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Herman M. Knoeller

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COMMENTS ON THE 1936 SURTAX ON UNDISTRIBUTED CORPORATE EARNINGS

HERMAN M. KNOELLER

IN this day there is a constantly growing social demand upon the government for action to protect and promote the individual and collective interests of its citizens. This pressing social demand is bound to be reflected by an expanding field of governmental activity in all the social sciences, and in the law itself.

These impelling demands made by the various interests of society upon the present government enlarge the public functions and manifest themselves in greater taxation. Comparative studies, cumulative figures, statistical charts and graphs showing among other things the staggering increase in national debt over a period of years, the mounting annual government deficits, the alleged wild public expenditures, and the enormous public revenues are often times not only worthless but grossly misleading when they are not properly explained and qualified from a social point of view. This is especially true when they are judged solely from motives of profit rather than public service. All that the fair and socially minded business man demands today is that the necessary taxes for the administration of the government be equitably apportioned among the citizens according to their ability to pay without destroying or impeding the development of American industry. Full sympathy exists with the view of the President regarding the problem of the unscrupulous individual's avoidance (sometimes evasion) of his just surtaxes by withholding corporate dividends. But the serious question is whether the new graduated surtax on the corporation's undistributed earnings is a solution to this problem, or, instead, an economically unsound principle resulting in gross injustice when applied generally under hard and fast rules of mathematical averages or percentages.

What are the facts? Commissioner Guy T. Helvering testified before the Senate Finance Committee on April 30, 1936,[1] in respect to the proposed 1936 Revenue Act and submitted schedules in support of his testimony showing the compiled net profit, reinvested current earnings, and the ratio of the reinvested earnings to the compiled net profits of the corporations for the years 1923 to and including 1933. Of course, his testimony and schedules were based upon the tax returns of the corporations reporting a net income. From an examination of the submitted schedules it appears that for 1923, 49 per cent of the compiled net corporate profits were reinvested whereas in 1932 only four and eight-tenths per cent of the net corporate profits were reinvested. The figures for 1933 showed a corporate compiled net profit amounting to three billion five hundred and eighty million dollars of which seven hundred and seventy-eight million dollars or twenty-one and seven-tenths per cent were reinvested by the corporations. The average ratio of reinvested current earnings of corporations to the compiled net corporate profits for the aforesaid eleven years was computed at thirty and seven-tenths per cent. Great importance was attached to this elusive figure and mathematical average.

As the 1936 Revenue Act emerged from the Conference Committee and eventually became law[2] we find therein no flat corporation tax rate upon the distributed or undistributed net income comparable to the average rate of the combined normal and surtax rates imposed upon an individual stockholder if all his corporate earnings were distributed. We find a stockholder taxable individually for dividends received at a normal tax rate of four per cent and a surtax rate ranging from four per cent on the first $2,000 of surtax net income in excess of $4,000 to 75 per cent on surtax net income in excess of five million dollars. We find the corporation taxed for the very same profits represented by the dividends later declared and paid. It is subject to a graduated normal tax rate ranging from eight per cent to 15 per cent on the net taxable income and (for the year in which the profits were retained) a graduated surtax on undistributed corporate profits ranging from seven per cent to 27 per cent of the portion of undistributed

[1] *Hearings before Senate Committee on Finance on H. R. 12395*, 74th Cong., 2d Sess. (1936) 18.
[2] 49 STAT. 1648 (1936).

net income not in excess of certain percentages of the adjusted net income.

Curiously enough, the deception and vice existing in the foregoing mathematical averages and percentages never seems to have been fully realized and appreciated. The income tax is distinctively a personal tax and, as Attorney Oliphant pointed out, after all is said and done, taxes must be paid and come out of the pockets of individuals irrespective of the fact that they conduct their business life in a proprietary, partnership, or corporate form. To tax the proportionate earnings of stockholders of a corporation under a flat corporation income tax rate regardless of each individual stockholder's true ability to pay (measured also by income other than corporate earnings) may often prove discriminatory and unjust when compared with the taxes imposed upon other persons deriving their income from sources other than dividends. To impose graduated corporate normal tax rates upon the proportionate earnings of each stockholder, irrespective of the size of his holdings in the corporation, increases this discrimination and injustice. Now, to superimpose a graduated surtax upon the undistributed and proportionate earnings of the stockholder regardless of the factors mentioned above is to magnify this injustice and discrimination to an alarming degree. Just as there are often large stockholders in small corporations so also are there many small stockholders in large corporations. If the large stockholders, whether in the small or large corporations, can escape paying a four per cent normal tax and as high as a 75 per cent individual surtax by withholding the corporate earnings and permitting the corporation to pay 27 per cent (the highest corporate surtax rate) on the undistributed corporate earnings, why should they not do so? The small stockholders thereby suffer a diminution in their proportionate corporate earnings. But this is not all. To accentuate the discrimination and increase the injustice against a small stockholder we now find that although a stockholder's proportional earnings in a corporation have been taxed twice to the corporation (normal and surtax on undistributed profits) as, if, and when his remaining proportional corporate earnings are distributed after the taxable year, they are again taxable for both the normal and the surtax on his individual income. This is double or triple taxation in its worst form. It is injustice with a vengeance.

Now, turning to the corporation itself and its taxable income let us inquire as to the effect of this new surtax on undistributed corporate earnings. The modern corporation has a sort of real economic entity and durability. It cannot count profit in terms of a year both from a legal and an accounting long-time point of view.[3] Mathematical aver-

[3] Arthur A. Ballantine, *Hearings before Senate Committee on Finance on H. R. 12395*, 74th Cong., 2d Sess. (1936) 434.

ages and percentages, when applied without consideration of the economic conditions of the time and the particular corporations affected again prove odious and futile. This is especially true in the durable or capital goods industries which thrive on the ephemeral peaks of prosperity and languish in the long, deep valleys of the depression. They are often termed the feast and famine industries. So long as the corporation in one single, solitary year earned one dollar of profit, it was taxable. No necessary cash exemptions whatever from the normal tax has been allowed even the smallest corporation.

As with the past, so with the future business prospects it meant little or nothing that lean future years confronted the corporation and the surplus of one year might be completely absorbed in the next few years by business losses, necessary charges for replacements, maintenance, repair, depreciation, obsolescence, and supersession of the fixed assets (machinery, tools, buildings, patterns, and patents). Also, the corporate surplus of one year might well be needed as working capital[4] in a growing infant industry or as a "corporate cushion" against financial shocks in commerce. The government did not tax the average profits of the corporations which reinvested thirty and seven-tenths per cent of their earnings from 1923 to 1933, as testified by Commissioner Helvering, but the profits, if any, of each successful year. It ignored the losses that could not be offset legally against the gains. The government was a silent partner in every business during this period of time, always sharing the profits but never suffering the losses. He will now be the uninvited guest and invisible director on the board of every private corporation casting a standing vote for the distribution of corporate profits irrespective of the peculiar financial and economic vicissitudes of the particular corporation.

Also, it must not be overlooked that true accounting net income of a corporation is not its net taxable income. The tax must be paid not *from* but *on* the corporation's net taxable income. The tax must be paid from the true accounting net income and corporation profits.[5] Thus, a corporation may have no true accounting income whatsoever, but still be forced to pay a federal tax because (a) the capital losses of a corporation are limited to only $2,000 plus its capital gains; (b) federal income, war profits, and gift taxes, taxes paid in foreign countries, and other forms of taxes are unallowable tax deductions; (c) shrinkage in market value of merchandise inventory, stocks and bonds are not allowable tax deductions until sold or otherwise disposed of; (d) bad debts suffered but not deducted in the years in

[4] The "working capital" of a business is the excess of its current assets over its current liabilities, see FINNEY, 1 PRINCIPLES OF ACCOUNTING 17.

