The Case of the Re-lived Facts

Louis M. Brown*

To what extent, if at all, may the Tax Court in deciding a case consider the taxpayer's position in the same manner, as though the court were a planning lawyer advising the taxpayer as a client at the time the facts were being created? The difference between a court deciding a case and a preventive law lawyer advising a client is not primarily a difference of law—it is a difference in the life of facts. A court considers dead, past, cold facts. A preventive law lawyer considers unborn, sometimes not yet conceived facts. He assists in guiding the course of factual events. The preventive law lawyer has choices: he may advise a client to act or not to act, and if he advises the client to act, he may advise him to do the act in one of several ways. These choices are apparently not available to a court. The problem here posed is whether the court can, or should, consider the facts as though the choices of the preventive law lawyer were available to the court. This problem is posed in the context of a hypothetical conference of the sixteen Tax Court judges discussing the income tax consequences after the trial of a somewhat typical case of thin incorporation.

I

FACTS OF THE CASE AND ARGUMENT OF COUNSEL

CHIEF JUDGE: The taxpayer is a corporation. In 1950 the taxpayer deducted $12,000 as interest on outstanding loans. This deduction was disallowed by the Government.

*Member, California Bar.

1 The use of a discussion by judges, as the method of posing a problem, was employed by Fuller in The Case of the Speluncean Explorers, 62 Harv. L. Rev. 616 (1949). Professor Fuller's explorers' case was staged in an appellate tribunal much like the English appellate bench. This article uses the judicial "stage" of the Tax Court. While the judges of the Tax Court hold regular conferences (Raum, Tax Court Litigation, U. So. Cal. 1957 Tax Inst. 631, 637) the similarity, if any there exists, between this hypothetical conference and a real conference is coincidental.

There is no dispute concerning the basic facts. The corporation was formed early in 1950 with one class of stock. Two men, \( R \) and \( S \), were essentially the moving forces in organizing this and other similar enterprises. In this case, as the principal officers and directors, they caused four hundred of the one dollar par value corporate shares to be issued at one dollar per share: two hundred shares to \( R \)'s minor daughter and two hundred shares to \( S \)'s son-in-law, for cash. The corporate activities were substantial. Considerable money was used to purchase land and erect various buildings. The initial financing was obtained by loans from \( R \) and \( S \). At various times during 1950 \( R \) and \( S \) each loaned the corporation almost identical sums on almost the same dates. Together they loaned a total of $400,000. No sums were repaid during 1950. There is evidence that the corporation issued negotiable promissory notes for these loans, the obligations maturing in eighteen months, bearing interest at the rate of six percent per annum.

There is testimony by \( R \) and \( S \) that before the corporation was formed they had fairly well defined plans for its activities. Negotiations were undertaken in the latter part of 1949 for the purchase of vacant land at a price of $175,000 payable $35,000 in 1950 and the balance secured by a purchase money trust deed or mortgage payable in five equal annual installments with six percent interest. The negotiations for the purchase did not include discussion as to whether or not the seller would be willing to subordinate the balance ($140,000) to construction loans. However, \( R \) and \( S \) both testified that they had considerable experience in the purchase of land and their reputation in the community was such that had they deemed it necessary, the transaction would have included a subordination of the secured balance to the construction they undertook. They testified that they had purchased other vacant land from the seller on such terms. The seller confirmed the testimony of \( R \) and \( S \). \( R \) and \( S \), however, decided to have the corporation purchase for cash because they then had ample funds or access to them and preferred, as they said, to lend the corporation the money at six percent interest rather than pay interest to the seller.

In addition to the $175,000 the corporation needed money for construction purposes. \( R \) and \( S \) planned to and did lend an additional $225,000 which was used to enable the corporation to proceed with the construction. There was testimony that had it been advisable or necessary \( R \) and \( S \) could have caused the corporation to borrow these funds elsewhere upon \( R \) and \( S \) guaranteeing repayment.

The corporate activities proceeded generally as anticipated. During 1950 the corporation did in fact proceed with construction, made a profit from some sales, paid $12,000 interest to \( R \) and \( S \), and deducted the interest on its tax return.
The loans were not repaid in 1950 but were repaid in the years 1951, 1952 and 1953. On June 30, 1952 (eighteen months from December 31, 1950 when the last loan advance was made) there was outstanding $60,000 in loans.

