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TAX AVOIDANCE SCHEMES END IN DISASTER

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This is a plain spoken article on the hazards of tax reducing schemes as they apply to the federal taxing system. This article is addressed to businessmen and business lawyers, and in it I shall not use words of art. I shall use words in their general or street corner meaning. I am afraid that, in my discussion, I shall not command two opposing armies of irreconcilable cases, meeting in countless engagements, all arranged by me—armies which I eventually lead into a morass where I invite you and your hapless client to meet me. Quite the contrary, I shall advise you in plain English about pitfalls which you and your client ought to avoid. I shall try to give you the metes and bounds of a no-man's land into which you are advised not to lead your client. In this no-man's land there are some small veins of rich gold, but the general terrain is full of pitfalls into which your client is almost certain to fall to his destruction. (In this article I shall refer to all taxpayers, corporate and individual, as "he.")

The principal text of this article is:

Almost all tax avoidance schemes end in disaster.

My secondary text is this:

If your client has made some money, or if he expects to make some money and his hopes are later realized, let him pay his taxes, and you; and let him go out and earn some more money so that he may pay some more taxes and some more to you. Such a course is far more profitable to him than wasting time and money in schemes to defeat his taxes.

It is true that there was a time before the 1921 Revenue Act, when the tax statutes were full of loopholes and pitfalls. In those days many tax avoidance schemes succeeded, and it might be said that in those days the chance for success warranted the risk. For example: in those days, a man who had an offer to sell something at a profit could delay the sale an hour, give the property to his wife, and then make the sale in her name. Such a transaction was tax-free, for there was no gift tax, and a donee's base from which gain was computed was the value at the time of the gift. The value at the time of the gift would be the same value as the sale price an hour later, so there would never be a taxable gain on such a sale. It is true that, upon such a sale, the sales money would belong to the wife, but through

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**Editor's Note: The author of this article expressed the view that its theme and style would not draw great acclaim and would add little to the popularity of its author or that of the Miami Law Quarterly. We agree that, both as to style and content, the article departs from the usual type published in legal periodicals. However, we consider the theme to be timely and commendable since it advocates greater cooperation of attorneys towards developing a just and equitable scheme of taxation so that everyone will bear his fair share of maintaining our government.

various devices, such as loans or joint bank accounts, this obstacle generally could be overcome. Occasionally, a wife would take the purchase money and a train to Reno, but every man believed that such a tragedy could not happen to him.

The many inequities that existed prior to 1921 did not always favor the taxpayer. They often destroyed him. Thus, if a successful corporation, prior to 1921, changed its legal domicile from, say, Maryland to Delaware, a disastrous tax might fall upon its stockholders. They would be assumed to have sold their original stock and to have received, as the purchase price, the new stock at its present value. The old stock might have cost very little. The new stock might be worth a great deal. Thus, the mere exchange of certificates without any change of beneficial interests might result in a huge tax. (It should be remembered that in those days there was no distinction between capital gains and ordinary income. Everything was ordinary income.) In order not to soften the blow, the taxing authorities always added a value for Good-will when they put a valuation upon the new stock, particularly if the company was closely held and there were no immediate outside sales of the stock. By this means the calamity was made complete and usually the helpless stockholders had to sell part of the stock to pay their taxes. You can see that the sword cut with both edges.

There is no need, however, for me to go as far back as 1921 to write this article. I am writing now about the client who comes into your office tomorrow and wants you to work up for him a tax saving scheme on money he has made recently or expects to make soon. To this end, I do not think it would be amiss to review recent tax avoidance schemes, for such a review might be helpful in considering the current problems. New schemes are often old ones dressed up.

Before I get down to a discussion of cases, there are a few points which I should mention to you.

I want to remind you that the harassed Treasury Department has been fighting its tax gathering fight against all the lawyers, accountants and taxpayers in the country for many years, and that this has been a major battle during the past 33 years. It is not improper to suggest that the Treasury Department has been hopelessly outnumbered; but I very much doubt if it has been out-skilled.

