation's existence will be ignored.[78] Inferences will not be made solely because a single shareholder owns the corporation.[79] Simply put, *National Carbide* has been interpreted in subsequent cases to require that the corporation must perform the duties of an agent.[80]

The Service's predisposition with respect to an agency argument is disclosed in two private letter rulings. In these the Service insists that the agency-principal relationship must be the result of an arms-length agreement.[81] In *Harrison Property Management Co. v. United States*, the Court of Claims stated the determining criteria for this relationship is "whether the so-called 'agent' would have made the agreement if the so-called 'principals' were not its owners, and conversely whether the 'principals' would have undertaken the arrangement if the 'agent' were not their corporate creature."[82] However, the *Bolger* court rejected an agency argument relying on the same factors used to deny the taxpayer's assertion that the corporations involved in the case had no separate taxable identity.[83] This merely reflects the Supreme Court's observation in *Moline* that "the question of agency . . . depends upon the same legal issues as does the question of [separate corporate] identity . . . ."[84]

Keeping this in mind, the Service's approach creates great difficulty for the taxpayer trying to argue an agency exception to the general rule of corporate recognition. Normally, the taxpayer must be able to point to an agency agreement and prove that the agency is entered into as a result of arms-length negotiations.[85] This may be difficult when the agent-corporation is owned by the principal sole shareholder since "there are few meaningful criteria available for determining the capacity in which the corporation really is acting."[86] Nevertheless, there are safeguards which have proved bene-

78. *See* Factor v. Commissioner, 281 F.2d 100 (9th Cir. 1960); Van Heusden v. Commissioner, 44 T.C. 491 (1965); Skarda v. Commissioner, 27 T.C. 137 (1956), *aff'd*, 250 F.2d 429 (10th Cir. 1957).

79. *See generally* Siegel v. Commissioner, 45 T.C. 566 (1966).

80. *See generally* Spermacet Whaling & Shipping Co. v. Commissioner, 30 T.C. 618 (1958), *aff'd*, 281 F.2d 646 (6th Cir. 1960).

81. *See* Private Letter Rulings 7,911,004 and 7,912,007.

82. 475 F.2d 623, 627 (Ct. Cl. 1973).

83. 59 T.C. at 766.

84. 319 U.S. at 440-41.

85. 475 F.2d at 617-28.

86. *See* Kurtz & Kapp, *supra* note 20, at 655.

ficial for the taxpayer; for instance: (1) defining the agency status of the corporation and the interest of its shareholder as principals; (2) avoiding the use of corporate owned assets to carry out agency duties; (3) maintaining an agency contract and corporate records disclosing the agency; (4) communicating the agency arrangement to outsiders, and most importantly; (5) planning the agency as a reasonable business arrangement that could be entered into after arms-length bargaining.[87] Absent these, the taxpayer's agency argument is likely to fall on deaf ears. Furthermore, in recalling the Supreme Court's observation in *Moline*, presumably when the disjunctive test is satisfied the corporation cannot be the agent of its sole shareholder.[88]

Ogiony stands as a recent application of the *Moline* test and perpetuates the trend established by *Strong*. In *Ogiony* taxpayers sought to have the corporations ignored because they were intended to function solely as financing vehicles. They neither performed any other function nor engaged in any business activity apart from that required in order to obtain loans.[89]

The Tax Court grounded its decision both on *Strong* and *Moline*. It expressed the view that once a taxpayer obtains a benefit from the corporate form the corporation cannot be ignored.[90] Adopting the *Strong* approach, the court concluded that where a corporation serves some purpose it will be considered a separate taxable entity.[91]

Having determined that *Strong* applied, the Second Circuit held that " 'income from property must be taxed to the corporate owner.' "[92] Neither of the exceptions enunciated in *Strong*, that the corporation was a "dummy" or that it was used to avoid taxes, were found to be present by the court.[93]

Both courts felt adoption of the *Strong* rationale sufficed to support their decisions. But even the *Strong* court summarily dismissed the "dummy" corporation argument, stating simply that the taxpayer's argument "is not without some appeal, but we conclude that it should not be accepted."[94]

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87. *See* Watts, *Tax Problems of Regard for the Corporate Entity*, 20 N.Y.U. TWENTIETH ANN. INST. ON FED. TAX. 867, 868 (1962).
88. *See* 59 T.C. at 766; 319 U.S. at 440.
89. 38 T.C.M. (CCH) at 127, 130.
90. 38 T.C.M. (CCH) at 132.
91. *Id.* at 131-32.
92. 617 F.2d at 16, 80-1 U.S.T.C. ¶ 9265 at 83,523 (quoting *Strong*, 66 T.C. at 22).
93. *Id.*
94. 66 T.C. at 21.

