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

A transaction, even if structured to comply with the literal terms of the law, is not effective for tax purposes if it lacks economic substance and serves no business purpose other than tax avoidance.

Summary

The Supreme Court held that a corporate reorganization, structured solely to avoid tax liability and lacking any legitimate business purpose, was a sham transaction and therefore ineffective for tax purposes. The taxpayer, Mrs. Gregory, owned all the stock of a corporation (the original corporation) that held shares in another company. To extract these shares without incurring a tax liability, a new corporation was created, the shares distributed to Mrs. Gregory, and then the new corporation was immediately dissolved, distributing the shares to her. The Court determined that while the steps taken technically complied with the statutory definition of a reorganization, they lacked economic substance and were therefore disregarded for tax purposes. The Court emphasized that the transaction's sole purpose was tax avoidance, with no other business reason for its existence.

Facts

Mrs. Gregory owned all the stock of the United Mortgage Corporation, which in turn held 1,000 shares of stock in the Monitor Securities Corporation. Mrs. Gregory wanted to transfer the Monitor shares to herself without paying taxes on a dividend distribution. To achieve this, she caused the United Mortgage Corporation to create a new corporation, the Averill Corporation. United Mortgage then transferred the Monitor shares to Averill in exchange for all of Averill's stock. Averill was then dissolved, and its assets, including the Monitor shares, were distributed to Mrs. Gregory. The entire transaction was completed within a week, and Averill never engaged in any business activity beyond this single transaction.

Procedural History

The Commissioner of Internal Revenue assessed a deficiency against Mrs. Gregory, arguing that the distribution of the Monitor shares was taxable as a dividend. The Board of Tax Appeals (now the Tax Court) sided with the Commissioner. The Second Circuit Court of Appeals affirmed the Board's decision. The Supreme Court granted certiorari.

Issue(s)

Whether the creation and dissolution of the Averill Corporation constituted a "reorganization" as defined by the Revenue Act of 1928, thereby allowing Mrs. Gregory to receive the Monitor shares tax-free.

Holding

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No, because the creation and dissolution of Averill was not a reorganization in substance, even though it met the literal requirements of the statute, because the transaction lacked any legitimate business purpose.

Court's Reasoning

The Supreme Court, in an opinion by Justice Sutherland, found that the transaction, while technically complying with the statutory definition of a reorganization, was a mere "device" and a "sham" devoid of economic substance. The Court emphasized that the reorganization provisions of the tax law were intended to facilitate legitimate corporate readjustments, not to serve as a vehicle for tax avoidance. The Court stated that to be considered a valid reorganization, a transaction must have a business purpose beyond the mere avoidance of tax. The Court said:

"The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted. But the question for determination is whether what was done, apart from the tax motive, was the thing which the statute intended."

The Court concluded that because Averill Corporation served no business function and was created solely to facilitate the tax avoidance scheme, it should be disregarded, and the distribution of the Monitor shares was therefore taxable as a dividend.

Practical Implications

The Gregory case established the "economic substance" doctrine, a fundamental principle of tax law. It instructs courts to look beyond the form of a transaction to its substance. This means that even if a transaction technically complies with the tax laws, it may be disregarded if it lacks economic substance and is primarily motivated by tax avoidance. This case has significant practical implications for attorneys and taxpayers, including:

1. **Structuring Transactions:** Taxpayers and their advisors must ensure that any transaction has a genuine business purpose beyond tax savings. Simply complying with the formal requirements of tax law is not enough. A transaction must also have economic substance – that is, it must meaningfully alter the taxpayer's economic position.

2. **Challenging Tax Avoidance Schemes:** The IRS uses the economic substance doctrine to challenge transactions that are designed to avoid tax liability. This case provides a key precedent for such challenges.

3. **Analyzing Similar Cases:** Courts and practitioners must analyze each transaction's business purpose and its effect on the taxpayer's economic position. Other cases have expanded on Gregory, but the core principle remains constant: form follows function, especially in the context of taxation. If the function of a

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transaction is solely to evade tax, then the transaction will fail.

4. **Legislative Impact:** Congress has attempted to codify the economic substance doctrine. The American Jobs Creation Act of 2004 introduced a penalty for underpayments attributable to transactions lacking economic substance. The Patient Protection and Affordable Care Act of 2010 strengthened the economic substance doctrine. These legislative actions illustrate the enduring importance of the Gregory decision in shaping tax law.

5. **Later Cases:** Later cases such as *ACM Partnership v. Commissioner* (9th Cir. 1998) and *United States v. Midland-Ross Corp.* (1965) further clarified the application of the economic substance doctrine.

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