[5] For legal definition of "net profits" see Warren v. King, 108 U.S. 399, 2 Sup. Ct. 789, 27 L.ed. 769 (1883).

which they became worthless, or, doubtful accounts receivable not legally ascertainable to be worthless and so demonstrable within a reasonable degree of certainty to the satisfaction of the Commissioner are not allowable tax deductions; (e) inadequate or lost depreciation of previous years is not an allowable tax deduction; (f) corporate contributions are limited to certain specified types of charitable institutions and are further limited to only five per cent of the net income of the corporation as computed without the benefit of the contribution; (g) premiums paid on any life insurance policy covering the life of any officer or employee are not allowable deductions when the corporation is directly or indirectly beneficiary under such policy; (h) losses from sales or exchanges of property mentioned in Section 24 of the Revenue Act of 1936 are not deductible; (i) consolidated returns for affiliated corporations (not railroad or railway corporations) are not allowed, consequently, there is taxation of the profits of each subsidiary without consideration of the entire corporation business as a unit or entity and without deducting the losses sustained by the several subsidiaries, which are often required to be organized because of business exigencies and domestic or foreign laws.

Also, let it not be forgotten that taxes must be paid in cash and not in any other form or medium. A corporation's surplus may often be represented by raw materials, finished or unfinished stock, as shown by the inventories at the close of the calendar or fiscal year. The general conservative rule is to calculate these inventories at cost or market price, whichever is lower. A corporation may be extremely conservative in its inventory calculations; still it may suffer a grave loss in the valuation of its merchandise that is irretrievable under the tax laws. No reserves for possible fluctuations in the market price of inventories are allowable deductions. Likewise, a corporation's surplus may be reflected in its accounts receivable which is subject to estimated allowances for bad debts, in stock and bonds of uncertain or declining market value, or, lastly, in land and buildings, tools and dies, patterns and patents, trade marks and good will, all of which are subject to the law of depreciation, obsolescence, and supersession. Under these circumstances it is an extremely delicate and difficult question for honest and conscientious directors of private corporations to determine just how much of the corporate surplus should be distributed and how much retained to cover certain but indeterminable future losses in the business.[6] To burden them with a heavy graduated surtax will not relieve them but rather incite them to make either unwarranted distributions of needed working capital, or, seeking to safeguard themselves

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[6] For a discussion of surplus and dividend policies in respect to corporate distributions see DEMING, FINANCIAL POLICY OF CORPORATIONS (1934) 604-632.

against legal liability to the stockholders for improvident distributions, freeze all present corporate surplus and reserves which they fear are not replaceable except upon the payment of a heavy surtax on undistributed future earnings. The surplus account and the reserves for various contingencies of a corporation represented in cash or other liquid assets have always proven a great financial aid during a period of depression. They absorb the loss by which otherwise the corporation might have been forced into bankruptcy or state insolvency proceedings. They are the necessary funds upon which business men draw in order to keep their factories open for production, to pay wages to laborers, rent to land owners, interest upon their obligations, profits to stockholders, and taxes to the state and the federal governments. In short, they have been aptly denominated "the life insurance policies of business firms." Moreover, it is a flagrant weakness of our income tax law that in times of prosperity it produces the largest revenue and in times of depression it produces the least; thus, operating conversely to the fiscal needs of the government.

Sometimes it is said that corporate savings increase booms and accentuate depressions by causing (a) an excessive expansion of plant, machinery, and other capital goods, (b) an accumulation of idle surplus funds of corporations thereby reducing the purchasing power necessary to maintain the smooth flow of industrial products, (c) a great increase in corporate loans to the stock market, thus augmenting speculation. It is suggested that a substitution of the discretion of the actual owners of the corporation—the stockholders—in place of their directors for the management and distribution of corporate earnings will result from the proposed corporate tax on undistributed earnings. These arguments do not lend themselves to the support of tax legislation. They savor of regulation rather than taxation. They lead to the destruction of the very life-blood of the many small struggling corporations because of the economic sins and social abuses of a few large corporations in the use of their surplus funds. As well might we penalize all individual savings because of the imprudent and improvident investments of a few. As, if, and when the federal government receives the delegated powers from the states and the people of the United States to regulate corporate savings within the corporation and substitute the stockholders for the board of directors of a private corporation, then it will be timely to discuss this proposition. The avowed purpose of the tax bill under discussion was to produce revenue and not social control of the financial depressions through the taxing powers. The means employed must be naturally and reasonably adaptable for fiscal purposes, otherwise there is no true tax. The end does not justify the means.

Is the theory that needed working capital can always be raised in practice by every corporation through the sale of stock or stock rights to its stockholders or to the public very realistic? Can a corporation without impairing its credit position retain the current profits through the declaration of a dividend in its own bonds, notes, or scrip? Will the distribution of optional stock dividends, that is, one payable either in cash or stock of the corporation at the option of the stockholder aid the situation? The answer is emphatically in the negative. The argument that small stockholders in small companies will have proportionately more money remaining in their hands for reinvestment purposes after paying their smaller income tax to the government than the larger stockholders who pay a larger individual normal and surtax upon dividends received is often stated in reply. This argument eliminates or ignores the great outside source of corporate capital, namely, the public, the banks, the insurance companies, the bond and mortgage companies. Can we realistically ignore the distinction between capital sources within and without the corporation? The answer to this argument from a stockholder's point of view is that by forcing the corporation to distribute all its earnings you also force an election upon all the stockholders to resubscribe to new stock or exercise the stock rights issued. Upon the failure to subscribe to new stock the relative position of the smaller stockholder in the corporation is diminished in proportion and in value. His failure to reinvest cannot always be ascribed to unwillingness. If he receives a taxable dividend payable in an obligation of the corporation or in stock where will he obtain the cash with which to pay his income tax? Can he always sell the corporation's obligation or stock on the market? Must he not sacrifice his proportionate interests and valuable position in the corporation by doing so? Possibly, because of necessitous circumstances and financial distress he cannot resubscribe to further stock in the corporation, or sell his bond or stock dividend received, or even raise the necessary cash to pay his income tax. Should he lose his relative position in the corporation to wealthier stockholders or be subject to legal penalties for not paying his income tax? Then again, suppose the dividend is paid in cash or stock at the option of the stockholder. He is placed in the dilemma of either accepting the cash, paying his income tax, and suffering a loss in his relative and proportional right to the corporate assets on dissolution, in corporate management, voting, and future earnings, or accepting the stock with the hope of raising the tax money somewhere and somehow.

If, on the other hand, the board of directors of a corporation declares a 100 per cent cash dividend thereby escaping entirely the graduated surtax on the undistributed corporate profits it may within the very near future be called upon to meet an unforeseen business contingency, an acute demand for immediate capital. With its credit position impaired by the issuance of a dividend in cash (or even in obligations of the company) it may have great difficulty in obtaining credit; banks will be disinclined to finance or help corporations to rebuild or rehabilitate themselves (and thereby increase employment) because of the poor credit and unliquid position of the corporation. The fact that the corporation will not be entitled to any dividend credit in respect to a contract restricting the payment of dividends in the future because it is not contained in a written contract executed prior to May 1, 1936, will not only affect its tax but also its credit.[7] Why limit this dividend credit only to written contracts executed prior to May 1, 1936?

So far as the stockholder himself is concerned in respect to 100 per cent cash dividends, we must consider the human factor. Once the stockholder receives the cash in his hands he must pay his federal income tax and, therefore, will have less to spend or reinvest. He will realize that the corporation has already paid a normal tax and a graduated surtax on the same profits; he may be greatly inclined to spend rather than save or reinvest his money. This would be placing a penalty on prudence and a bounty on improvidence. Or, this might lead to an investment by the stockholder in tax-exempt securities and a withdrawal of investments from productive enterprises. Furthermore, let us not forget the existence of the speculative investor in the corporation who acquires stock with an expectation of an immediate dividend and a quick turnover by an early sale of his securities at a profit. He cares little for the continuity of the corporate enterprise from year to year; the durability and stability of a necessary economic unit of industry has no social value to him. Thus, a tax upon the undistributed corporate earnings becomes a deterrent to the stability and expansion of productive enterprise and may result in a serious contraction of American productive industry. It is very properly said: "The school of thought which fosters contraction of industry by taxation is disturbative not only of the growth of industry but of the flow of government revenue from this source as well."[8]

Some corporations undoubtedly can satisfy their capital requirements through the sale of stock or stock rights to its stockholders or to the public, but they are primarily the large, financially sound, and controlling corporations of the country in which they have established a strong line of credit and a long list of regular dividend payments.

