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Recent Cases

TAXATION—AVOIDANCE OF PERSONAL PROPERTY TAXES THROUGH THE HOLDING OF TAX-EXEMPT SECURITIES

*State ex rel. St. Louis Union Trust Co. v. Hoehn*¹

For several years Yantis, the decedent, had withdrawn the substantial part of his bank deposits in May, the bank purchasing for his account United States Treasury Bills maturing early in June, said Treasury Bills being left with the bank with instructions to collect the face amount on maturity and deposit the proceeds to his account. These certificates were not reported as taxable property held on June 1st. The State Board of Equalization and the State Tax Commission found that Yantis did not acquire the Treasury Bills as an investment,² and that his sole purpose was to evade the taxing laws of Missouri which levied a tax on all property owned on June 1st, and held that this transaction was colorable and a fraud upon the State. The estate of the deceased was assessed for the omitted property and relator brought certiorari to quash the record. The court found a *bona fide*, rightful ownership of tax-exempt certificates and ordered the record quashed.

The courts are unanimous in declaring that a transaction is not illegal or void³ solely because actuated by tax-avoidance motives,⁴ yet presence of such

1. 351 Mo. 382, 173 S. W. (2d) 393 (1943).

2. The Commission seemed influenced by the fact that Yantis received no income from the certificates but as the court said, "Of course, relator's bank account did not produce any income either."; *id.* at 387, 173 S. W. (2d) 395.

3. *Stilwell v. Corwin*, 55 Ind. 433, 437 (1876) (Bank depositor surrendered deposit certificate in exchange for a note by which the bank agreed to hold U. S. bonds and to give them to him on demand. Depositor's administrator sues on the note, the defense being that this was a fraudulent attempt to evade taxation. Held: Agreement not void, for "Any person has a right to exchange money on deposit in a bank for bonds on the United States, at any time, even if the express purpose in the transaction was to exchange money which was taxable, for bonds which were not taxable"); *Berridge v. Gaylord*, 108 Kan. 105, 193 Pac. 1066 (1920) (Defense to suit on note and mortgage was that payee on note was made one other than creditor in order for latter to avoid taxes. Payee had assigned note to true creditor who then sued. Defense not sustained.); *Nance v. Merchants' Fertilizer and Phosphate Co.*, 200 N. C. 702, 158 S. E. 486 (1931) (In suit for negligently killing hogs the defense was that the plaintiff had not returned the hogs as taxable property. Defense not allowed.); Note (1939) 118 A. L. R. 1175.

4. *Iowa Bridge Co. v. Commissioner of Internal Revenue*, 39 F. (2) 777 (C. C. A. 8th, 1930) (Income tax case—even though transaction was to avoid taxation it isn't for that reason alone illegal); Board of Commissioners of City of Hoboken v. State Board of Taxes and Assessments, 107 N. J. Law 35, 151 Atl. 364 (1930), *aff'd*, 108 N. J. Law 195, 156 Atl. 377 (1931); *People ex rel. Thurman v. Ryan*, 88 N. Y. 142 (1882); *see United States v. Isham*, 17 Wall. 496, 21 L. Ed. 728 (1873); *Shotwell v. Moore*, 129 U. S. 590, 9 Sup. Ct. 362 (1889); *Lantz v. Hanna*,

motives prompts all courts to scrutinize a case more closely to ascertain whether it has "crossed the line," ceasing to be tax avoidance and becoming tax evasion. But as with all cases involving varying degrees of right or wrong, it is impossible to make a sharp distinction between the permissible and the non-permissible. "We do not speak of evasion, because, when the law draws a line, a case is on one side of it or the other, and if on the safe side is none the worse legally that a party has availed himself to the full of what the law permits. When an act is condemned as an evasion, what is meant is that it is on the wrong side of the line indicated by the policy if not by the mere letter of the law."⁵

A common method of minimizing taxes is the holding of tax-exempt securities on tax assessment day, but such a policy subjects the property owner to the scrutiny of the authorities when the securities are held for a short time only, being purchased immediately preceding tax day and sold immediately thereafter. The court is then confronted with a difficult choice for on the one hand the statute requires that the tax be computed on the basis of taxable property held on tax day and it is apparent that the taxpayer held none, yet on the other hand it is evident that this was a manipulation with the sole purpose of avoiding taxation. Which factor should be the determining one?⁶ The majority of the courts, feeling

