***Electric Ferries, Inc. v. Commissioner, 16 T.C. 792 (1951)***

A corporation can be taxed on income when a third party makes payments directly to the corporation's stockholder, if those payments are pursuant to an arrangement where the corporation gives rights to the third party in exchange for that consideration.

**Summary**

Electric Ferries, Inc. ("Electric Ferries") managed and controlled the petitioner corporation, also named Electric Ferries, Inc. (the "Ferry Company"). Electric Ferries made payments directly to the Ferry Company's sole stockholder pursuant to an agreement where it leased the management and control of the Ferry Company. The Commissioner argued these payments should be included in the Ferry Company's gross income. The Tax Court agreed, holding that the payments constituted income to the Ferry Company because they were part of a contractual arrangement where the Ferry Company granted rights to Electric Ferries. The court also found reasonable cause for the Ferry Company's failure to file timely excess profits tax returns, as it relied on professional advice.

**Facts**

The Ferry Company owned and operated a ferry service. In 1939, it entered into an agreement with Electric Ferries, Inc., and its sole stockholder. The agreement, as amended over time, effectively gave Electric Ferries, Inc., the management and control of the Ferry Company's operations, including its physical assets and franchise. In exchange, Electric Ferries, Inc., made payments directly to the Ferry Company's sole stockholder, initially based on a percentage of gross income, and later as a fixed annual rental. Electric Ferries, Inc., also received management fees, charter hire, and dividends related to its operation of the Ferry Company.

**Procedural History**

The Commissioner of Internal Revenue determined deficiencies in the Ferry Company's income and declared value excess profits taxes for the years 1939-1943, including amounts paid directly to the stockholder as income to the Ferry Company, and assessed penalties for failure to file excess profits tax returns. The Ferry Company petitioned the Tax Court for a redetermination of these deficiencies. The Tax Court addressed whether the payments made directly to the stockholder constituted taxable income to the Ferry Company and whether the penalty for failure to file excess profits tax returns was justified.

**Issue(s)**

1. Whether payments made by Electric Ferries, Inc., directly to the Ferry Company's sole stockholder, pursuant to a management and control agreement, constitute taxable income to the Ferry Company.

© 2025 SCOTUSreports.com. All rights reserved. 

2. Whether the Ferry Company's failure to file timely excess profits tax returns was due to reasonable cause.

**Holding**

1. Yes, because the payments were part of a contractual arrangement where the Ferry Company gave rights to Electric Ferries, Inc., in exchange for consideration paid directly to the stockholder.

2. Yes, because the Ferry Company relied in good faith on the advice of a qualified accountant who determined that the payments to the stockholder did not constitute taxable income, and therefore, the filing of excess profits tax returns was not necessary.

**Court's Reasoning**

The court reasoned that the arrangement between the Ferry Company and Electric Ferries, Inc., was "of the general nature of a lease," where the Ferry Company effectively leased the management and control of its operations to Electric Ferries, Inc. Even though the payments were made directly to the stockholder, they were consideration for the rights granted by the Ferry Company to Electric Ferries, Inc. The court relied on the principle established in *Lucas v. Earl*, 281 U.S. 111 (1930), and *United States v. Joliet & C. R. Co.*, 315 U.S. 44 (1942), that a taxpayer may be charged with income paid directly to another pursuant to a prior arrangement. The court emphasized that the Ferry Company owned valuable assets, including an unassignable franchise, and that the rights conferred upon Electric Ferries, Inc., could not exist without the Ferry Company's continued operation. The stockholder's right to receive the payments was "derivative in origin" as in the *Joliet* case. As for the penalty, the court found that the Ferry Company acted in good faith, relying on the advice of a qualified accountant. The court distinguished this case from others where reasonable cause was not found, highlighting the accountant's qualifications and the complexity of the tax issue.

**Practical Implications**

This case illustrates that the IRS can look beyond the form of a transaction to its substance when determining tax liability. Corporations cannot avoid tax obligations by arranging for payments to be made directly to their stockholders if those payments are effectively consideration for the corporation's assets or rights. It reinforces the principle that income is taxed to the entity that controls the earning of that income. The case also provides guidance on what constitutes "reasonable cause" for failure to file tax returns, emphasizing the importance of seeking and relying on professional tax advice. This case is relevant to situations involving closely held corporations, leasing arrangements, and transactions between related parties. Later cases may cite this to address the assignment of income doctrine and the importance of economic substance over form in tax law.

© 2025 SCOTUSreports.com. All rights reserved. 