I ought to remind you, too, that since each tax avoidance scheme that fails is marked by a case, and since each case has a name and address, and has lawyers who also have names and addresses, it is my duty, before getting down to the cases, to say to you that neither the parties to the test cases nor their attorneys or accountants are to be blamed, or even criticized. Ten to one the plan reviewed by the test case was not even theirs. A thousand to one they thought it would work out all right. I might add that it often happens that tax avoidance schemes were not meant to be tax avoidance schemes; they were sometimes meant to be simple business transactions.

Coming now to tax avoidance schemes as a national pastime, you must bear in mind that when a clever scheme is devised, hordes of enthusiastic taxpayers immediately adopt it. The circulation among wealthy people and their counsel of tax avoidance schemes is incredible. A clever scheme may be devised by a hungry lawyer in New York, and, within ten days, law offices in St. Louis and San Francisco are working nights applying the scheme for some of their avid clients. I think it is fair to say that every clever tax scheme involves millions upon millions of dollars in taxes by the time the inevitable test case comes along.

Experience shows that if the taxpayer in the test case loses, thousands of taxpayers all over the country face disaster. Let me add, parenthetically, that if the taxpayer wins the case, Congress closes the loophole.

The actual number of reported disaster cases is few. The number of taxpayers affected is legion. You must remember that the size of the calamity cannot be gauged by the test case, for there is no relation between the two. The real question is: How many thousands of taxpayers adopted this clever scheme, and how many millions of dollars of tax will this decision produce?

The answer to the last question is often in the hundreds of millions of dollars. Perhaps it is because there is no way to gauge the effects of the test case that we do not all realize that tax avoidance schemes really do result in disaster.

Now, without further palaver, I shall offer to you, and through you to your clients, the benefit of that one asset which you cannot find in the case book, the classroom, or the Law Review article—Experience. I am aware of the fact that the asset, while of inestimable value to the holder, is usually non-transferable. For that reason, I do not expect you always to follow my advice. What I really expect is that, at some future date, you will wish you had done so.

One of the great calamity cases of the past was the *Gregory*[1] case. In principle, the class of transactions that came under the *Gregory* decision and are familiarly called "*Gregory* cases" involved plans to work out tax-free corporate reorganizations exactly in accordance with the directions of the Internal Revenue Code, with the real purpose, or the effect, of making indirect distribution of surplus. The Code provided, in clear and positive language, that certain corporate reorganizations in which no money or property passed, and which left the stockholders in possession of the same beneficial interest that they already owned, even though such beneficial interest was evidenced by different classes and kinds of securities, should not be presently taxed. It is probable that this provision of the Code grew out of the thought that it facilitated business progress to encourage corporate reorganizations, and that, therefore, no tax should be charged when the stockholders

1. Gregory v. Helvering, 293 U.S. 465 (1935).

received nothing more than one piece of paper in exchange for another. There is reason for such a rule for it is obvious that if a tax were charged upon such a transaction, the parties would have to raise the money from other assets, or sell part of their holdings in the instant venture. (That is what they had to do before 1921.)

Every move in the *Gregory* case was made exactly in accordance with the tax-free provisions of the Code, yet a murderous and entirely unnecessary tax resulted. Thousands of taxpayers lost millions of dollars as a result of the *Gregory* decision.

There is a lesson to be learned from the *Gregory* decision which is more important now than it was even then. The lesson is that it is no defense to a claim by the Government charging that certain transactions are tax avoidance schemes to urge that the scheme fit perfectly into provisions of the Code which expressly declared such transactions to be tax-free. This lesson has been translated by the Courts into an axiom:

> Every transaction, in contemplation of tax law, must have a sound business purpose. Saving taxes is not a sound business purpose.