[7] A charter of a corporation does not constitute a written contract executed by the corporation prior to May 1, 1936, within the meaning of Section 26(c) of the Revenue Act of 1936. Regulations, T.D. 4674, Art. 26-3.

[8] Godfrey Nelson, New York Times, June 6, 1936.

Thus, as Representative Fred M. Vinson of Kentucky pointed out[9] the American Telephone and Telegraph Company during the prosperous years from 1921 to 1930 sold stock rights amounting to nine hundred fifty-eight million dollars and declared out in dividends but eight hundred fifty-four million dollars, or in other words, they recovered back from the sale of stock rights one hundred four million dollars in excess of their dividend distributions. This same corporation in its consolidated balance sheet as of December 31, 1935, showed an equity in the consolidated surplus as follows, to wit: surplus reserved, $86,043,049 and an unappropriated surplus of $268,943,306. Likewise, Senator Henry Flood Byrd of Virginia presented to the Senate Finance Committee[10] the fact that the Atlantic and Pacific Tea Company has an accumulated surplus of ninety-eight million dollars of which fifty-four million is in cash and call loans and forty-two million is invested in government securities. He further disclosed, that in 1934 the same corporation earned twenty million dollars and paid out as dividends sixteen million dollars.

What is there to prevent these large corporations and others in a similar financial position from freezing their present huge surpluses and thereafter distributing all or practically all their current earnings in dividends and thereby escaping entirely the heavy surtax on undistributed corporate earnings? Let us not forget these corporations are but two of the few hundred giant corporations in this country with strong credit positions fortified by years of regular dividend payments. They do not belong to the rank and file of the five hundred thousand corporations in the United States that Commissioner Helvering mentioned to the Senate Finance Committee on April 30, 1936. The "Big Corporations" are the exclusive ten per cent of all the corporations having far-flung interests extending into every corner of our country and controlling 90 per cent of all the corporate business in the United States as noted by Senators Robert M. LaFollette and Hugo L. Black in their minority report of the Senate Finance Committee on the Revenue Act of 1936. They are the giant combinations—the legal *alter ego*—that Messrs. Berle and Means say in substance have the power to control economic production, stifle competition, harm or help the multitude of individuals, affect the whole districts, shift the currents of trade, and bring poverty to one community and prosperity to another.[11] They are truly the challenge to American economic, social, and political

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[9] *Hearings before Committee on Ways and Means on H. R. 12395,* 74th Cong. 2d Sess. (1936) 436.

[10] *Hearings before Senate Committee on Finance on H. R. 12395,* 74th Cong. 2d Sess. (1936) 922, 923.

[11] BERLE AND MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1934) 44-46.

life. Let the government use its heavy artillery to keep these powerful corporations within check, to prevent avoidance or evasion of taxes, to remove all semblance of economic tyranny or monopoly, to clear the highway of trade and commerce for free competition, and the blessings and plaudits of the American multitude will follow.

But, as intimated by Mr. May,[12] there should not be a Herod's massacre, a wide-spread slaughter of the innocent, that is, the small corporations and its stockholders, in order to reach a few offenders. In view of this new tax on undistributed corporate profits what chance of success have the new small corporations without a long dividend record and an established credit against the larger corporations which in the past have been able to build up enormous surpluses and ample reserves free from heavy surtaxes on undistributed earnings? Can there ever result any true competition under these circumstances? In fact, some of these smaller corporations might easily be forced into bankruptcy or receivership by creditors for the reason that a lower tax rate will reduce expenditures to the extent of the tax savings.

Unquestionably, we need the new small corporation. Big business is not always a boon to civilization, much less, to the development of American industry. Let us not forget what Mr. Justice Brandeis of the United States Supreme Court so vividly wrote over twenty years ago in his brief and penetrating analysis of *Big Men and Little Business.*[13] In reply to the argument that practically all the railroad and industrial development of this country has taken place initially through the aid of the men of the great banking houses he stated, *inter alia,* that the statement was entirely unfounded in fact. On the contrary, he disclosed that nearly every such contribution to our comfort and prosperity was initiated without the aid of big bankers or big financiers; the great banking houses came into relation with the early productive enterprises either after success had been attained, or upon reorganization after the possibility of success had been demonstrated and the funds of the hearty pioneers, who had risked their all, were exhausted. He cites as striking examples our early railroads, early street railways, the automobile, the telegraph, the telephone, the wireless, the gas and oil, the harvesting machinery, the steel industry, the textile, paper, and shoe industry, and nearly every other important branch of manufacturing. It would not be surprising at this day to find the 1936 undistributed corporate profit tax result as a boon to this undesirable "Big Business" and as a bane to the needed new and small corporations struggling and striving to gain a foothold in the commercial world.

[12] George O. May, *Hearings before Senate Committee on Finance on H. R. 12395,* 74th Cong. 2d Sess. (1936) 538-549.
[13] BRANDEIS, OTHER PEOPLE'S MONEY 88-92.

At times it has been intimated that the 1936 undistributed corporate profits tax was unconstitutional.[14] The basis for this suggestion usually is that the purpose of this act is to control private corporation policies, dividend distributions, and corporate surpluses. This, it is rightly claimed, is a power touching a subject not within the delegated powers of Congress but reserved to the states under the Tenth Amendment. Likewise, it is sometimes heard that the tax is so arbitrary, excessive, and capricious as to amount to confiscation in violation of the Fifth Amendment to the constitution. However, confining ourselves to the income tax features of the 1936 Act, it seems clear from a careful examination of the act itself, its history, and its avowed purpose to raise permanent, additional revenue amounting to six hundred and twenty million dollars annually, that the act is constitutional. It falls within the federal powers of taxation. The primary purpose of the act being for revenue the incidental motive to effect distributions of corporate earnings does not vitiate the bill. Many arguments may be made concerning the abuse of the congressional power to tax but such arguments cannot, and do not legally challenge or deny its existence. The regulations adopted in the act seem to be quite naturally and reasonably adapted for the administration, collection, and enforcement of the tax. There is no elaborate and detailed plan of regulation comparable to that contained in the unconstitutional Child Labor Act of 1918.[15] Nor is there an expropriation of funds for a particular group as condemned in the *Hoosac Mills* Case.[16] Furthermore, it must not be forgotten there is such a substantial difference between a business carried on as a corporation and one carried on as a partnership or proprietorship as to justify a separate and reasonable classification for federal taxation. A federal excise tax upon private corporations chartered under state authority is not an infraction of the general power of the states to authorize the formation of corporations; nor does the mere fact that the private corporation is a creature of the state exempt it or its franchises from the exercise of the federal authority to levy excise taxes.[17]

The argument claiming that the 1936 Income Tax violates the Fifth Amendment in that it takes property without due process of law likewise is untenable. This limitation, if it can be called one, upon the federal powers of taxation is rarely invoked successfully when the sub-

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[14] Joseph J. Klein, *Hearings before Senate Committee on Finance on H. R. 12395,* 74th Cong. 2d Sess. (1936) 108-109; George T. Evans, *Hearings before Senate Committee on Finance on H. R. 12395,* 74th Cong. 2d Sess. (1936) 439, 440.

[15] Hammer v. Dagenhart, 247 U.S. 251, 38 Sup. Ct. 529, 62 L.ed. 101 (1918).

[16] United States v. Butler, 297 U.S. 1, 56 Sup. Ct. 312, 80 L.ed. 477 (1936).