Government counsel argued that the taxpayer was plainly a thin corporation. Four hundred dollars capital, when compared with $400,000 in "loans," a ratio of 1:1,000, is clearly inadequate capital. In the context of this case he argued that the so-called loan money of $400,000 was put in at the risk of the business, just as capital is invested, and that it should be treated as equity capital. The corporation received the $400,000 just as it did the $400, not essentially from a general creditor making a loan, but rather for investment purposes. So he urges that we treat the entire $400,400 as capital invested.

Taxpayer's counsel conceded that the stock structure was inadequate but argued that the Court need not make an "all or nothing" decision. There is a middle ground. He cites cases that seem to strive for a middle ground, some amount of the advance being treated as capital and the remainder as loans. He would have us adopt a middle course, but for a different reason than was advanced in those cases.

Taxpayer's counsel asks us to decide this case as though the Tax Court were counsel advising the taxpayer when the corporation was formed. It is for this reason that he put in testimony (over Government objection), which we allowed subject to motion to strike, concerning the intentions of the principals and alternative methods of purchasing the land and financing the corporation. He argues that had he been consulted in 1950, he would have recommended that the corporation be formed with $35,000 initial capital because $35,000 was ample to start the corporation. The balance would be working capital.

His position is that it is the function of tax administration and the courts to treat all taxpayers the same in substance. There is in his position a strong point made of "real" equality in taxation. To treat taxpayers differently because they cast the form of the transaction one way or the other is morally abhorrent. And he pushes forth to the point of asking this Court to look at form and substance not from what the parties did, but from the point of view of what counsel would have advised. It is his view that in this way we do real justice in that we do not distinguish between taxpayers who received no advice (which amazingly was the fact here) or poor advice and those who received competent advice.

---

3 Mill Ridge Coal Co. v. Patterson, 58-1 U.S. Tax Cas. ¶ 9489 (N.D. Ala. 1958). (The trial judge instructed the jury that it might find that a portion of the advances made to the corporation "represents loans" and the remainder is "contributions to capital"). In Benjamin D. Gilbert v. C.I.R., 17 CCH Tax Ct. Mem. 29 (1958), rendered pursuant to an opinion reported at 248 F.2d 399 (2d Cir. 1957) the Tax Court held that advances by a husband were capital contributions and that similar, though not identical, advances made by his wife were loans.
There were numerous reasons, pro and con, given by both counsel in connection with the approach put forth. It is not necessary to report counsel’s contentions further because they received discussion by the judges.

II

CONFERENCE OF THE JUDGES

JUDGE ONE: I am willing to start this discussion by supporting the argument made on taxpayer’s behalf. My experience as a lawyer before coming to the bench confirms that of taxpayer’s counsel: the same practical result can be achieved in more than one way by counsel advising when the transaction is being made. This being so, it seems proper for us to look at basic reality. We should treat this taxpayer the same as other taxpayers, whether or not this taxpayer, or other taxpayers, received competent advice. To do so seems to arrive at substantial justice. Accordingly, I would decide this case as though $35,000 were capital and the balance, $365,000, a loan.

JUDGE TWO: I am indeed sympathetic to the principle of like treatment for like transactions. But I believe Judge One has failed to take into account one extremely significant factor which causes me to vote against the taxpayer. That factor is that in planning a transaction, various choices are available. While I am not troubled with the possible notion that we may be doing hindsight planning for the taxpayer, I am of the opinion that we should only do so in the clearest case where the choices do not vary so greatly. Doubtless there are choices for the planning lawyer to plan the transaction anywhere from, say, stock of $35,000 to $175,000 or more, the balance being loans. So while I might in some cases welcome the opportunity to adopt this novel approach of reaching a tax result, I decline to do so in this case.

JUDGE THREE: I think Judge One is too much taken in by the intrigue of counsel’s suggestions, and Judge Two is too reluctant to point out a possible avenue for the use of the theory of counsel’s argument. There is no need to accord to the taxpayer the best of all possible planned results, which is what Judge One has done, or to deny the taxpayer all relief as Judge Two has done. The equitable solution, it seems to me, is to reach a result which would accord the taxpayer the most conservatively planned situation. This result is one in which we accord to the taxpayer a relationship of capital to loan which bends every doubt in favor of a higher capital and lower loan. Taxpayers, as we know from the experience of prior cases before us, seek to have the smallest possible capital so that all the rest of the monetary advance is loan. The case before us is certainly one in which we can determine a capital amount and a loan amount in
which we reach a most conservative view and which would in no wise give rise to doubt. Such a result would allow for the approach taxpayer's counsel seeks to have us espouse. The argument for taxpayer equality seems just. Because there are obviously a variety of possible results, I would give this taxpayer the least favorable of those possible results, rather than the most favorable. I would, therefore, treat this taxpayer as though he had consulted counsel in advance but where counsel advised in the most cautious view. Within this framework the proper result seems to me to be that $235,000 is capital and $165,000 is loan. The $235,000 consists of $175,000 as the price for the land plus an estimated $60,000 for capital construction financing. This $60,000 is the sum outstanding at the time when the parties had planned no sums would be due to R and S. On this basis I would award judgment for the taxpayer.

