*2 T.C. 460 (1943)*

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A foreign corporation formed solely to avoid U.S. taxes can be disregarded, and the liquidation of a U.S. corporation to that foreign entity will be attributed directly to the individual taxpayer, thus subjecting the taxpayer to U.S. income tax.

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**Summary**

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Hay, a U.S. citizen, sought to avoid U.S. estate taxes by becoming a Canadian citizen and transferring his shares in a U.S. corporation (Hay, Ltd.) to a Bahamian corporation (Colonial), which he also owned. Colonial then liquidated Hay, Ltd. The Tax Court held that Colonial was a sham entity created solely for tax avoidance purposes and disregarded it. The liquidation of Hay, Ltd., was therefore attributed directly to Hay, making him liable for U.S. income tax on the liquidation proceeds. The court emphasized that the liquidation was pre-planned and that Colonial served no legitimate business purpose.

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**Facts**

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Hay, a U.S. citizen, owned all the shares of Hay, Ltd., a California corporation. To avoid U.S. estate taxes, Hay became a Canadian citizen on June 17, 1937, making him a non-resident alien. He then formed Colonial, a Bahamian corporation, and transferred his Hay, Ltd. shares to Colonial in exchange for Colonial stock. Four months later, Colonial liquidated Hay, Ltd., receiving its assets. Hay admitted that liquidating Hay, Ltd., was part of his original plan. The liquidation was prompted by concerns about potential taxes on personal holding company surpluses.

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**Procedural History**

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The Commissioner of Internal Revenue determined that Hay was liable for income tax on the liquidation of Hay, Ltd. Hay petitioned the Tax Court, arguing that the gain should be treated as a non-taxable exchange of property outside the U.S. The Tax Court ruled in favor of the Commissioner, disregarding the Bahamian corporation and treating the liquidation as if it had been made directly to Hay.

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**Issue(s)**

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Whether the formation of a foreign corporation and the subsequent liquidation of a domestic corporation into the foreign corporation should be disregarded for tax purposes when the primary purpose is tax avoidance?

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**Holding**

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Yes, because the Bahamian corporation served no legitimate business purpose other than tax avoidance and should be disregarded. The liquidation of the U.S. company is attributed directly to the individual taxpayer as if the foreign corporation did not exist.

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**Court’s Reasoning**

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The court applied the principle that a corporation can be disregarded for tax purposes if it is a mere sham or conduit without a legitimate business purpose. Citing cases like *Gregory v. Helvering* and *Higgins v. Smith*, the court emphasized that the mere existence of a corporation is not enough to insulate a taxpayer from tax liability if the corporation is used solely to avoid taxes. The court stated that the all-important requirement for recognizing the corporation as a separate taxable entity is that its purpose must be “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 a business by the corporation.” The court found that Colonial was formed solely to minimize taxation, which is not the equivalent of business activity. The court also reasoned that the liquidation of Hay, Ltd., was a

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unilateral act of the corporation, occurring in California, and therefore the gain was derived from sources within the United States, regardless of the fact that the

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