[17] See Flint v. Stone Tracy Co., 220 U.S. 117, 31 Sup Ct. 342, 55 L.ed. 389 (1911); Veazie Bank v. Fenno, 8 Wall. 533, 19 L.ed. 482 (1869).

ject taxed is within the taxing powers of Congress; secondly, the legislative act must upon its face be so arbitrary as to compel the conclusion that it does not involve an exertion of the taxing power but constitutes in substance and effect the true exertion of a different forbidden power, as, for example, the confiscation, expropriation, or spoliation of property. Thus, it is only in an extreme case when Congress glaringly disregards fair dealing and instead of taxing, really confiscates property, that it can be said there is a violation of the Fifth Amendment. This can hardly be said of the 1936 Revenue Act, especially so far as the income tax features are concerned.

The courts, it is believed, will hold that the amount and the rate of the excise tax is a matter of Congressional policy or legislative discretion and that petitions for relief from high and oppressive taxes must be addressed to the legislative and not the judicial branch of the government. The required uniformity of an excise tax on private corporations does not call for the equal application of the tax to all persons or corporations who may come within its operation but is limited to a geographical uniformity throughout the United States.[18] Consequently, it is respectfully submitted that, with the presumption of constitutionality to fortify it in case of any court attack, the Revenue Act of 1936, especially so far as its income tax features are concerned, will prove legally invulnerable and violative of neither the Fifth nor the Tenth Amendment to the Constitution.[19]

Corporate Income and Stockholders' Income

Now turning our attention more particularly to the nature of corporation income and the stockholders' rights thereto we find within the recent past that two theories have been suggested for establishing more of an equality in taxation. One of the theories is to extend the provisions of Section 102 of the 1936 Revenue Act relating to the surtax on corporations improperly accumulating surplus to the surtax on undistributed corporate profits. Section 102 (a) of the new act provides in substance that the corporate surtax on improperly accumulated surplus shall not be applied against the corporation if all the shareholders of the corporation include in their gross income their entire *pro rata* shares of the retained net income of the corporation, and if 90 per cent or more of such retained net income is so included in the gross income of shareholders other than corporations. It is to be observed that the tax under Section 102 is levied against the corporation and not the individual stockholders. Furthermore, it is entirely

[18] Flint v. Stone Tracy Co., *supra* note 17.

[19] In Kingan & Co. v. Smith, 17 F. Supp. 217 (D.C. Ind., 1936) it was held that the "windfall tax" of the Act of 1936 was neither a penalty nor an arbitrary exaction.

optional with the specified shareholders whether or not they will relieve the corporation of this surtax by including it in their individual returns. Because of the option so given this section is distinctively different from the tax requirements in relation to partners and partnerships. The law requires that there be included in computing the net income of each partner his distributive share, whether distributed or not, of the net income of the partnership for the taxable year.[20] There is no federal income tax levied against the partnership, as such. It is, therefore, readily seen that there is no existing analogy between corporation income and partnership income from a tax point of view. The suggested theory gives rise to grave questions as to the constitutional taxing powers of Congress, the limitations thereon, the corporate personality, the distinction between capital and income, and the practicability of the entire plan. These questions will be examined after the presentation of a second and cognate theory now gaining considerable support.

Another theory advanced is to disregard the corporate entity entirely and to tax the undistributed profits of corporations as though "constructively received" by the stockholders.[21] Section 42 of the 1936 Revenue Act, provides that the amount of all items of gross income is to be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under Section 41, any such amounts are to be properly accounted for as of a different period. The Commissioner of Internal Revenue, pursuant to law, has provided in his compiled regulations for the constructive receipt theory in respect to income.[22] It is therein stated that income which is credited to the account of or set apart for a taxpayer and which may be drawn upon by him at any time is subject to the tax for the year during which so credited or set apart, although not then actually reduced to possession. To constitute receipt in such a case the income must be credited or set apart to the taxpayer without any substantial limitations or restriction as to the time or manner of payment or condition upon which payment is to be made, and must be made available to him so that it may be drawn at any time and its receipt brought within his own control and disposition. As examples of constructive receipt it is indicated that if interest coupons have matured and are payable, but have not been cashed, such interest though not collected when due and payable shall be included in gross income for the year during which the coupons mature, unless it can be shown that there are no funds available for payment of the interest during such

[20] Section 182 of the Revenue Act of 1936; Regulations T. D. 94, Art. 192-1.
[21] Sherman, Note, 13 TAX MAGAZINE 19.
[22] Regulations, T. D. 94, Art. 42-2, 42-3.

year. Also, dividends on corporate stock, it is said, are subject to tax when unqualifiedly made subject to the demand of the shareholder: interest credited on savings bank deposits even though the bank nominally has a rule, seldom or never enforced, that it may require so many days' notice before withdrawals are permitted, is income to the depositor when credited. An amount credited to shareholders of a building and loan association, when such credit passes without restriction to the shareholder, has a taxable status as income for the year of the credit, but if the amount of such accumulations does not become available to the shareholder until the maturity of a share, the amount of any share in excess of the aggregate amount paid in by the shareholder is income for the year of the maturity of the share.

Now, in examining the aforesaid two theories and their application to federal taxation of stockholders in respect to the undistributed corporate profits we must, perforce, revert to fundamental principles of the power of taxation. We find that Congress has only such powers that have been delegated to it expressly or impliedly. We know that the Sixteenth Amendment must be construed in connection with the taxing clauses of the original constitution and the effect attributed to them before the amendment was adopted. Prior to the Sixteenth Amendment, it was held that taxes upon rents and profits of real estate and upon returns from investment of personal property were, in effect, direct taxes upon the property from which such income arose, and were imposed by reason of ownership, and that Congress could not impose such taxes without apportioning them among the states according to population as required by Article 1, Paragraph 2, Clause 3, and Paragraph 9, Clause 4, of the original constitution. We also found that the Sixteenth Amendment, adopted February 25, 1913, provided that Congress shall have the power to lay and collect taxes on *"incomes,"* from whatever source derived without apportionment among the several states and without regard to any census or enumeration. This amendment did not extend the taxing power to new subjects but merely removed the necessity which otherwise might exist for an apportionment among the states of taxes laid on income. In order, therefore, that the clause above cited from Article 1 of the constitution may have proper force and effect, save only as modified by the Sixteenth Amendment and that the latter also may have proper effect, it becomes essential to distinguish between what is and what is not *"income"* as the term is therein used. We must apply the distinction according to truth and substance and without regard to form. Congress cannot by any definition it may adopt conclude the matter since it cannot by legislation alter the constitution from which alone it derives the power to legislate and within whose limitations alone that power can be lawfully exercised.[23] Not only is it necessary to define income, but it is also necessary to distinguish it from capital. Furthermore, we must ascertain the true nature of a corporation, when the corporate veil will be pierced for tax purposes, when income belongs to the corporation, and when it is severed and realized by the stockholder so as to make the same taxable to him.

A great deal of learning has been expended and exhausted on the true definition of income, and, it is said, the further we pursue the subject, the more difficult the definition becomes. However, it is not necessary for us to indulge at great length in any philosophic or economic distinctions. Money income to an economist is essentially psychic; in other words, it resolves itself into the unfree utilities which the money indirectly and the goods directly through the benefits they render, afford, or control.[24] Generally, economic income is regarded as a flow of human satisfactions over a period of time, which may be long or short, regular or irregular, recurring or non-recurring. It is sufficient, for our purposes, simply to observe the fact that there is no unanimity in the opinions of economists as to just what are the necessary elements contained in the concept of income.

