***Sherin Mfg. Co. v. Commissioner*, 13 T.C. 446 (1949)**

A corporation is not necessarily taxable on income derived from illegal or unauthorized activities of its officers if the corporation did not authorize the activities, did not directly or indirectly receive the income, and repudiated the actions upon discovery.

Summary

Sherin Mfg. Co. was assessed deficiencies and fraud penalties related to unreported income from over-ceiling price sales facilitated by its sales agent, Biehl, with the knowledge of the corporation's president, Berger. The Tax Court held that the corporation was not liable for tax on this income because it did not authorize or receive the funds. The court found Berger liable for fraud penalties due to his failure to report his share of the over-ceiling payments on his original return. The court also addressed depreciation rates, equity invested capital, interest expenses, and travel/entertainment expenses, making adjustments based on the evidence presented.

Facts

Ernest Biehl, a sales agent for Sherin Mfg. Co., made agreements with seven customers to secure preferential treatment in exchange for payments exceeding OPA ceiling prices. Berger, the president of Sherin Mfg. Co., approved this arrangement and received 90% of the profits from Biehl in cash. Sherin, the other 50% owner of the company, was unaware of the arrangement and disavowed it upon discovery. The corporation's books did not reflect these transactions; standard contracts reflecting only ceiling prices were used. Berger did not initially report the income received from Biehl on his personal tax return.

Procedural History

The Commissioner of Internal Revenue determined deficiencies and fraud penalties against Sherin Mfg. Co. and Berger. Sherin Mfg. Co. and Berger petitioned the Tax Court for a redetermination. The Tax Court reviewed the Commissioner's determinations regarding unreported income, fraud penalties, depreciation, equity invested capital, interest expense, and travel/entertainment expenses.

Issue(s)

1. Whether Sherin Mfg. Co. is taxable on the amounts exceeding OPA ceiling prices received by Biehl and paid to Berger.

2. Whether Berger is liable for fraud penalties for failing to report income received from Biehl on his original tax return.

3. Whether the Commissioner properly adjusted the depreciation rate on the

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corporation’s machinery and equipment.

4. Whether the corporation can increase its equity invested capital based on stock issued for unpaid salaries.

5. Whether the corporation correctly calculated interest paid on borrowed capital.

6. Whether the corporation’s claimed travel and entertainment expenses were reasonable.

7. Whether the Commissioner correctly disallowed a portion of a partnership’s travel and entertainment expenses.

Holding

1. No, because the corporation did not authorize the illegal arrangements, did not receive the income directly or indirectly, and repudiated the actions upon discovery.

2. Yes, because Berger’s original income tax return for 1941 was false and fraudulent, filed with intent to evade tax.

3. No, because the corporation failed to demonstrate that increased usage and other operating conditions actually shortened the remaining useful life of the assets, justifying abnormal depreciation.

4. Yes, because the stock was issued for unpaid salaries and accounted for as income by Berger and Sherin.

5. The court determined specific amounts for interest paid in 1940 and 1941 based on the record.

6. The court found that $2,000 was a reasonable allowance for such expenses, adjusting the Commissioner’s determination.

7. No, because the record did not justify disturbing the respondent’s action.

Court’s Reasoning

The court reasoned that the corporation could not be held responsible for Berger’s actions because the corporation itself never authorized the illegal arrangements nor did it receive any of the proceeds directly. The court emphasized that command over income is a primary test of taxability, and in this case, the corporation never had such command. Regarding the fraud penalty, the court followed Aaron Hirschman, 12 T.C. 1223, holding that filing amended returns does not eliminate fraudulent elements from the original returns. Berger’s amended return, filed after the OPA settlement, was seen as an admission that the funds should have been reported in the original return. The court found Berger’s claim of believing the

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arrangement was a joint venture unconvincing, especially since Biehl reported his share of the income in both years. Regarding depreciation, the court cited Copifyer Lithograph Corporation, 12 T. C. 728 to emphasize the need to show actual shortening of asset life to justify accelerated depreciation under the straight-line method. The remaining issues were resolved based on factual determinations from the record.

Practical Implications

This case illustrates that a corporation will not automatically be held liable for the unauthorized and illegal actions of its officers. For tax purposes, the key is whether the corporation authorized, benefited from, or ratified the actions. This decision provides a defense for corporations where officers act outside their authority and against the corporation's interests. It also reinforces that filing amended returns after detection of fraud does not absolve a taxpayer of fraud penalties on the original fraudulent return. It also underscores the importance of substantiating claims for accelerated depreciation with concrete evidence demonstrating a shortening of the asset's useful life.

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