The court's limited analysis undoubtedly resulted from the Supreme Court's observations in *Moline* that a taxpayer, once having elected the corporate form, could not ignore the disadvantages concomitant with such a decision.[95] Hence, it may be inferred that the mere existence of the corporation is the unarticulated criteria used in decisions like *Strong* and *Ogiony*. However, analysis should relate not to the corporation's status but rather to the legal relationship between the corporation and the property under consideration.[96] Where "the corporation's activity or ownership of property is so transitory or so confused with those of affiliated persons as to be without significance,"[97] the conclusion should be that the corporation, as a separate entity, does not have adequate dominion and control over the property. The beneficial owner should be recognized as retaining the taxable interest and consequently any benefits or costs associated with such property ought to attach to him.

But the approach adopted by the Tax Court and the Second Circuit in *Ogiony* is dominated by an excessive concern for form in a misguided belief that abuse of the tax system will be avoided. This rationale fails to recognize the alternate scenario in which a "dummy" corporation is employed to shield anticipated large revenues from higher individual tax rates. Centering attention on the mere existence of a corporation will not therefore better protect the federal revenues. *Moline* should be construed to require a searching analysis of the facts to determine whether the true substance of the arrangement is different from its form or whether the form reflects what actually happened. To do otherwise simply opens the flood gate to schemes in which the true nature of a transaction will be disguised by mere formalisms designed only to alter tax liability. *Ogiony* is merely the latest decision unflinchingly employing the *Strong* approach which unnecessarily hampers

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95. *Id.* at 26.

96. Watts, *supra* note 87, at 883-85. *See also* United States v. Brager Bldg. & Land Corp., 124 F.2d 349 (4th Cir. 1941), in which the court said:

> But it is going too far to say that if a taxpayer forms a corporation for his convenience, he is thereafter estopped from disclosing the true nature of the arrangement, whenever it is of advantage to the government to recognize only the corporate form . . . . In a number of these cases . . . under circumstances quite similar to those found in the case at bar, it has been held that when a corporation has been formed merely as an agency to hold title to real estate for the convenience of the owner, and has served this purpose with little or no independent activity on its part, the property and the income therefrom should be regarded as belonging to the stockholder.

Id. at 351.

97. *See* Watts, *supra* note 87.

the freedom with which the corporate entity may be employed to further business goals.

An approach which highlights the legal niceties but ignores the real economic and beneficial ramifications of an arrangement simply exalts form over substance. But, as the *Strong* court concluded, although the taxpayer "took most precautions consistent with business exigency to [prevent separate taxation of the corporation] . . . we simply hold that their goal was not attainable."[98] In a footnote the court admits that "whether there are limits, albeit narrow, within which taxpayers might successfully structure transactions of the type involved herein is a question we do not decide."[99]

After *Ogiony*, this observation may be prophetic, for it is reasonable to conclude that avoiding state usury laws through the use of a corporation falls within the scope of the *Moline* test regardless of the extent of corporate activity. The test, once concerned with both purpose and independently taken corporate action, has been narrowed to the point that most taxpayers are hard pressed to prove no business purpose nor business activity whatsoever. In light of the Supreme Court's refusal to review the decision of the Second Circuit, the taxpayer is well-advised to be wary of the lure that a corporate entity may have with respect to non-tax motives since the tax consequences can be disastrous.[100]

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98. 66 T.C. at 26.

99. *Id.* at 26, n.13. This view may simply betray the court's concern that leniency with respect to schemes employing a corporation may eventually be used by imaginative taxpayers to abuse the tax system. The approach adopted by the courts, however, ignores the potential for abuse when excessive income and not loss is the prime concern on the taxpayer's mind. He may simply create a paper corporation to shelter income from higher personal tax rates. More than likely, substance would then indeed triumph over form and the corporation would be viewed a mere sham! Indeed, as the court noted in Commissioner v. State-Adams Corp., 283 F.2d 395, 398-99 (2d Cir. 1960), *cert. denied*, 365 U.S. 844 (1961): "The Commissioner, to prevent unfair tax avoidance, has greater freedom and responsibility to disregard the corporate entity than a taxpayer, who normally cannot be heard to complain that a corporation which he has created and which has served his purpose well, is a sham."

100. Ogiony v. Commissioner, 49 U.S.L.W. 3270 (Oct. 14, 1980) *(cert. denied)*. Hence, as the rule stands, the corporation and not its creators, is entitled to claim losses when the corporation is organized in order to skirt a state's usury laws.

For a brief discussion of American Bar Association activity in this field, *see* Baker & Rothman, *supra* note 32, at 1297-98.