To the accountant income is the money value of the flow of economic goods or human-want satisfiers during a fixed period of time, usually a year,[25] that is, the increase of a recipient's economic power between the beginning and the end of the accounting or tax period. The profits of a corporation are cautiously segregated by the accountant into realized profits arising out of business sales or exchanges in which the value received is greater than the value parted with, and unrealized profits, representing mere increases in the value of the property due to market conditions, unattended by actual sales or exchanges. The accountant further differentiates between operating profits representing those gains derived from the sale of the commodity in which the business normally deals and extraneous profits made by sale of assets owned but not regularly dealt in by the corporation.[26]

Now, the legal distinction between capital and income is of the gravest importance because Congress may tax only "income" without apportionment by virtue of the Sixteenth Amendment; it may not tax "capital" without complying with the constitutional rule of apportionment. Moreover, the federal government has not the freedom in taxation as possessed by the states or the English Parliament; the state decisions and the English cases merely present questions of statutory construction and, consequently, cannot act as precedents for the guid-

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[23] Eisner v. Macomber, 252 U.S. 189, 206, 40 Sup. Ct. 189, 64 L.ed. 521 (1920).
[24] DAVENPORT, THE ECONOMICS OF ENTERPRISE 488.
[25] KLEIN, FEDERAL INCOME TAXATION (1929) 47.
[26] FINNEY, 1 PRINCIPLES OF ACCOUNTING 1, 2.

ance of the United States Supreme Court testing an act of Congress by the limitations of a written constitution having superior force. The federal Supreme Court's definition of income emphasizes the attributes of severability and realization. Thus, it is said: "Income may be defined as the gain derived from capital, from labor, or from both combined, provided it be understood to include profit gained through the sale or conversion of capital assets. . . . Here we have the essential matter; not a gain *accruing* to capital, not a *growth* or *increment* of value in the investment, but a gain, profit, something of exchangeable value *proceeding from* the property, severed from the capital however invested or employed, and *coming in,* being derived, that is, received or drawn by the recipient (the taxpayer) for his separate use, benefit, and disposal; that is, income derived from property. Nothing else answers the description."[27] In determining the legal definition of the word "income" the court has consistently refused to enter into the refinements of lexicographers or economists and has approved the aforesaid definition on the ground that it is believed to be the commonly understood meaning of the term which must have been in the minds of the people when they adopted the Sixteenth Amendment to the constitution.[28] Taxation is eminently practical and is, in effect, brought to every man's door; for the purpose of deciding upon its validity, a tax should be regarded in its actual, practical results rather than with reference to those theoretical or abstract ideas whose correctness is the subject of dispute and contradiction among those who are experts in the science of political economy.[29] The latest court definition of income was stated by Justice Cardozo as follows: "Income within the meaning of the Sixteenth Amendment is the fruit that is born of capital, not the potency of fruition. With few exceptions, if any, it is income as the word is known in the common speech of man; when it is that, it may be taxed though it was in the making long before."[30]

In considering the above-mentioned legal income of a taxpayer it is imperative that a distinction be made between the income belonging to the corporation as a separate legal entity and the income of the stockholders who have a beneficial and equitable interest in the assets of the corporation as reflected in the certificates of stock issued by the

[27] Mr. Justice Pitney in Eisner v. Macomber, 252 U.S. 189, 207, 40 Sup. Ct. 189, 64 L.ed. 521 (1920); see also Doyle v. Mitchell Bros. Co., 247 U.S. 179, 38 Sup. Ct. 467, 62 L.ed. 1054 (1918); Stratton's Independence v. Hawbert, 231 U.S. 399, 415, 34 Sup. Ct. 136, 58 L.ed. 285 (1913).

[28] Merchants' Loan & Trust Co. v. Smietanka, 255 U.S. 509, 519, 41 Sup. Ct. 386, 65 L.ed. 751 (1921).

[29] Mr. Justice Peckham in Nicol v. Ames, 173 U.S. 509, 515, 516, 19 Sup. Ct. 522, 43 L.ed. 786 (1899).

[30] United States v. Safety Car Heating & Lighting Co., 297 U.S. 88, 99, 56 Sup. Ct. 353, 80 L.ed. 500 (1936).

corporation. This calls for a clear concept of the term "corporation." In America at a very early date Chief Justice John Marshall in one of the many famous cases then coming before the United States Supreme Court defined a corporation as "an artificial being invisible, intangible, and existing only in the contemplation of law; being the mere creature of the law it possesses only those properties which the charter of its creation confers upon it either expressly or as an incidental to its very existence."[31] The foregoing concept of a corporation is now considered the orthodox or old view. The rapidly gaining modern view conceives incorporation as an act creating a corporate legal personality of the members rather than a corporate legal person which is separate and apart from the members. Legal personality is said to be the sum total of the rights and the obligations attributed to a legal person in a given capacity or legal relation whereas corporate personality signifies the sum total of the rights and the obligations which the members have in their distinct corporate capacity.[32]

For the purposes of federal taxation the term corporation is not limited to the artificial entity usually known as a corporation but includes also associations, joint stock companies, and insurance companies.[33] The subjection of the so-called Massachusetts Trust, certain limited partnerships, joint stock companies and associations to taxes applicable to corporations has had a very interesting legal history.[34] Since the decision in *Hecht* v. *Malley*,[35] the applicability of federal corporation taxes to business trusts has generally neither been successfully assailed nor seriously questioned.[36] Thus, the term "association" contained in the recent revenue acts has been held to embrace business trusts in almost every variety and form.[37] The Commissioner of Internal Revenue in his latest publication of the Regulations on the 1936 Income Tax Law states that the term "association" is not used in the act in any narrow or technical sense, but includes any organization created for the transaction of designated affairs or the attainment of

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[31] Dartmouth College v. Woodward, 4 Wheat. 518, 636, 4 L.ed. 629 (1819).

[32] STEVENS, HANDBOOK ON THE LAW OF PRIVATE CORPORATIONS (1936) 9.

[33] Section 1001 (a)-2, Revenue Act of 1936.

[34] Eliot v. Freeman, 220 U.S. 178, 31 Sup. Ct. 360, 54 L.ed. 424 (1911); Crocker v. Malley, 249 U.S. 223, 39 Sup. Ct. 270, 63 L.ed. 573 (1919); Hecht v. Malley, 265 U.S. 144, 44 Sup. Ct. 462, 68 L.ed. 949 (1924).

[35] Hecht v. Malley, *supra* n. 34.

[36] Burk-Waggoner Oil Ass'n. v. Hopkins, 269 U.S. 110, 46 Sup. Ct. 48, 70 L.ed. 183 (1925); Little Faun Oil & Gas Co. v. Lewellyn, 29 F. (2d) 137 (W.D. Penn. 1928); White v. Hornblower, 27 F. (2d) 777 (C.C.A. 1st, 1928); Swanson v. Commissioner of Internal Revenue, 296 U.S. 362, 56 Sup. Ct. 283, 80 L.ed. 273 (1935).

[37] Morrissey v. Commissioner of Internal Revenue, 296 U.S. 344, 56 Sup. Ct. 289, 80 L.ed. 263 (1935); Helvering v. Combs, 296 U.S. 365, 56 Sup. Ct. 287, 80 L.ed. 675 (1935); Helvering v. Colman-Gilbert Associates, 296 U.S. 369, 56 Sup. Ct. 285, 80 L.ed. 278 (1935); Commissioner v. Vandergrift Realty & Investment Co., 82 F. (2d) 387 (C.C.A. 9th, 1936).

some object which, like a corporation, continues notwithstanding that its members or participants change and the affairs of which like corporate affairs are conducted by a single individual, a committee, a board, or some other group, acting in a representative capacity.[38] It is immaterial whether such an organization is created by an agreement, a declaration of trust, a statute or otherwise.