111 Kan. 461, 207 Pac. 767 (1922); *Commonwealth v. Harris*, 118 S. W. 294 (Ky. 1909); *Holly Springs Savings and Insurance Co. v. Marshall County*, 52 Miss. 281, 289 (1876) ("We must not be understood as holding that government bonds are taxable merely because the motive for their purchase was to escape taxation. Neither do we intimate that they must be held for any particular time, or be bought with any intention of holding them for any period whatever. They may be bought solely because of their non-taxable character and disposed of at the very earliest practicable moment, and such purchase will not subject them to taxation." The Missouri court in the instant case relied strongly on this argument); *State ex rel. Orr v. Buder*, 308 Mo. 237, 271 S. W. 508 (1925); *Wachovia Bank and Trust Co. v. Nash County*, 196 N. C. 704, 146 S. E. 861 (1929); *Robert Jemison, Jr., as Trustee of Forest Park Realty Co.*, 3 B. T. A. 780, 803 (1926) (Income tax case—"The fact that by the procedure taken the corporation avoided a tax is not sufficient reason, in the absence of proof of fraud, to hold the transaction other than what it actually was.").

*5. *Bullen v. Wisconsin*, 240 U. S. 625, 630, 36 Sup. Ct. 473, 474 (1916); *United States v. Wurzbach*, 280 U. S. 396, 399, 50 Sup. Ct. 167, 169 (1930) ("Wherever the law draws a line there will be cases very near each other on opposite sides. The precise course of the line may be uncertain, but no one can come near it without knowing that he does so, if he thinks, and if he does so, it is familiar to the criminal law to make him take the risk.") PAUL, *STUDIES IN FEDERAL TAXATION* (1937).

6. Cases wherein taxation was not sustained although taxpayer's intention was apparent: *United States v. Isham*, 17 Wall. 496, 21 L. Ed. 728 (1873) (Isham used an instrument similar to a promissory note but which wasn't one in form. Tax on promissory notes did not apply.); *City of Dallas v. Higginbotham-Bailey-Logan Co.*, 37 F. (2d) 513 (C. C. A. 5th, 1930) (part of the business policy); *Commonwealth v. Harris*, 118 S. W. 294 (Ky. 1909) (not shown that government bonds were later sold although decision doesn't hinge on this); *Dixon County v. Halstead*, 23 Neb. 697, 37 N. W. 621 (1888) (no showing of intention to sell shortly); *Board of Commissioners of Hoboken v. State Board of Taxes and Assess-*

that the taxpayer's responsibility of carrying his proportionate share of the government costs should not be dodged in such an open-faced manner, find (a) this is a fraud against the state,⁷ (b) that this is a colorable transaction,⁸ (c) or that there was not a bona fide purchase and sale.⁹

In such cases, however, the fact remains that the taxpayer actually owns tax-exempt property on assessment day. Who can say whether or not fraud is present? How long must a taxpayer own such securities before he can dispose of them without being guilty of a "colorable" transaction? When is the purchase of government bonds bona fide? What of one who purchases tax-exempt bonds on May 31st, intending to make a permanent investment, yet is forced to convert them into cash early in June due to unexpected contingencies? What standard can be established by which we can determine who shall be exempt from taxation of his government securities, and who shall not be exempt due to his fraud in purchasing the bonds solely for the purpose of tax evasion?

It is clear that if there is not a bona fide purchase of tax-exempt securities, no exemption can be claimed. "Not bona fide" is often loosely used as a "catch all" for situations in which it is felt that the taxpayer should not be permitted to avoid taxation through such an artificial investment. It seems, however, that a transaction is not bona fide wherein the taxpayer makes an agreement with his bank whereby a few days prior to tax day it is to charge his account for the pur-

ments, 107 N. J. Law 35, 151 Atl. 364 (1930), *aff'd*, 108 N. J. Law 195, 156 Atl. 377 (1931); *Wachovia Bank and Trust Co. v. Nash County*, 196 N. C. 704, 146 S. E. 861 (1929).

7. *Automobile Acceptance Corporation v. Hopkins*, 121 Cal. App. 168, 8 P. (2d) 509 (1932); *In re People's Bank of Vermont*, 203 Ill. 300, 67 N. E. 777 (1903) (court placed emphasis on the fact that the bank never had physical possession of the bonds); *Holly Springs Savings and Insurance Co. v. Marshall County*, 52 Miss. 281, 288 (1876) ("... fraud vitiates everything into which it enters, and nullifies the advantages which fair dealing would have conferred"); *Jones v. Seward County*, 10 Neb. 154 (1880); *Poppleton v. Yamhill County*, 8 Ore. 338 (1880) (\$12,000 in notes assigned to secure a note of \$1,000 in another county. Court found the security too disproportionate and that this was a fraud against the assessing county); *Highland Park Independent School Dist. of Dallas County v. Republic Insurance Co.*, 80 S. W. (2) 1053, 1061 (Tex. Civ. App. 1934) ("If such bonds were purchased with the sole intent of evading taxation, then such an action would be fraudulent and render said sum subject to taxes.")