JUDGE FOUR: This case has taken the most curious turn in which my brothers have been completely taken in by counsel's proposal. It seems to me utter nonsense to regard the argument with the credulity my brothers give to it. Once we open our ears to such an argument, there will be no end to the amount of litigation that could be thrust upon us. And it has never been the function of a court to substitute its judgment for that of the parties, or their counsel, at the time a transaction is made. The result counsel urges upon us has, as I see it, tremendously far-reaching consequences in the whole framework of the attitude judges should have in reaching a decision. Our function is to decide a case upon the facts presented to us, not to remake the facts. We are not planners of transactions. We are to apply the law to existing facts, not to re-plan or replace facts. The argument thrust upon us would lead us into a wilderness of argument in future cases which we should not tolerate. Judgment for the Government.

JUDGE FIVE: I had not come to a decision until my brother, Judge Four, stated his views. Until then I had considerable doubt about going along with taxpayer's argument. Rather than to persuade me to hold for the government, I tend now to hold for the taxpayer. The argument that we ought to disallow the taxpayer's approach because to do so would open the flood gates of litigation would result in a sheer failure to do our job. If our job is to decide cases so as to reach a proper result (some call this doing justice), I cannot close my ears and eyes to a worthwhile approach.

Judge Four states that our function is limited to the facts before us and that we cannot, indeed dare not, alter or vary these facts. We cannot, he says, re-create or rearrange the facts. However, this Court has been re-creating and rearranging facts as long as we have been deciding cases,
RE-LIVED FACTS

and I believe that I can somewhat reliably predict that we will continue
to do so. In this very area of law tax—the area so aptly called "thin incor-
poration"—we constantly redo the facts. The parties, with or without help
of counsel, set up small capital and large loans. We sometimes hold that
the loans were not really loans at all, but essentially capital. We change
the facts but do so with some polish because we say we look to substance
rather than form. We say we look to the realities, but in so doing we
actually recreate the "form" if not the "substance" of the facts. What tax-
payer's counsel urges upon us is that in looking at the realities we take
into account the additional reality that able tax planning puts such tax-
payers at an advantage over other taxpayers. Consequently basic reality
should compel us to look to the concept of planning as part of our looking
to the substance of the transaction. I would reach the result reached by
Judge Three.

JUDGE SIX: It occurs to me that in deciding this case in favor of
the taxpayer with the result reached by Judges Three and Five, we are
essentially doing as judges what is achieved in the settlement process. In
my experience before becoming a judge I had on many occasions negoti-
atcd, or sought to negotiate, settlements. Settlements were reached when
the parties could agree to some midway solution.

It would be interesting indeed if we had before us the statistics show-
ing the settlements reached in cases of thin incorporation. The recorded
experience is only the experience of decided cases, primarily in this Court.
While we have occasion to accept settlement stipulations, we do not
accumulate the data which leads to such settlements. Indeed, there is no
procedure for us to do so. Our procedure encourages the parties to stipu-
late to facts and invites the parties to reach a negotiated settlement. But
the experience gained from that process is not recorded.

In deciding this case upon a principle akin to the approach of pre-
ventive law, that is, adopting the view of the lawyer engaged in the plan-
ning stage to prevent (or minimize) trouble, we encourage the settlement
process to reach a similar result. We are probably doing nothing more nor
less than should have been done in this case, that is, to settle it upon the
reasonable basis of the proper result had the taxpayer obtained competent
tax advice in the formative stage of incorporation. I would therefore hold
that of the $400,000, $95,000 should be treated as capital ($35,000 the
required down payment, plus $60,000 capital investment for construction)
and the balance ($305,000) as loan.