Now, just how far can we go in piercing the corporate veil so as to disregard the corporate entity for tax purposes and call corporation income the stockholders' income? An excellent general rule has been offered, to wit: "For all business transactions consistent with the spirit and purpose of corporation laws, the corporate personality of persons who have associated under those laws must be recognized; on the other hand, their corporate personality will not be recognized when to do so would run counter to the purpose which prompted the establishment of the corporate device or when the conflicting rights and obligations in litigation can be more fairly adjusted by ignoring the corporate personality."[39] The courts have generally stated that the corporate form will be disregarded (1) when necessary to prevent fraud, (2) when a corporation is so organized and controlled as to make it merely an instrumentality or adjunct of another corporation for a sinister or wrongful purpose or to work injustice.[40] It has also been held that if any general rule can be laid down in the present state of authority, it is that a corporation will be looked upon as a corporate entity as a general rule and until sufficient reason to the contrary appears; but when the notion of legal entity is used to defeat public convenience, justify wrong, protect fraud, or defend crime, the law will regard the corporation as an association of persons.[41]

Probably the strongest expression used by the United States Supreme Court in sustaining the corporate entity theory is found in the opinion of Mr. Justice Pitney in the famous case of *Eisner* v. *Macomber* when he said: "We have no doubt of the power or duty of a court to look through the form of a corporation and determine the question of the stockholder's rights, in order to ascertain whether he has received income taxable by Congress without apportionment. But, looking through that form, we cannot disregard the essential truth disclosed; ignore the substantial difference between the corporation and the stockholder; treat the entire organization as unreal; look upon stockholders as partners when they are not such; treat them as having

[38] Regulations, T. D. 94, Art. 1001-2.
[39] STEVENS, HANDBOOK ON THE LAW OF PRIVATE CORPORATIONS (1936) 16.
[40] Pittsburgh & Buffalo Co. v. Duncan, 232 Fed. 584 (C.C.A. 6th, 1916).
[41] United States v. Milwaukee Refrigerator Transit Co., 142 Fed. 247 (C.C. E.D. Wis. 1905); see also Buick Motor Co. v. City of Milwaukee, 43 F. (2d) 385 (E.D. Wis. 1930); Note (1932) 7 WIS. L. REV. 250; Finkelstein, *The Corporate Entity and the Income Tax* (1935) 44 YALE L. J. 436.

an equity, a right to a partition of the corporate assets, when they have none; and indulge in the fiction that they have received and realized a share of the profits of the company which, in truth, they have neither received nor realized. We must treat the corporation as a substantial entity separate from the stockholders, not only because such is the practical effect, but because it is only by recognizing such separateness that any dividend—even one paid in money or property—can be regarded as income of the stockholders. Did we regard the corporation and the stockholders as altogether identical, there would be no income except as the corporation acquired it; and while this would be taxable against the corporation as income under appropriate provisions of law, the individual stockholders could not be separately and additionally taxed with respect to their several shares even when divided, since, if there were entire identity between them and the company they could not be regarded as receiving anything from it, any more than if one's money were to be removed from one pocket to another."[42]

In accordance with the above-mentioned principles the Board of Tax Appeals has formulated the rule that if a corporation is formed in the ordinary course of the taxpayer's business and for the purpose of serving the proper ends of its commercial activity, then the corporation entity will be respected; but if the corporation is formed when the shadow of the tax hovers over the taxpayer and in a last-minute attempt to avoid its blow, then the law will ignore the legal fiction of the corporate person.[43]

Consequently, with rare exceptions, the corporation property has been considered separate and distinct from the property of the several stockholders. In 1870, it is true, the Supreme Court did decide that under the Revenue Act of 1864, the gains and profits of all companies, whether corporation or partnership, should be included in estimating the annual gains, profits, or income of any person entitled to the same, whether distributed or not, that an individual, therefore, was taxable upon his proportion of the earnings of a corporation although the profits had not been declared as dividends and although invested in assets not in their nature divisible.[44] However, it was later held that insofar as the aforesaid case seems to uphold the right of Congress to tax without apportionment a stockholder's interest in accumulated earnings prior to the declaration of dividend it must be regarded as over-ruled;[45] since the Sixteenth Amendment applies only to income what is called the stockholder's share in the accumulated profits of the company is capital and not income.

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42 Eisner v. Macomber, 252 U.S. 189, 213, 40 Sup. Ct. 189, 64 L.ed. 521 (1920).
43 In *re* George H. Chisholm, 29 B. T. A. 1334.
44 Collector v. Hubbard, 12 Wall. 1, 20 L.ed. 272 (1870).
45 Eisner v. Macomber, *supra*, note 42, at 208.

So, under the modern theory corporate property is the joint property owned by the shareholders in their corporate personality, and corporate rights and obligations are the joint rights and obligations of the shareholders in their corporate personality.[46] The authority of the board of directors over the ordinary business of a corporation is normally exclusive and free from interference or control by a majority of the stockholders; this is because all the shareholders have agreed by their contract of membership to concentrate control and corporate management in a duly elected board of directors, not in a majority of the shareholders. Thus, even a majority of the shareholders may not interfere with the corporate control, or override the action taken by the board when acting within the scope of authority conferred upon it.[47] According to the corporate scheme of association, the power of management vested in the board of directors includes the authority to determine whether, when the corporation has a surplus, a dividend shall be declared and, if declared, how much it shall be and when and how it shall be payable. It does not follow, however, that a shareholder may not secure judicial review of directorate action, with a view to nullification, if it can be shown to be the result of a decision arbitrarily arrived at, in contravention of the shareholder's contract rights, or without proper consideration of the interest of all the shareholders.[48] But, the mere existence of a large surplus is not in itself enough to justify a court in ordering the declaration of a dividend.[49]

Now, if the assets, the surplus, and the earnings of a corporation in the first instance and before the declaration of a dividend belong entirely to the corporation as a separate and distinct legal entity and the corporate veil will not be pierced except to prevent fraud in taxation or otherwise, just when thereafter do the earnings and the property of a corporation become severed and realizable to the stockholder so as to become taxable as income to the stockholder? Is every receipt of a dividend whether in cash or otherwise taxable? These are difficult and delicate questions to answer.

The courts strive to draw a line between capital and income[50] and insist that the undivided corporate profits of a corporation do not constitute income to the stockholder until there is a separation and a

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[46] STEVENS, HANDBOOK ON THE LAW OF PRIVATE CORPORATIONS (1936) 65, 71.

[47] STEVENS, HANDBOOK ON THE LAW OF PRIVATE CORPORATIONS (1936) 548, 549; Bloom v. Vehon Co., 331 Ill. 200, 173 N.E. 270 (1930); Automatic Syndicate Co. v. Cunningham [1906] 2 Ch. 34.

[48] See Dodge v. Ford Motor Co., 240 Mich. 549, 170 N.W. 668 (1919).

[49] In Trimble v. American Sugar Refining Co., 61 N. J. Eq. 340, 48 Atl. 912 (1901), the court refused to order the declaration of a dividend where a surplus of sixty million dollars was only six per cent of the capital stock.

[50] See Doyle v. Mitchell Bros. Co., 247 U.S. 179, 38 Sup. Ct. 467, 62 L.ed. 1054 (1918); Hays v. Gauley Coal Co., 247 U.S. 189, 38 Sup. Ct. 470, 62 L.ed. 1061 (1918).

realization thereof by the stockholder.[51] Let us first examine dividends other than true stock dividends and then stock dividends.

The mere accretion in value of a stockholder's investment does not constitute income but there must be some change in the form, quality, or extent of the taxpayer's investment. Thus, where the market value of a stockholder's share in a corporation organized prior to March 1, 1913, had increased to twice the par value of his stock on March 1, 1913 (when the Revenue Act of 1913 took effect) and afterwards the corporation sold all its property making a final distribution of the proceeds to the shareholders on surrender of their stock certificates and paying each stockholder twice the par value of his stock, it was held that the value thus received by the stockholder in excess of the par value of his stock was not "income, gains, or profits" of the shareholder but capital and, therefore, it was not subject to the income tax; the value received represented merely a conversion of the stockholder's existing investment; furthermore, the gain did not "arise" or "accrue" after the act became effective.[52] In other words, a single and final dividend in liquidation of the entire assets and business of a corporation and a return to a stockholder of the value of his stock upon the surrender of his entire interests in the company at a price that represented the stock's intrinsic value at and before March 1, 1913, was not taxable income but capital of the stockholder. Similarly, upon the cancellation of an insurance policy the amount realized by the insured over and above the premiums paid and attributable to and accrued during the period before March 1, 1913, must be deemed an accretion to capital and not taxable as income.[53]