8. *Board of Commissioners of City of Hoboken v. State Board of Taxes and Assessments*, 107 N. J. Law 35, 151 Atl. 364 (1930) (spoke of cited cases as involving colorable transactions which are not genuine and without reservation); *Holly Springs Savings and Insurance Co. v. Marshall County*, 52 Miss. 281 (1876) (the court will investigate whether the holding of securities is colorable only).

9. *Holly Springs Savings and Insurance Co. v. Marshall County*, 52 Miss. 281 (1876) (the court investigates to see whether the holding of government bonds is bona fide); *cf. Commonwealth v. Harris*, 118 S. W. 294, 295 (Ky. 1909) (The court found a bona fide transaction but said, "Of course, if the evidence had shown that the defendant only made a pretended sale of his bonds for the purpose of hiding them and escaping taxation, undoubtedly they could be assessed in his hands as omitted property.")

chase price of bonds, said bonds being "sold" to him from the bank's portfolio and then being "purchased" back a few days after tax day—the entire transaction being accomplished by bookkeeping entries.¹⁰ Less predictable cases arise when there is no pre-arranged agreement with the bank and as far as it knows the depositor actually purchased the securities for investment purposes and only when he later sells them back to the bank is it advised of the true nature of the transaction. Even then, the majority of the courts find there is no "bona fide" purchase.¹¹

One degree further removed is the instant case for although there was a pre-arranged plan with the bank, it was not that the bank should "sell" and "buy" the bonds with bookkeeping entries. Yantis had the bank buy the bonds, directing it to hold them until their redemption date, dispose of them, and credit his account with the proceeds. Admitting that it was not a coincidence that the bonds matured shortly after June 1st, the fact remains that Yantis had actually purchased them and could not have held them longer had he so desired. "Here the only reason Yantis received money for these bonds, when he did, was because the United States Government had issued non-taxable bonds maturing so soon

10. No case involving property taxes has been found which clearly illustrates this type situation. *Stimson v. Commissioner of Internal Revenue*, 55 F. (2d) 815 (C. C. A. 8th, 1932), *cert. den.*, 286 U. S. 555, 52 Sup. Ct. 579 (1932) (is in point as to facts, but income tax is concerned and the court found an absolute sale of taxable securities and a valid purchase of government bonds); *Stilwell v. Corwin*, 55 Ind. 433 (1876) (similar facts but case involved suit on written promise of bank to deliver the government bonds to its depositor on demand); *Automobile Acceptance Corporation v. Hopkins*, 121 Cal. App. 168, 8 P. (2d) 509 (1932) (not as obvious as a mere bookkeeping entry but the court pointed out that the banks knew the purpose of the company since they allowed it to borrow on unsecured notes so as to comply with the statute in question); *Whiting Finance Co. v. Hopkins*, 115 Cal. App. 756, 2 P. (2d) 461 (1931) (involved the same facts as the *Automobile Acceptance Corporation* case); *See State ex rel. St. Louis Union Trust Co. v. Hoehn*, 351 Mo. 382, 389, 173 S. W. (2d) 393, 396 (1943) (This court indicates that such a transaction would not be bona fide by saying that Yantis wouldn't be liable unless he still owned the bank deposit and "That could only be true if there were some strings attached to the deal by some understanding that it was not an actual purchase and sale but was in fact some other kind of transaction.")