I have stated the rule a little too strongly. Perhaps I should have said that every *business* transaction should have a sound business purpose, for there are some transactions such as those in estate planning which do not require a sound business purpose. For example, a bona fide gift by a man to his children may have the effect of reducing his estate taxes, but there is, of course, no business reason why he should give his property to his children. The reasons are purely personal. I put in this parenthetical clause because there is a tendency to read Law Review articles too technically. I remember once that I was bitterly criticized in the course of a lecture because I used the word "jurisdiction" in the place of the word "venue." I was helped out of the situation by an uncouth youth in the back row who exclaimed: "What difference does it make whether it is venue or jurisdiction—you are in the wrong Court and your case is dismissed!"

If you should read the *Gregory* case, you might say that it deals with a specific problem, and you might even think that it doesn't fall into the class in which I place it. But as a practical matter, I think that, after study, you will conclude that it does.

Long after the *Gregory* case, and despite its lesson, there arose the tax reducing plans which culminated in the *Adams* and *Bazley*[2] cases. Disregarding the exact facts of these two cases, and taking their plans into account, it might be suggested that there were two tax avoidance ideas governed by this line of cases. One plan was to recapitalize a company, exchanging preferred stock, the dividends on which were not deductible, for some form of security, the interest on which would be deductible. A variation of this plan was to issue a tax-free stock dividend, and later call it

2. Adams v. Comm'r, Bazley v. Comm'r, 331 U.S. 737 (1947).

in, in a recapitalization in exchange for an interest bearing obligation, thus making the dividends on the preferred stock a deductible expense to the corporation.

The other plan was merely to call in the old stock in a recapitalization and issue stock and interest bearing securities therefor, thus making part of the dividends an expense of operations as interest. There were literally thousands of recapitalizations based on these two basic theories and upon variations thereof. The Supreme Court put an end to these plans when it declared, in the *Adams* and *Bazley* cases, that these plans involved taxable income in the exchange.

Still another twist on the same proposition is found in the *Bedford Estate* case.[3] This decision threw the entire tax bar into a turmoil. Yet there seems to be very little doubt but that the rule in the *Bedford Estate* case always was the correct rule of law.

The reader will note that, in each of the cases discussed so far, the taxpayers could have stood perfectly still without incurring any loss at all; and the reader will note that in each case the loss was disastrous.

It is important in the practice of tax law to remember that no tax saving plan ought to be adopted, no matter how safe it appears, that causes the taxpayer to change his position when he could stand perfectly still without any loss at all, *unless* he can be put back in his old position if the case is lost. If there is no compensation for the loss, and no chance to move back to a safe position, the transaction becomes a dead loss when successfully challenged, and the person who advised the taxpayer to change his position to his destruction has much to answer for. As a general rule, it is unwise to allow a client to change his position at the risk of disaster if the plan does not work, just to save taxes.

In 30 years of tax practice, I have found that more than half the time the best advice to the client is to do nothing at all; and I have found that that is also the best way to lose him.

While we are considering the cases of taxpayers who change their position to their hurt, we ought to consider the transactions that come under the *Higgins v. Smith*[4] theory. In that case the taxpayer, having something that had shrunk in value and desiring to take his loss, sold it to another taxpayer who was so closely related to him that the transaction was set aside for tax purposes and the loss was not allowed. The best rule to follow in cases of this sort is to advise the client that if he wants to sell something, to sell it and be done with it; and if he wants to give something away, to give it away completely and forever. In your practice you will meet many such cases, for there are literally hundreds of thousands of *Higginses v. Smiths*. A rule has developed about handling such cases and I have just stated it: if you want to sell and take your loss, then sell and get out; if you want to

3. Comm'r v. Estate of Bedford, 325 U.S. 283 (1945).
4. Higgins v. Smith, 308 U.S. 473 (1940).

give something away, then give it away, lock, stock and barrel, and be done with it. Giving this sound advice to your client is another excellent way to lose him.