On the other hand, where cash dividends were declared and paid not in liquidation but in the ordinary course of business by a corporation to its shareholders after March 1, 1913, whether from current earnings or from a surplus accumulated before that date, they were held taxable as income to the individual shareholders under the Revenue Act of 1913.[54]

In the more recent income tax acts provisions have been inserted for the purpose of excluding from the effects of the tax any dividends declared out of earnings or profits that accrued prior to March 1, 1913. This originated with the act of September 8, 1916, and was granted as a "concession to the equity of stockholders."[54a] On the very same day that *Lynch* v. *Hornby* was decided the Supreme Court also held

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[51] Magill, *Realization of Income Through Corporate Distributions* (1931) 31 Col. L. Rev. 519.
[52] Lynch v. Turras, 247 U.S. 221, 38 Sup. Ct. 537, 60 L.ed. 1087 (1918).
[53] Lucas v. Alexander, 279 U.S. 573, 49 Sup. Ct. 426, 73 L.ed. 851 (1929).
[54] Lynch v. Hornby, 247 U.S. 339, 38 Sup. Ct. 543, 62 L.ed. 1149 (1918).
[54a] United States v. Safety Car Heating Co., 297 U.S. 88, 96, 56 Sup. Ct. 353, 80 L.ed. 500 (1936).

that a dividend by a corporation of shares owned by it in another corporation was not a true stock dividend and was subject to the tax like an equivalent distribution of money or other property.[55]

Gains realized by stock fire insurance companies from sale or other disposition of property accruing after March 1, 1913, were taxable as income, for the tax being upon "realized gain" it may constitutionally be imposed upon the entire amount of the gain realized within the taxable period even though some of it represents enhanced value in an earlier period before the adoption of the 1918 taxing act.[56] In this last-mentioned case Mr. Justice Stone stated that the "realization of the gain is the event which calls into operation the taxing act, although part of the profit realized in one accounting period may have been due to increase of value in an earlier one."[57]

The tendency to look upon March 1, 1913, as fixing a point of time when claims of every kind no matter how contingent became transmuted into capital at least for taxing purposes was recently condemned by the United States Supreme Court. The contrary idea, with few exceptions, was held the correct one, to wit: "That every form of income accruing fully and unconditionally after February, 1913, shall contribute to the Treasury, though it had a potential existence for years before its capacity to fructify."[58] In the last-cited case the Treasury Regulations classifying claims that existed unconditionally (as distinguished from those conditionally or contingently existing) on March 1, 1913, as non-taxable was approved; consequently, the claim of a patent owner against an infringer for damages like the claim of accounting for profits, although existing prior to March 1, 1913, was too contingent and conditional as of that date to be considered capital, so that when the infringement suit was thereafter settled (subsequent to March 1, 1913) the entire amount received in compromise was income and so taxable.[59] Also, where a corporation had a surplus on March 1, 1913, but in the subsequent years suffered yearly losses and then again enjoyed yearly profits it was held that the subsequent yearly losses could not be charged against the subsequent profits but the losses must be deducted from the surplus of March 1, 1913, in determining the amount of dividends exempt from federal income tax under the 1921 Revenue Act.[60]

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[55] Peabody v. Eisner, 247 U.S. 347, 38 Sup. Ct. 546, 62 L.ed. 1152 (1918).

[56] MacLaughlin v. Alliance Insurance Co., 286 U.S. 244, 52 Sup. Ct. 538, 76 L.ed. 1083 (1932).

[57] MacLaughlin v. Alliance Insurance Co., *supra* note 56 at p. 249.

[58] United States v. Safety Car Heating Co., 297 U.S. 88, 96, 56 Sup. Ct. 353, 80 L.ed. 500 (1936).

[59] United States v. Safety Car Heating Co., *supra* note 58.

[60] Helvering v. Canfield, 291 U.S. 163, 54 Sup. Ct. 368, 78 L.ed. 706 (1934). When dividend checks are mailed by the corporation in one year and received by the shareholder in a subsequent year they are taxable as income under the 1924 and 1928 Acts for the calendar year when received by shareholder. See Avery v. Commissioner, 292 U.S. 210, 54 Sup. Ct. 674, 78 L.ed. 1216 (1934).

In respect to the taxability of stock dividends as income to the stockholders, long and bitter legal contests have been waged. Some of the best legal talent in the country, including Charles E. Hughes, George W. Wickersham, Albert M. Kales, and W. C. Herron, participated as attorneys and counsellors in the judicial determination of this perplexing problem. The original case upon which all the tax cases with reference to stock dividends are based is, undoubtedly, that of *Gibbons* v. *Mahon*[61] in which it was held that as between a life tenant and a remainder-man under an equitable trust created by will a stock dividend was not income but an accretion to capital; that only the income from a stock dividend was payable to the tenant for life, not the stock dividend itself. The stock dividend, it was said, really took nothing from the property of the corporation and added nothing to the interest of the shareholders; the only change was in the evidence which represented that interest, namely, the new shares and the original share together representing the same proportional interest that the original shares represented before the issue of the new shares.

Thereafter, it was held that the value of new shares of a corporation issued and distributed as a stock dividend on December 26, 1913, but representing surplus profits earned before January 1, 1913, and transferred to the capital account, was not taxable to the shareholders as income.[62] The same legal reasoning used in the said *Gibbons* case applied, although the Attorney General sought to draw a distinction between the proper construction to be placed on an equitable trust created under a will and a tax statute created by Congressional act.

Now, unlike the Revenue Act of 1913, the Revenue Act of 1916 expressly provided that stock dividends should be considered income to the amount of their cash value. Accordingly, the government sought to collect income tax on a fifty per cent stock dividend declared by the Standard Oil Company of California from surplus earned between March 1, 1913, and January 1, 1916. The United States Supreme Court held that Congress could not by any definition it may adopt conclude the matter as to what is or what is not income within the meaning of the Sixteenth Amendment since it cannot by legislation alter the constitution from which alone it derived its power to legislate;[63] consequently, a stock dividend was not income within the Sixteenth Amendment merely because it was so declared by Congress. A stock dividend, it was said, merely evinced a transfer of an accumulated surplus to the capital account of the corporation, took nothing from the property of the corporation and added nothing to that of the shareholder; a tax on such dividends was a tax on capital and not on income; and,

[61] Gibbons v. Mahon, 136 U.S. 549, 10 Sup. Ct. 1057, 34 L.ed. 525 (1890).
[62] Towne v. Eisner, 245 U.S. 418, 38 Sup. Ct. 158, 62 L.ed. 372 (1920).
[63] Eisner v. Macomber, 252 U.S. 189, 40 Sup. Ct. 189, 64 L.ed. 521 (1920).

therefore, was invalid without apportionment under the constitution. Of course, the same legal reasoning does not apply to a dividend of shares owned by one corporation in another corporation as this type of dividend distribution is not a true stock dividend but is equivalent to a distribution of money.[64]

Income being judicially defined by the aforesaid cases as a gain derived from capital, from labor, or from both combined, including profits gained through a sale or conversion of capital assets, it was, quite logically, held in 1921 that this included a gain from capital realized by a single, isolated sale of property held as an investment as well as profits realized by sales in a business of buying and selling such property.[65] In this last-mentioned case the court definitely refused to follow the economic theory holding income to be a flow of economic goods over a period of time and possessing the essential attribute of "recurrence."