11. *Mitchell v. Board of Commissioners of Leavenworth County*, 91 U. S. 206, 208 (1875) (Mitchell withdrew cash from bank, purchased greenbacks, sealed them in an envelope, left them in bank vault, and after tax day, deposited the greenbacks. While cited as authority for and against this type transaction, all the case can be said to hold is that "a court of equity will not knowingly use its extraordinary powers to promote such a scheme, etc."); *Shotwell v. Moore*, 129 U. S. 590, 9 Sup. Ct. 362 (1889); *Durham v. State ex rel. Anderson*, 6 Ind. App. 23, 32 N. E. 104 (1892); *Crowder v. Riggs*, 153 Ind. 158, 53 N. E. 1019 (1899); *Jones v. Seward County*, 10 Neb. 154 (1880) (While there doesn't appear to have been any prior understanding with the purchasing agency, this seems to be a transaction which could have been handled by bookkeeping entries only); *Wachovia Bank & Trust Co. v. Nash County*, 196 N. C. 704, 146 S. E. 861 (1929) (bought and sold the bonds on the open market—transaction upheld as valid).

after June 1st, 1941. Certainly it was not illegal or improper to buy them because of that fact."¹²

Although no infallible rule can be developed whereby one can predict whether there has been a bona fide purchase of tax-exempt securities which will not be a fraud against the state, certain factors which have motivated the courts in their decisions are discernible:

1. It may be felt that an essential source of governmental revenue is obtained through borrowing and that "Investors are . . . induced to buy government bonds, notwithstanding the fact that they bear interest at a less rate than other sound investments. These investors rely upon the integrity of the statutory provisions exempting such bonds from taxation. Good faith to purchasers and holders of such bonds demands that the integrity of these statutory provisions . . . shall not be impaired by . . . judicial construction."¹³ To tax such bonds after the issuing authority has declared them to be tax-exempt would impair the credit of the borrower and directly increase the tax burden.

2. Frequently the purchase of tax-exempt securities does not deprive the state of any tax revenue since the purchase is from some individual or financial institution in whose hands the bonds were not assessable but who will be assessed on the cash received from the sale of the bonds.¹⁴ If, however, the purchase was

12. *State ex rel. St. Louis Union Trust Co. v. Hoehn*, 351 Mo. 382, 389, 173 S. W. (2d) 393, 396 (1943).

13. *Wachovia Bank and Trust Co. v. Nash County*, 196 N. C. 704, 707, 146 S. E. 861, 862 (1929); *Lantz v. Hanna*, 111 Kan. 461, 207 Pac. 767 (1922); GRAY, *LIMITATIONS OF TAXING POWER* (1906) § 755 (tax on possession of government bonds makes them less desirable and impairs borrowing power of the federal government); *See Pullen v. Corporation Commission*, 152 N. C. 524, 540, 68 S. E. 155, 163 (1910) (Concurring opinion: Bank purchased state bonds at a large premium, relying upon a statute authorizing their deduction from surplus in valuing capital stock. ". . . good faith and fair dealing require" that the court allow the bank to deduct these bonds); *cf. Holly Springs Savings and Insurance Co. v. Marshall County*, 52 Miss. 281, 289 (1876) ("It is urged, however, that the non-taxability of the national securities is guaranteed by the federal government; that their exemption from taxation constitutes one of the main ingredients of their value, and that this cannot be infringed by the state . . . yet . . . there remains power in the courts to investigate whether the holding is actual and bona fide, or colorable only, and fraudulent . . . the courts will look through the sham, and measure the rights of the parties by the real nature of the transaction.")

14. *Commonwealth v. Harris*, 118 S. W. 294, 295 (Ky. 1909) ("The commonwealth loses nothing by a bona fide transfer of property, although the transfer may be made just before assessment day, etc."); *State ex rel. Orr v. Buder*, 308 Mo. 237, 271 S. W. 508 (1925) (says that the state would gain nothing by taxing the securities for then the company could not afford to hold them and would dispose of them to persons who could hold them as non-taxable); *Wachovia Bank and Trust Co. v. Nash County*, 196 N. C. 704, 146 S. E. 861 (1929) (changing of ownership doesn't relieve the owner of the taxable property on tax day from the liability of taxes); *cf. Holly Springs Savings and Insurance Co. v. Marshall County*, 52 Miss. 281 (1876) (Court fears that the bankers of the country can shift tax-exempt securities from city to city so as to meet tax day in each state and thus

from a bank which is assessed on its average taxable holdings while the individual is taxed on his property as of the one day, the state will be deprived of revenue and the court may feel justified in finding fraud against the state.