JUDGE SEVEN: I cannot hold for the taxpayer in this case and I
am encouraged in my view upon obtaining the reasons set forth by Judge
Six. I, too, have high regard for the settlement process. But I differ with
Judge Six on the very objective he believes would be accomplished. He believes that to give a judgment upon the same basis that is used in settlement negotiations would lend weight to settlements and therefore encourage further settlements. It is indeed heart-warming to see a judge so vitally interested in furthering settlements, but in my opinion his decision neither encourages nor discourages settlements.

Let me state my view as follows. Whatever the law of a subject, disputes will still arise. The taxpayer starts by filing a tax return and thus tentatively establishes income tax liability. The Government later asserts a deficiency. A dispute arises and that dispute basically can be a dispute of fact or law, or both. Certainly in Judge Six's view, he does not eradicate or reduce disputes of fact or law. He, in fact, increases the potential for disputes because his opinion sets forth new avenues for decision. Each time this or any other court permits any new principle to prevail (without at the same time eliminating some existing law) we invite disagreement as to the interpretation of the legal principle, and since each legal principle (rule or standard) must be grounded on the facts of the case, we enlarge the quantity of facts which the parties may introduce into evidence.

JUDGE EIGHT: The decision for me is relatively easy to determine. I am not one to encourage judicial legislation. To hold for the taxpayer means that we legislate, so I hold for the Government.

JUDGE NINE: I hope I will be forgiven for continuing the discussion of judicial legislation. I, too, generally deplore judicial legislation but in this case I am particularly troubled. Ordinarily it seems to me improper for this Court to inject rules into our decisions not founded on statute. In the usual case I feel particularly keen about this because this Court is concerned solely with statutory law and particularly because the statutory tax law undergoes constant scrutiny and revision by Congress. Tax law is perhaps the most dynamic body of statutory law in our society. I object to judicial legislation upon the ground that the legislative body, and not the courts, should legislate. But when I ask myself what legislation could be proposed to decide this case as the taxpayer desires, I find no ready answer. The taxpayer's approach is really not one grounded on legislation. It seems rather directed to some basic viewpoint of judicial decision, some inherent power of the court. Indeed, holding for the government is some kind of judicial legislation. Without specific statutory authority we are asked to treat money invested in the form of loans as money invested as capital. I search in vain for statutory language that allows us to look to what we call substance over form, yet we frequently do so in opinions we render.

It does not seem proper for Congress to enact a law that would require
this Court, or any other court, to consider a case as though the transaction were planned *ab initio*. This is not a principle of tax law. Rather it is a fundamental doctrine, or a basic habit, in the judicial process. So I do not believe that our decision to deny the taxpayer's argument should be grounded on the notion that we ought not engage in judicial legislation.

Rather I would favor decision against the taxpayer because I am frankly not yet ready to accept the novelty of the taxpayer's approach. I would, however, not seek to foreclose the argument in future cases. Rather I prefer to encourage it. One of the reasons I do not hold for the taxpayer is that I do not know where the taxpayer's argument might lead us in other cases. This theory, like all theories, should be given the test of time before it is adopted. One way to give such a test is to allow the argument to be made in future cases whether or not they are thin incorporation cases. The test of argument in a number of cases might lead me to alter my view. Judgment should be for the Government.

**JUDGE TEN:** It appears to me that a significant factor has been neglected in the discussion of this case. This is a case in which the taxpayer is a corporation seeking to deduct certain payments as interest. If we disallow the deduction, we do so upon the ground that the so-called loans were not really loans but are, for income tax purposes, to be treated as capital. A corollary of such a holding is that repayment of the "loans" is really a dividend to the "lenders." We do not have before us as parties in this case the stockholders of the corporation. We do not know how they treated the loan repayments on their income tax returns. Consequently we cannot now replan the transaction. Assuming, for the moment, that I might be disposed to decide a case as though I were the lawyer advising when the transaction was given birth, I am not—as a judge—in that position. The reason is that I do not have all the affected parties before me, as does a lawyer (or group of lawyers) when setting up the transaction initially.

In deciding in the government's favor in this case, I do not intend to foreclose the possibility in some future case of using the preventive-law approach to a decision.