The last expression from the United States Supreme Court as to whether stock dividends are taxable as income in the hands of the shareholders was rendered on May 18, 1936. It was decided in the case of *Koshland v. Helvering*[66] that where a stock dividend gives to the stockholder an interest different from that which his former stockholdings represent, he receives income within the meaning of the Sixteenth Amendment; consequently, where common voting shares of a corporation were received by the holder of cumulative preferred shares as a dividend they were not to be treated as returns of capital but taxable income to the stockholder. The court through Mr. Justice Roberts in the last-mentioned case distinguished the earlier stock dividend cases in which the dividend was held not to be income by stating: "Under our decisions the payment of a dividend of new common shares conferring no different rights or interests than did the old,—the new certificates, plus the old, representing the same proportionate interest in the net assets of the corporation as did the old,—does not constitute the receipt of income by the stockholder."[67] In analyzing this last decision of the Supreme Court in relation to stock dividends, it will be noticed that the crux of the decision lies in the fact that the stock dividend gave the stockholder an interest different from that which his former stockholdings represented. Query, where a corporation has only common stock and no preferred stock outstanding and the directors declare from accumulated corporate surplus a dividend to

[64] Peabody v. Eisner, 247 U.S. 347, 38 Sup. Ct. 546, 62 L.ed. 1152 (1918).
[65] Merchants' Loan & Trust Co. v. Smietanka, 255 U.S. 509, 41 Sup. Ct. 386, 65 L.ed. 751 (1921). See also Taft v. Bowers, 278 U.S. 470, 49 Sup. Ct. 199, 73 L.ed. 460 (1929), recognizing the right of Congress to fix the value of a gift in the hands of the donee at the price paid by the donor.
[66] Koshland v. Helvering, 298 U.S. 441, 56 Sup. Ct. 767, 80 L.ed. 1268 (1936).
[67] Koshland v. Helvering, *supra* note 66 at page 445.

the common stockholder payable in newly created preferred stock is it a taxable dividend? The same voting rights, management, and control in the corporation are retained. True, the investment is now different in form but the ownership in the corporate assets—the substance thereof—is the same. The new certificates plus the old certificates represent the same proportionate interest in the net assets as did the old common stock certificates before the preferred stock dividend was declared. Under these facts and circumstances can it be said legally and logically that the stockholder has received an interest different from that which his former stockholdings represent thus constituting income within the meaning of the Sixteenth Amendment? This and cognate problems have not been decided by the United States Supreme Court. However, in summarizing the stock dividend cases it seems very logical that where both common and preferred stock are outstanding a dividend of common shares on common stock is tax exempt to the stockholder;[68] a dividend of common shares on preferred stock is taxable to the stockholder;[69] a dividend of preferred shares on common stock is taxable to the shareholder;[70] a dividend of preferred shares on preferred stock is or is not taxable income to the stockholder depending upon the possible difference in rights or proportional interest obtained by the stockholder, but where only common stock is outstanding a dividend of new preferred shares on the common stock is not taxable to the stockholder, for after the distribution the stockholder has the same proportionate interest in the corporation as he had previous to the dividend so declared.[71]

So far as stock rights are concerned a parity of reasoning has been applied as that used in the stock dividend cases. Where stock rights covering its own stock are issued by a corporation to the stockholder by way of a dividend, said stock rights do not constitute taxable income in the hands of the stockholder until income is realized by a sale thereof by him.[72] However, where a stockholder of a corporation receives through dividends certain warrants to subscribe to stock either of a different class in the same corporation or any stock in a different corporation, to the extent he acquires greater rights or "different interests" he receives taxable income. Thus, a taxable dividend was received to the extent that the market value of the stock, as to which the stock rights were issued, exceeded the price payable therefor where a stockholder of one corporation received warrants to subscribe at less than

[68] Eisner v. Macomber, 252 U.S. 189, 40 Sup. Ct. 189, 64 L.ed. 521 (1920).
[69] Koshland v. Helvering, 298 U.S. 441, 56 Sup. Ct. 767, 80 L.ed. 1268 (1936); Tillotson Manufacturing Co. v. Commissioner, 27 B. T. A. 913 (1933).
[70] Torrens v. Commissioner, 31 B. T. A. 787 (1934).
[71] Harriman v. Commissioner, 34 B. T. A. 180 (1936).
[72] Miles v. Safe Deposit & Trust Co., 259 U.S. 247, 42 Sup. Ct. 483, 66 L.ed. 923 (1922).

current market prices for stock in another corporation; and, "the date of receipt of the warrant" by the stockholder is the day for determining its value.[73]

In concluding it is submitted, in view of the fact that the courts will respect the corporate personality or the separate legal entity of the corporation for tax purposes unless it becomes clear that the fiction is used to defeat public convenience, justify wrong, protect fraud, defend crime, or evade the payment of taxes by setting up corporate instrumentalities or adjuncts for sinister reasons, the suggestion of taxing stockholders personally for the undistributed corporate profits, whether under the constructive receipt theory or otherwise, is legally fatal on constitutional grounds. The matter taxed is not "income" to the stockholder within the terms of the Sixteenth Amendment as determined by the above-mentioned decisions of the United States Supreme Court. On the contrary, the subject taxed is capital or the accretion of capital unsevered and unrealized—probably and pragmatically never to be realized by the stockholders. Being capital a tax thereon would be subject to the constitutional rule of apportionment of direct taxes, which, in turn, would make this entire scheme of taxation not only impractical but impracticable, especially so in respect to vertical and horizontal corporate combinations of vast intercompany stockholdings and of numerous scattered stockholders. Of course, the states of the union are not prevented by the federal constitution like Congress from taxing stock dividends or other evidences of corporate earnings directly to the stockholders. The constitutional rule of apportionment of direct taxes does not apply to them. Possibly, but very improbably, uniformity in this phase of taxation could be attained through state compacts (with the consent of Congress) under Article 1, Section 10, Clause 3, of the United States constitution. Congress itself might strive to gain this necessary power to tax directly and without apportionment the stockholders for the undistributed corporate earnings. But, this would require a constitutional amendment. Who would dare propose it? Would it ever be ratified?

It would seem far better that there be now imposed upon the corporation one flat normal income tax comparable to the average normal and the surtax imposed upon the individual. After putting teeth into Section 102 (relating to surtax on corporations which improperly accumulate surplus) and Section 351 (relating to personal holding companies) of the 1936 Revenue Act, let them grind and cut by vigorous and relentless prosecutions of tax evasion cases. Relax the legal

[73] Commissioner v. Mayer, 86 F. (2d) 593 (C.C.A. 7th, 1936). See also Moran v. Lucas, 36 F. (2d) 546 (D.C. App. 1929); Torrens v. Commissioner, 31 B. T. A. 787 (1934).

presumptions against fraud, and intent, in tax cases, modernize the federal court procedure according to the recent suggestions of Attorney General Homer Cummings, make the taxpayer justify the large undistributed corporate earnings or surplus by the needs and exigencies of his particular business.

At the same time, if additional governmental revenue is needed and not produced by the increasing improvement of business conditions throughout the country, the wisest course seems to be to reduce the personal exemptions and increase the normal tax rates for individuals. This has been successfully done in England. Furthermore, taxpayers of earned income from services rendered should be granted special and additional tax credits. This applies especially to laborers, salary-earners, and the professional men who are now unjustly suffering a heavy and disproportionate tax burden. They have no compensating allowances for depreciation; comparable advertising expenses; nor are they permitted to deduct losses not connected with trade, business, profit, or arising from fires, storms, shipwreck, or other casualty; they may set up no reserves for impairment of their earning power through sickness, accident, old age, or otherwise. On the other hand, owners of property incomes enjoy very substantial and special tax deductions.

Now, in view of the fact that the ever-recurring federal tax problems are so complex and vital to the welfare of the people and the administration of the government, the appointment of a special Federal Tax Commission to study constantly and report regularly on the development of an improved national tax system co-ordinating with the tax systems of the several states is expedient and advisable. As an administrative body it could take sworn testimony, make investigations, conduct hearings, collaborate with the Treasury Department, Board of Tax Appeals, representatives of American industry and independent tax economists. The constructive work to be done in this field of endeavor is far beyond the mental power and physical stamina of any single man. It requires firm collective action. But, at the same time, it must not be forgotten that confidence is inspired by the continuity and stability of a sound, adequate, certain, convenient, and just tax system. Hasty tax experiments embodying drastic retroactive provisions and sudden radical changes jeopardize American business, endanger the smooth flow of necessary government revenue and cast heavy and unjust burdens upon the people. Nevertheless, even the most ardent exponents of the 1936 Revenue Act must admit that there is vast room for improvement in the present law.