3. The business of the taxpayer may be such that it is to his advantage to own tax-exempt securities for a short time extending over tax day in order to: (a) avoid taxation, (b) earn more interest than a bank could pay, (c) and still have readily-liquidated assets available. While tax avoidance is one motivating factor it is not the sole consideration and the court will be justified in finding a bona fide ownership of the securities.¹⁵

4. Should there be a statute declaring one to be liable for a penalty if he temporarily converts his personal property into nontaxable property for the fraudulent purpose of evading the payment of taxes the court can follow the statute literally, not taxing the tax-exempt securities but assessing a penalty against their owner for his fraudulent purpose.¹⁶

A conflict of interests arises when through a pre-arranged plan with his bank a taxpayer disposes of taxable securities (at a profit) shortly before tax day, purchasing tax-exempt United States bonds with the proceeds, selling said bonds through the same bank and repurchasing at the "sales" price the very same taxable securities a few days after tax day—the bank accomplishing the entire transaction by means of bookkeeping entries. Since the tax avoidance purpose is obvious a court might find that this was not a bona fide transaction and that the taxpayer is subject to personal property taxes. But if suit were not for property taxes but

deprive the state of income and at the same time not benefiting the federal government since only a proportionately few bonds would be necessary). It must be remembered that some bonds are purchased direct from the government and so the cash will not be in a position to be assessed on tax day.

15. *City of Dallas v. Higginbotham-Bailey-Logan Co.*, 37 F. (2d) 513, 515 (C. C. A. 5th, 1930) (Operator of large mercantile business made large collections in the fall and purchased government bonds before tax day, selling them later to retire outstanding obligations incurred when cash had been borrowed with which to take advantage of cash discounts offered. Since several factors were present it was said, "We do not think a court would be justified in concluding that the sole purpose was to defraud the city of its revenue.") Some courts have taxed bonds held for a short time if it was clear they were not purchased in the line of business: *Whiting Finance Co. v. Hopkins*, 115 Cal. App. 756, 2 P. (2d) 461 (1931) (Finance company was taxed on solvent credits with an allowed deduction of outstanding debts. It borrowed large sums from banks, purchased government bonds, deducted the debts from credits, and claimed exemption from taxation on the intangible property. Court found that the transaction involved an immediate financial loss and clearly was not in the line of business of the investment company); *Automobile Acceptance Corp. v. Hopkins*, 121 Cal. App. 168, 8 P. (2d) 509 (1932).

16. *Durham v. State ex rel. Anderson*, 6, Ind. App. 23, 32 N. E. 104 (1892) (The action wasn't to tax treasury notes but was to recover a statutory penalty for tax evasion).

for income taxes instead, would the court be justified in taxing as income the capital gain realized on the "sale" of the taxable securities?¹⁷

The necessity of distinguishing between evasion and avoidance is disposed of when the individual is assessed on the average amount of taxable property held during the year,¹⁸ and the problem is greatly lessened when intangibles are taxed only in proportion to their income-producing ability, thus eliminating the urge to resort to devious schemes as heretofore discussed. Missouri has recently adopted the latter plan in its new constitution which provides, "and the tax shall be based on the annual yield and shall not exceed eight per cent thereof."¹⁹

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17. *Stimpson v. Commissioner of Internal Revenue*, 55 F. (2d) 815 (C. C. A. 8th, 1932), *cert. den.*, 286 U. S. 555, 52 Sup. Ct. 597 (1932) (The court found an actual sale resulting in a taxable gain despite petitioner's contention that there was no sale because the bank had no power to make a sale to itself. The court took judicial notice of the fact that the United States bonds weren't taxable by Missouri on June 1st, thus indicating her intention but, "Consideration of this statute in connection with the facts disclosed in the record does not raise an ugly imputation against petitioner as her counsel suggests. Actual sale of property prior to the incidence of a tax thereon is not illegal, even though the sale is made in order to avoid liability for the tax.")

18. *Shotwell v. Moore*, 129 U. S. 590, 598, 9 Sup. Ct. 362, 364, (1889) (Ohio statute authorized assessment on basis of average taxable holdings. "So far as we can see, the statute which does this does not tax the citizen for the greenbacks which he may have held at any time during the year, but taxes him upon the money, credits, or other capital which he has had and used, according to the average monthly amount he has so held"); *Lantz v. Hanna*, 111 Kan. 461, 207 Pac. 767 (1922) (Kansas had a statute which taxed on average taxable holdings during the year but it was held unconstitutional as denying equal protection since amounts invested in state and local tax-exempt securities held on tax day were completely exempted.) The Missouri court in the instant case directs attention to the fact that the "period" method is used in assessing merchants but that "The Legislature has not seen fit to apply it to property taxes and neither the executive nor judicial branch of the Government may do so," 351 Mo. 382, 392, 173 S. W. (2d) 393, 397 (1943).

19. Mo. CONST. 1945, Art. X, § 4.