There are many tax saving devices that do not result in complete destruction. They usually deal with a given amount of income, the amount not being affected by the plan. The question involved is not the artificial creation of taxable income and its resultant huge tax, but is the relatively simple question of who owes the tax on the given amount of income. Cases of this sort may result in disaster, too, but they are not so likely to do so as the tax avoidance plans which I have discussed above, since no new taxable income is involved here. The only question involved is that the tax falls upon a person who does not enjoy the income, and who, therefore, must meet the tax out of other income or out of capital. It is obvious, of course, that if the person who has to pay the tax without enjoying the income finds it difficult to pay the tax, then that person is hurt; and if he finds it impossible to pay the tax, then that person is destroyed.

The great landmark cases on this highway are *Lucas v. Earl*[5] and *Horst.*[6] Earl gave half his income to his wife before he earned it. He did this in some sort of pact with her, which we might say was a partnership agreement. But call it what you will, the income that he gave his wife was still taxed to him. The Courts reasoned quite forcefully that if the income was sufficiently his to give away, it must have been his indeed; and since he earned it, it was taxable to him. In the *Horst* case, which came long after *Lucas v. Earl,* there was a plan which tax counsel all over the country had adopted as being a wide open door to tax reduction. A taxpayer, on the cash basis, having earned income, and having nothing more to do, would give it away before it was collected, and the donee would take the income and pay the tax. Mr. Horst, I think, really clipped some coupons off some bonds he owned and gave them to his son. The son cashed them and paid his tax on them as owner. But the Supreme Court set this matter at rest by holding that the income was taxable to the senior Mr. Horst.

There has grown out of all these an axiom:

> The man who owns the tree owes the tax on the fruit, whether he gives it away in the bloom, in the bud or in the crate.

When we stop to think it over, it is quite clear that that always was the law. The wonder is that hundreds of tax lawyers ever thought the law could be different.

Then there was the *Clifford* case.[7] The general idea of the *Clifford* type cases was the so-called "term-trust." Under such a plan, a man sets up a large portfolio of stocks in trust for (let us say) his children, for, say, ten years. The income is theirs, irrevocably. He is the trustee or the man-

5. Lucas v. Earl, 281 U.S. 111 (1930).
6. Helvering v. Horst, 311 U.S. 112 (1940).
7. Helvering v. Clifford, 309 U.S. 331 (1940).

aging trustee. If he dies within the ten years the portfolio goes to them; if he lives out the ten years the trust ends and the stocks come back to him. There are thousands of variations of the *Clifford* idea. All these cases failed. All the income is taxable to the settlor. The situation here is not so calamitous, as it was in such plans as fall under the *Gregory* case,[8] the *Adams* and *Bazley* cases, *supra*, and others of that class where income was artificially created and then taxed. No new income is involved in *Clifford* cases. Here the income was the settlor's and he owed the tax on it. Through his plan he set up trusts. The income was the same, it stayed in the family. The settlor still owed the tax. The only difference is that the settlor's donee gets the entire income free of tax and the settlor gets the tax. Collectively there is no loss. Individually the settlor is double loser. The settlor can expect no help from his donee, make no mistake about that.

There is still another series of tax avoidance plans which failed, and which, it seems to me, were doomed to failure from the very beginning. Yet people are still trying them, and will continue to do so, because they attempt to cure, by a devious back-door plan, an inequality in the law, which, perhaps, Congress ought to have cured.

Under the Tax Code, if a corporation sells its business at a profit, it owes a tax on the profit and if, having sold out its business, it liquidates, the stockholders owe another tax on the same profit, based on the difference between the cost of their stock to them and the amount received for it. Many taxpayers think it unfair to pay two taxes on one sale, and consequently someone devised the scheme of negotiating the sale, then delaying it, then liquidating the corporation and having the stockholders make the sale. It was thought that this would eliminate the tax charged against the corporation on the profit made on the sale. The Supreme Court, however, put a speedy end to this plan by treating the liquidation as a tax saving device, which indeed it was, and by taxing both the corporation and the stockholders as though the artful liquidation had not taken place. The test case on this question was the *Court Holding Company* case.[9] A great furor was raised among tax practitioners when this case came down. Indeed, numerous bar groups and many very high class lobbyists worked on the idea that Congress should pass some kind of a law to nullify the decision. But the decision was right, and it has stood and will stand. (Ed. note. *But cf.* United States v. Cumberland, 338 U.S. 451 (1950); 4 MIAMI L.Q. 247.) It must be admitted that the taxpayers' hands were not entirely clean in many of the transactions falling under this type of tax planning.