**JUDGE ELEVEN:** Judge Ten, in giving his cogent reasons, has overlooked another significant factor which, if taken into account, vitiates much of the force of his argument. True it is that we do not have all the parties before us, nor do we now know how the individual stockholders reported the transaction, nor do we know whether the Commissioner investigated the stockholders' tax returns and has properly asserted a deficiency. Our function, however, is not that of administering the tax laws. We do not investigate tax returns and assert deficiencies. These are functions of
the Internal Revenue Service. The tacit assumption which Judge Ten makes is that the Internal Revenue Service has not adequately performed its task. As a judge, I need make no such assumption. It is certainly not the function of this taxpayer to bring all potentially affected taxpayers before this Court. Hence, I can decide this case favorably to the taxpayer. I concur with Judge Three.

JUDGE TWELVE: When I came to this conference, I had not anticipated all the various arguments and positions that have been expressed. Indeed, I had only the slightest notion that I would be making the comments I am about to express. But I feel obliged to discuss the reasons just given by Judges Ten and Eleven.

Judge Ten seems to assume inadequate tax administration. Judge Eleven, on the other hand, believes that we have no function at all in tax administration. Neither point of view is complete.

Judicial decision plays a role in tax administration. I hope that the manner in which we decide cases, and the reasons we give, have traceable effects on the administration of our tax laws. Cases are not difficult to find in which our decision sets a pattern of action (or inaction) into motion. Yet without looking to analogies, I prefer to examine the probable effect of this decision on tax administration.

Suppose our decision is for the taxpayer, as Judges Eleven, Three and others hold. Such decision should have consequences in the administrative forces. Such decision might point up the serious necessity for the Government in its audit procedure to pursue all the tax consequences of a given transaction on all possible parties.

Tax administration in my experience is not confined to government personnel. Every tax adviser is involved in tax administration. When a lawyer plans a transaction in its initial stages, he may do so with the view of minimizing taxes for his clients, but he also seeks to have his client pursue a reasonably safe course of action. Consequently he frequently steers his client into reporting and paying taxes his client might otherwise neglect. The case before us is precisely in point. The facts show that the taxpayer sought no independent and competent tax advice concerning the formation of his corporation. Had the taxpayer sought such advice and followed it, a substantial amount of the "loans" would have been set up as capital contributions. To hold that we can act as tax planners will have a clear effect on tax advisers. Their tax planning will not only be directed to minimizing proper taxes, but to seeing to it that the transaction is arranged so as to give the taxpayer two chances at tax reduction. First, they will set up the transaction so as to be completely tax-free because, second, the Tax Court will re-plan the transaction anyway. I am little im-
pressed with the position of judges holding, as does Judge Three, that it is sufficient to re-plan on a conservative basis, whereas a tax adviser might have arranged the transaction more favorably to the taxpayer.

I agree that like taxpayers should be similarly treated. However, I regard the tax lawyer's function as part of that like treatment. Fortunately, the taxpayer in this case had the opportunity of obtaining competent advice. That is sufficient like treatment. If, on the other hand, we hold for the Government, we encourage taxpayers to do their planning when it should rightfully be done. This will have a salutary effect on tax administration with proper credit to private counsel as well as Government personnel. Judgment for the Government.

JUDGE THIRTEEN: Because Judge Twelve has placed such importance on the function of the private lawyer, I pause to caution that his point is valid only to the extent that counsel is actually available. I have no doubt that counsel is available to a taxpayer such as the one before us where there is money to employ competent lawyers. There may be other cases before us, or before other courts, where it may not be so evident that counsel is available, though I am mindful of the activities of various bar associations to provide legal guidance for all. Judgment for the Government.

JUDGE FOURTEEN: This discussion has gone far afield. Judgment should be for the Government without resort to discussion of any function of the Court to replace tax counsel. I am hopeful that no written opinions in this case will allude to the taxpayer's argument. I think it would be a mistake to give credence to it by answering it in a written opinion. There are too many words now used in judicial opinions.

JUDGE FIFTEEN: Without expressing a decision for or against either litigant, I want only to comment on Judge Fourteen's point of silence. While I would agree that perhaps some way should be found to lighten the load of those who read cases and those who buy law books, I do not concur in an attitude which fails to give written expression to sincere argument of counsel. Our duty is to decide the case before us and to give answer to points forthrightly made to us. Regardless of the decision reached, I hope that counsel's argument will be fully expressed in the written opinions.

CHIEF JUDGE: I think each of us should reconsider his point of view taking into account the total discussion that has taken place. I, for one, would like the opportunity to evaluate all the points made before coming to a decision. I should say that I probably cannot at this time add any new point to those already made.

Adjourned for further consideration.