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### Legislation to Prevent Corporate Evasion of Taxes

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power," or upon the application of the doctrine of *stare decesis*,<sup>24</sup> but also from the standpoint of its practicability. It could not have been the intent of Congress to lay the tax at once, while the deed was still subject to the power of revocation, for such a gift might never have become consummate. If the grantor of a revocable trust deed would exercise his power of revocation, he would be burdened by a tax upon the transfer of the entire principal, when actually only a gift of the income had been made. Since it is the rule that in the construction of a taxing act doubt is to be resolved in favor of the greatest number of taxpayers effected by it,<sup>25</sup> the contention of the taxpayer, in the case under discussion,<sup>26</sup> cannot be upheld.

ALFRED HECKER.

LEGISLATION TO PREVENT CORPORATE EVASION OF TAXES.—As long as the Government's main source of revenue is derived from taxation just so long will the attempts of man to defeat it continue. Nor is the legislature unmindful of this as is evidenced by the preponderance of conditions, exceptions, limitations and modifications that constitute nearly every such statute.

Perhaps the outstanding embodiment of this is noticed in the Revenue Act of 1932, Section 104, dealing with surtax on personal income. The main objective of this act is to prevent the utilization of the corporate entity theory to lessen materially or defeat the amount due as a tax on personal income. That there is a considerable advantage to be gained by permitting one's income to accumulate in the coffers of a corporation can readily be perceived when we recall that the Government demands a levy of only thirteen per cent on the income of a corporation no matter how large it may be, but requests the private individual to pay over as much as fifty-five per cent. Further, the corporation is not taxable at all if the source of its income is derived from dividends of other corporations.<sup>1</sup> Is it surprising, then, that this situation will result

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<sup>24</sup> *Supra* note 10.

<sup>25</sup> *American Net and Twine Co. v. Worthington*, 141 U. S. 468 (1891); *Benzger v. United States*, 192 U. S. 38 (1904); *Gould v. Gould*, 245 U. S. 151, 153, 38 Sup. Ct. 53, 54 (1917), "in the interpretation of statutes levying taxes it is the established rule not to extend their provisions, by implication, beyond the clear import of the language used, or to enlarge their operations so as to embrace matters not specifically pointed out. In case of doubt they are construed most strongly against the Government, and in favor of the citizen"; *United States v. Merriam*, 263 U. S. 179, 44 Sup. Ct. 69 (1923); *Tyler v. United States*, *supra* note 10, 281 U. S. at 503, 50 Sup. Ct. at 503, "Taxation, as it many times has been said, is eminently practical \* \* \*." See also Note (1931) 6 ST. JOHN'S L. REV. 172 and cases cited therein.

<sup>26</sup> *Supra* note 4.

<sup>1</sup> REVENUE ACT of 1932, §23.

in attempts to utilize the advantages of corporate existence to avoid payment of tax?

It is to meet this situation that Section 104 was enacted.<sup>2</sup> Under it any corporation formed "for the purpose of preventing the imposition of the surtax on its shareholders \* \* \* shall be liable to a fifty-per-cent tax on all such accumulated income." Obviously the statute is punitive in its essence. Intent to evade is the *criteria* that is put forth. That such wrongful purpose will be difficult to establish is evident particularly since the taxpayer is entitled to the benefit of the doubt.<sup>3</sup> The difficulties encountered in the enforcement of this section is exemplified in the well known *Ford Motors* case.<sup>4</sup> In an action by the minority shareholders against the company to obtain a declaration of a dividend the court held that the accumulation of the twelve-million-dollar surplus was unreasonable and sustained the action. Nevertheless, the court held that the accumulation was not for the purpose of preventing a tax and therefore did not come within the Revenue Act, Section 104.

A further difficulty arises if the purpose of the corporation is twofold—to avoid tax and a legitimate purpose. Here again the court held the statute inapplicable.<sup>5</sup> There is little doubt that the courts are hesitant in applying the statute because of the punitive results that ensue from its breach.