Even today tax avoidance schemes similar to the one discussed above are extremely popular. One such scheme is worked something like this: When a sale is imminent, the would-be purchaser is admonished not to make an offer. The company is then liquidated. An offer is then solicited

8. *Supra* note 1.
9. Comm'r v. Court Holding Co., 324 U.S. 331 (1945).

from the would-be purchaser, and the sale is made. It is my opinion that one day one of these cases will find its way to the Supreme Court, and I haven't the slightest doubt as to its outcome. In the meantime, thousands of taxpayers are risking their fortunes on this twist in an already discredited scheme. Out of this line of cases an axiom has arisen and it is this:

> If there are any facts about the plan which cannot be disclosed to the taxing authorities, then the plan should not be adopted.

Strangely enough there is often a simple solution to this troublesome problem. Why not sell the stock? (I am aware of the fact that it often happens that the purchaser will not buy stock. He wants the business; but is afraid of the corporation's hidden obligations.)

Beginning in the 1940's, there was a very popular plan of tax avoidance which was used in many thousands of cases. The plan was to have a man go into partnership with his wife, or for a man to go into partnership with his wife and children. These plans included partnerships with minor children, carried on by the device of appointing trustees to represent the child, whereupon the trustee, as trustee, would go into partnership with the father or the father and mother. The idea was to spread one income between two or more people, thus to level the brackets and reduce the tax. Most of these plans involve a gift of the money necessary to provide the incoming partner's share of the capital. Many of these cases failed and many of them succeeded, and it might be suggested, if one wished to be facetious, that the worst ones succeeded, and the best ones failed. These plans, of course, finally reached the Supreme Court and can be found recorded in *Lusthaus*,[10] *Tower*[11] and *Culbertson*.[12] The current rule allowing joint returns removes the necessity for unreal partnerships between husbands and wives.

On principle, the rule seems to be fairly well established that if the wife puts up her own money and actually goes into partnership with her husband, and works at the business like he does, the partnership is good. And the same rule applies as to children. In these changing times, when it is almost impossible for a man to save enough money to keep his wife after he is dead in the circumstances in which he kept her when he was alive, it is not unwise for married women to go into business. In fact, it is necessary for them to do so if they hope to maintain their present standards of living. But the idea is still new to us. It is a problem that you will meet in your practice every day. When you meet it, you must remember that the wife must work harder in the business than her husband if she wishes to maintain her position as partner. A man who owns a business can go to Bar Harbor three months in the summer and Palm Beach three months in the winter. His income will be taxed to him. If he takes his wife into partner-

10. Lusthaus v. Comm'r, 327 U.S. 293 (1946).
11. Comm'r v. Tower, 327 U.S. 280 (1946).
12. Comm'r v. Culbertson, 337 U.S. 733 (1949).

ship with him and she takes off half that much time in the course of a year, I assure you that she will be disqualified as a partner and her income taxed to *him*. This is tragic, but it is true, and you will have to face it in your practice.

Bona-fide family plans involving a decision by wives to go into business have little chance of success, tax-wise. Woe betide the husbands of such wives.

One of the greatest difficulties here is the disrepute into which family partnerships have fallen. Another is the contempt lawyers and judges have for women who go into business. A third is the unwritten tax law that no woman may employ her husband. Consider the case of Mrs. Brownell.[13] She owned 12% of a corporation, of which her husband and two other men owned the balance. There were current losses and the men were quarreling, so it was decided to liquidate. The assets were distributed and all the parties paid their taxes on the values received. Mrs. Brownell and the wives of the two other men bought what was left of the business from the ex-stockholders with their own money, rented the machinery, hired their husbands and went into business. The women maintained control of the bank accounts, made money, and drew it from the business. It was held that the whole thing was, in contemplation of tax law, a fake. Mrs. Brownell, by increasing her 12% interest to 40% "lost" her entire interest, the old 12% and the 28% were both handed to her husband by judicial decree of the Tax Court. The new owners who put up the other 60% "lost" everything to their husbands by the same decision. As a corollary, the men had to meet the entire tax bill of the women, although the women got all the money. This case demonstrates the fact that married women are disqualified as taxpayers, unless they seek help from men other than their husbands; for if these women had not employed their husbands they would now own, in contemplation of tax law, the business they bought and financed and which the Tax Court took away from them. You might shed a tear for Mr. Brownell, who was taxed on the profit made by his wife, not only on her new 28% interest, but on the 12% interest that she had always owned.

I do not mean to suggest that all the old tax saving devices failed, for such a statement would not be true. It is because some of them succeeded that I told you in the beginning of this article that there were a few veins of gold hidden in the no-man's land of tax avoidance. The fact is that so many tax saving plans succeeded that a goodly portion of the 1950 Revenue Act was devoted to an attempt to stop well established abuses. I shall touch lightly upon some of the abuses to which Congress devoted its attention in the 1950 Act.

Up until the 1950 Revenue Act it was possible to move to Puerto Rico

13. Brownell v. Comm'r, 14 T.C. 228 (1950).

under the advice and guidance of able counsel and save a lot of taxes. Numerous patriotic citizens did so.

Then, too, there were some very clever schemes to convert straight gains into capital gains by an artful use of temporary corporations. These plans were so clever and had so many variations and were so well disguised in a cloak of alleged business purpose that I think I ought to explain one of them to you so that you may recognize the basic idea when it comes to you dressed up in entirely different clothing. A group of persons in high income brackets, desiring to reduce ordinary income to capital gains, thus reducing their tax from more than 75% to 25%, thereby multiplying their net take-away earnings by three, would form a corporation, let us say, to make a moving picture. They would employ the actors, paying them in stock, which, of course, had no value at the time the actor made his contract, and they would take stock for their investment and for Goodwill. After the picture was made, and after sales contracts for it were executed and had an established value, they would put a value on the contracts, which would not be realized income to the corporation as yet, and then they would liquidate the corporation, each participant taking his proportionate share of the contracts as a liquidating dividend. They would put a very high value on these contracts and would pay their tax on that value at capital gain rates.

The promoters would say: "We put $50,000 into this corporation. We got back, in liquidation, contracts worth two million dollars. We will pay a capital gains tax on a profit of one milion, nine hundred and fifty thousand dollars."

The actors would say: "We put our time into a corporation for which we got some stock of no value. The corporation liquidated and gave us contracts worth two million dollars. We will pay our tax on two million dollars at capital gains rates."

After the contracts were fulfilled, and the profits came in, the profits would be set against the two million dollar valuation, and there would be no further gain until that mark was passed. If that mark was not reached, there would be a deductible loss and it would probably be an ordinary loss incurred in business and fully deductible from other income. Under this plan both corporation and individual taxes would be eliminated, except for the 25% capital gains, and the actors would receive their compensation for services rendered at the capital gains rate. Let me add here that my explanation of this plan may not bear microscopic examination, but I have given you a rough idea of what the plans were and how they were effected.

I think you can agree with me that there is very little in good conscience to support a deliberate long distance scheme of this sort, the sole purpose of which is to defeat the revenue.

Perhaps the worst abuse was the device employed by some of our noblest colleges, churches, and charities, to buy and operate businesses tax-free in competition with legitimate taxpaying businessmen. This situation got so bad that a great university would sell you a tax-free spaghetti dinner —or, at least, thought it could do so.

I know that, in the above discussion, I have trod upon the toes of some extremely expensive patent leather shoes, but I still think the matter deserves some discussion, for you will meet this problem in your practice, although it will be disguised now, since the 1950 Revenue Act has singled it out as an abuse that must be stopped.