Perhaps the outstanding case on this subject is *United Business Corporation v. Commissioner*<sup>6</sup> where the statute was held applicable. Briefly, the facts are that in 1920 one Smith formed a corporation with a capital of some two million dollars, said Smith holding all the shares. But the purpose was concededly legal, for Smith was a sick man and desired to make it easier to dispose of his property in case of his death. Moreover, in exchange for this stock Smith transferred to the corporation two office buildings valued at two million dollars with a mortgage of seven hundred thousand. Smith declared no dividends during the first two years of the corporation's existence to meet this mortgage. But in the latter part of 1920 he transferred four hundred and fifty thousand dollars of his personal security holdings to the corporation, and in 1921 he added four hundred thousand more. The effect of these transfers was

<sup>2</sup> *Ibid.* §104: "(a) If any corporation, however created or organized, is formed or availed of for the purpose of preventing the imposition of the surtax upon its shareholders through the medium of permitting its gains and profits to accumulate instead of being divided or distributed, there shall be levied, collected, and paid for each taxable year upon the net income of such corporation a tax equal to 50 per centum of the amount thereof, which shall be in addition to the tax imposed by Sec. 13 and shall be computed collected and paid upon the same basis and in the same manner and subject to the same provisions of law, including penalty as that tax."

<sup>3</sup> *United States v. Merriam*, 263 U. S. 179, 44 Sup. Ct. 69 (1923).

<sup>4</sup> *Dodge v. Ford Motor Co.*, 204 Mich. 459, 170 N. W. 668 (1919).

<sup>5</sup> *Kales v. Woodworth*, 32 F. (2d) 37 (C. C. A. 2d, 1929).

<sup>6</sup> *United Business Corp. v. Commissioner*, 62 F. (2d) 754 (C. C. A. 2d, 1933); 19 B. T. A. 809 (1930).

to reduce his income from dividends from eighty thousand dollars in 1919 to three thousand five hundred in 1921. Smith went further. He borrowed about six hundred thousand dollars from the corporation, to provide which the corporation itself went in debt. The net result of these bookkeeping manipulations was to relieve Smith's payment of any income tax as well as to indicate on the corporation books that no money was available for distribution. From these facts the board decided that the intent required by the statute was present and the penalty was imposed.

But should the Government be restricted to such flagrant conduct before revenue can be collected? Should it be deprived of a considerable portion of its income simply because of inadequate statutory enactment? Each day the insufficiency of the current legislation becomes more apparent, and each day suggested remedies are tendered. In a recent article<sup>7</sup> it was proposed to remodel the statute according to that of an English law.<sup>8</sup> This proposition would substitute for "purpose" the fact of evasion. That is, regardless of purpose, if there is an undistributed surplus there is a presumption that it is taxable and the duty of establishing that it is necessary for the business would be on the corporation.

This is but one of the suggestions for the improvement of the law. That modification of some kind is necessary to accomplish justice must be admitted. The loss in revenue to the Government through the accumulation of the undivided profits of one company alone during the four years of 1922-1925 has been estimated at some 186 millions of dollars.<sup>9</sup> Are we to allow those trained in the technicalities of law to impede the accomplishment of equitable distribution of taxes?

WILLIAM H. SMITH.

FEDERAL INCOME TAXATION—NET LOSSES.—The Revenue Act of 1918 provided for determination of "net losses" by definition therein contained.<sup>1</sup> Later revenue acts<sup>2</sup> have incorporated net losses, with a variation, as a deduction. The object and effect of this provision is to provide for equalization of taxes in abnormal cases. Due to changes in economic conditions, such as the period of deflation experienced following the World War, unusual losses occur. In the English statute<sup>3</sup> this situation was provided for by

<sup>7</sup> TAX MAGAZINE (Nov. 1932) at 415.

<sup>8</sup> INCOME TAX FINANCE ACT OF 1922, 12-13 Geo. V., c. 17, §21, SCH. 1.

<sup>9</sup> L. H. Parker, NAT. INCOME TAX MAGAZINE (April, 1927) at 125.

<sup>1</sup> REVENUE ACT OF 1918, §204 (a).

<sup>2</sup> REVENUE ACT OF 1921, §204; REVENUE ACT OF 1924, §206; REVENUE ACT OF 1926, §206; REVENUE ACT OF 1928, §206.

<sup>3</sup> See KLEIN, FEDERAL INCOME TAXATION (1929) 533.