Let us assume that you and I were, in 1945, each running a factory manufacturing canned spaghetti dinners. Your business was incorporated, and if you made a profit in that high tax year of World War II, your top bracket income fell into the 95% bracket. That was 95c to the Government and 5c to your corporation. The corporation paid you a dividend out of that nickel; the Government took at least 3/5 of it, so that the value to you of a dollar profit on a spaghetti dinner was 2c.

Let us assume that my situation was exactly the same. Let us assume that one day a gentleman in a silk hat and striped pants and patent leather shoes, representing one of America's finest universities, walked into my plant and told me that his university could buy my plant and sell those spaghetti dinners under such circumstances that, whereas I got two cents on the dollar of the profits, they could get 100c on the dollar profits, or 50 times as much as I. He said that, with that differential in their favor, his university could pay me twice as much for my factory as it was worth, and could pay me twice as much salary as I was worth, and that I could report the sale at capital gains; and suggested that I sell out to his university. Under such circumstances you can see that I could not resist such an attractive offer. So I would sell out to him and his university would start manufacturing these spaghetti dinners. It would then cut the price enough to run *you* out of business, because, after all, his university could make more profit for itself out of ten cents of manufacturing profit than you could make out of a dollar of manufacturing profit. So it wouldn't be long before you would sell your spaghetti factory to my university, and at a bargain price. Notwithstanding the very high grade people who went into plans of this sort, it must be suggested that these plans were a heavy blow to our national economy.

It is true that these plans would not always work, because, like everything else, they required some doing, and it is true that while most of the institutions which went into this kind of work made large tax-free profits, one or two of them did lose out.

Let me add, now, for the benefit of the methodical thinkers who sometimes exercise their talents on articles of this sort, that I am aware of the fact that, in the high tax years, there was an over-all 80% total tax and that there was a 10% post-war excess profits tax refund. If you want to open a can of my spaghetti and figure out the advantage that my tax-free manufacturer has over your tax paying factory, you will find that, counting in these items, the situation is still about as bad as I have pictured it; and I will even get my university to send you the can of spaghetti with its compliments.

These things are, happily, a thing of the past since the enactment of the 1950 Act.

It is considered proper, in a discussion of tax problems, somewhere in the lecture or article, to touch upon the subject matter of the article, and having devoted all of the preceding pages to a studious avoidance of the subject of this article, I shall now devote a few paragraphs to it.

There are today many tax-saving schemes which are budding and flowering right on our desks. Some of these will bear rich fruit, but most of them, like the schemes of the past, will produce a seductive but fatal poison. Perhaps not today, but certainly within the next few days, some client is going to walk into your office and ask you to put into effect a clever scheme that was outlined to him by a fellow who stood next to him at 3:00 A. M. yesterday morning at a bar and grille on Third Avenue. The interesting part about it is that the scheme will be clever, and it will look like it will work. There is a chance, about one in a hundred, that it *will* work. That is one of the things that causes the trouble.

Let's look at one or two of today's schemes that are being employed by taxpayers all over the United States, and since we have no client right now involved in any of these plans and have no fee involved in any of them, let us disinterestedly consider their chances of succeeding if the judge who hears the case is as clever as we.

One of the most popular plans and one that has recently been given the greatest amount of publicity and approval by the tax lecturers, writers and "authorities" is this:

An individual having business assets of great value pays them into a corporation in exchange for a generous amount of stock and bonds. There is no gain on such a transaction under the Code, for it is an exchange of property for stock and securities under circumstances declared to be tax-free. The same plan can be put into effect by a group of individuals provided they are skillfully advised.

When the company has acquired a surplus, the bonds are redeemed. The money received is reported as capital gains—that is to say, as gains from the sale (or redemption) of a capital asset. The saving in taxes is very great, for capital gains are taxed at 25%, whereas ordinary income may be taxed as high as 80% or more.

It is my opinion that these cases will all fail for this is neither more nor less than a clever way to pay a dividend at capital gains rates.

Another device which, in my opinion, will result in disaster is found in many estate plans. It will fail for quite a different reason from the one discussed above. It is the custom, in estate planning, to leave a full half of the estate to the spouse who dies last in the belief that a large amount of estate taxes will be saved.

Let us assume that the one so favored is the wife, who never has had any business experience. To leave her half the estate is fatal, both to her and the children. She will run through her inheritance, either by bad handling or simple spending, in a few months. Thus the tax will be saved, but half the estate will be destroyed.

In order to prevent the loss due to the surviving widow's inability to handle money, a plan has been devised to give the property to her under a power of appointment to be exercised in her will. This is a very popular device. Lawyers love powers of appointment.

On general principle, I advise against the use of any power of appointment. What is a power of appointment anyway? A power of appointment is a device whereby a man who has not the character or courage to make up his mind to whom he wants his life accumulations to pass, designates some incompetent to make the decision for him.

There are thousands of tax-saving schemes going the rounds of the law offices, bars and grilles, and night clubs. It is useless to outline them. My discussion of past schemes gives you sufficient notice.

Many tax-saving schemes involve estate planning; many of them involve insurance. Let me say right here that honest and clear cut estate planning is absolutely necessary; and it is a rare person who does not need insurance.

The thing you have to do is determine the genuine and distinguish the counterfeit. You have to do that for yourself in each case. Don't forget the Estate Planner is looking for a fee, and the Insurance Agent for a commission.

I realize that an article which points out pitfalls is of no great value unless it suggests some way to avoid them. A consideration of the following questions and the answers thereto form a basis by which any tax plan can be tested to see if it will work:

(1) What motives, and what persons initiated this plan? If the person is a salesman and the motive is a fee or profit, the plan can be discounted.

(2) Has the plan any real purpose besides tax-saving? If it has no other purpose, it will probably fail. This rule does not necessarily apply to estate planning. The test there is this: Does the person who is selling or giving away property in order to reduce his estate taxes want to control it, or even hold on to the tiniest thread of ownership or control?

(3) If the plan should come before you as a judge, would you, knowing what you do about it, pass it, or would you tax it? If you would tax it, you may be sure it will be taxed.

(4) Does the plan, while searching for a tax saving, however great, change the course of the lives of your client or his family for the worse? If it does, the plan is no good, and should be abandoned. If it hampers the

freedom of your client, or makes him beholden to anyone, do not consider it further; for even if it works, it is no good.

(5) Does this plan incite any human passions such as hate, envy, or greed? If it does so, do not go into it.

(6) *Can* you make full disclosure to the taxing authorities of what you are doing? If you cannot, the plan is worse than no good.

(7) *Will* you make full disclosure at the time you put the plan into execution? Do it!

After you have answered the above seven questions, ask yourself two more questions:

(1) Will this plan work in a business way? A tax-saving scheme that won't work in a business way is a very bad plan indeed.

(2) If this plan fails, what will be the client's situation? If failure of the plan will be a disaster for the client, do not go into it.

Let me repeat that I doubt if a single taxpayer in a single one of the test cases thought he was taking any advantage of the Government. I doubt if any accountant or attorney who had anything to do with any of them thought there was anything unfair about them. I am sure the trial attorneys believed in their cases. Because of this, numerous bar association groups labored hard and long in efforts to induce Congress to pass appropriate laws to nullify the *Gregory, Adams, Bazley, Bedford, Court Holding* and some of the other cases because they thought those cases laid down the wrong rule of law. I, myself, handled the *Brownell* case, and I *know* it lays down the wrong rule of law, for I know the transactions were bona-fide. It is perfectly obvious that Mr. Horst, Mr. Clifford and Mr. Earl acted in good faith.

Nevertheless, the facts remain. All those cases are mile-posts on the road of tax avoidance. Thousands of actual transactions turn on them, some being bona-fide and some not. Whether bona-fide or not, however, almost all tax-avoidance schemes end in disaster, and the attorney who advises his client to pay his just taxes rather than to try to avoid them is the wise attorney and the one who shows the greatest degree of appreciation of the great heritage which is his.