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# WASHINGTON UNIVERSITY LAW QUARTERLY

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## CORPORATE POLICY UNDER THE SURTAX ON UNDISTRIBUTED PROFITS

CHRISTIAN B. PEPPER†

In its present stage the surtax on undistributed corporate profits<sup>1</sup> presents problems of a nature chiefly strategic. In view of its legislative history<sup>2</sup> it is not surprising that a considerable portion of the Act is devoted not so much to the taxing of undistributed earnings as to the offering of inducements to their distribution. The Act, in effect, urges a rule of corporate conduct. Thus the problem of how best to conform to this rule and avoid the penalties incident to deflection becomes of first importance to the corporate taxpayer. It is the purpose of this article to sketch and evaluate the various avenues of conformance indicated by the Act. A study thus concerned with the dynamics of proposed corporate action will not deal exclusively with the legal merits of debatable issues, but will also stop to point out what types of action are more likely than not to involve the taxpayer in these legally imponderable situations; for the avoidance of such constitutes the most immediately problem in corporate strategy.

The charting of a plan of conformance is rendered complex by the presence of a number of complicating elements. Upon the normal difficulties of statutory construction are superimposed problems of constitutional law. Distributions which appear most

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1. Revenue Act of 1936, Pub. L. No. 740, 74th Cong. 2nd Sess., 26 U. S. C. A. (Supp. 1936) secs. 14, 26, 27. Hereafter the Act will be referred to only by section numbers.

2. *Minority Views of Senate Committee on Finance on H. R. 12395*, 74th Cong. 2nd Sess. (1936); *Report of Senate Committee on Finance on H. R. 12395*, 74th Cong. 2nd Sess. (1936). And for a survey of earlier legislative adumbrations of the Act see, Graham, *The Undistributed Profits Tax and the Investor* (1936) 46 Yale L. J. 1, at 10.

safely to conform to the legal and constitutional requirements of the Act may be rendered undesirable by considerations of sound or practical corporate finance. Normally the taxpayer's sole antagonist is the government; yet here, inasmuch as the corporation is given credit only for distributions taxable in the hands of the shareholder, it may be confronted with the situation in which a distribution encouraged by the taxing authorities, is established by a shareholder not to constitute taxable income in his hands. Over facile encouragement by the taxing authorities is not the least, then, of the difficulties inherent in making proper distributions.

This study will be chiefly directed to an evaluation of the credits provided by the Act whereby a corporation normally subject to the undistributed profits tax may avoid its incidence.<sup>3</sup> These credits fall broadly into two categories. (1) In the first group are embraced credits based upon contractual inability of the corporation to distribute its income. These present problems of a more conventional nature since they depend upon no future action of the taxpayer. Here the problem is almost entirely one of statutory construction. (2) The second type of credit depends upon the making of distributions which constitute taxable income in the hands of shareholders. Here the center of inquiry must be shifted from statutory construction to constitutional law; for these provisions of the Act are stretched upon a constitutional framework the nature of which can only be ascertained by reference to a considerable body of judicial definitions.

#### I. CREDITS BASED UPON CONTRACTUAL INABILITY TO MAKE DISTRIBUTIONS

##### A. *Prohibitions Upon Dividends*

Credit is given for amounts which cannot be distributed without "*violating a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly*

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3. Exempted from the surtax provisions of the 1936 Act are:

- "(1) Banks as defined in section 104.
- (2) Domestic corporations which for any portion of the taxable year are in bankruptcy under the laws of the United States, or are insolvent and in receivership in any court of the United States or of any State, Territory or the District of Columbia.
- (3) Insurance companies subject to the tax imposed under section 201, 204, or 207.
- (4) Foreign corporations.
- (5) Corporations which, by reason of deriving a large partion of their

*deals with the payment of dividends.*"<sup>4</sup> The careful phraseology of this section severely limits its availability for general use. Its scope is further restricted by the interpretations rendered by the Treasury department.<sup>5</sup> For the most part these interpretations are directed toward a rigid insistence upon the letter of the statute. Thus if distributions can be made in one form but not in another, without violating contractual inhibitions, or at one time during the current year and not at another time, the credit will not be allowed.<sup>6</sup> And the amount of credit is further restricted by provision that earnings accumulated prior to the current year are to be included in the computation of the amounts which can be distributed without violating a contract.<sup>7</sup> The requirement that dividends be expressly mentioned renders unavailable such common covenants as those providing that, while bonds are outstanding, corporate assets shall not be reduced below a specified amount.<sup>8</sup> Only such indentures as expressly declare that no dividends shall be paid unless a current asset ratio is preserved or that some similar requirement is met, would be able to fall under the credit. More uncertainty is centered about

gross income from sources within a possession of the United States, are entitled to the benefits of section 251.

(6) Corporations organized under the China Trade Act, 1922.

(7) Joint Stock Land Banks organized under the Federal Farm Loan Act as amended." Sec. 14 (d).

4. Sec. 26 (c) (1). It is further provided that "If a corporation would be entitled to a credit under this paragraph because of a contract provision and also to one or more credits because of other contract provisions, only the largest of such credits shall be allowed, and for such purpose if two or more credits are equal in amount only one shall be taken into account."

5. 70 Treas. Dec. No. 7 (Int. Rev. 4674, XV Int. Rev. Bull., No. 32 Regulations (1936) Art. 26-3(a). Hereafter the Regulations will be referred to by Articles.

6. Art. 26-3(b).

7. *Ibid.* As an example is given the case of a corporation which has executed an indenture requiring it to set aside earnings and profits sufficient to retire 10% of outstanding bonds annually before any dividends can be paid on the stock. If the corporation has on hand earnings and profits of prior years it will be deemed to be able to apply these toward the sinking fund payments. Art 26-3(b) Example 1. And see *ibid.* Example 2. It has been argued that the Act intended only current income to be taken into account in determining whether a distribution would violate such contractual inhibitions. Hendricks, *The Surtax on Undistributed Profits of Corporations* (1936) 46 Yale L. J. 19, at 27, 28.

8. "The requirement \* \* \* is not met in case (1) a corporation is merely required to set aside periodically, a sum to retire its bonds, or (2) the contract merely provides that while its bonds are outstanding the current assets shall not be reduced below a specified amount." Art. 26-3(b). For the effect upon the normal corporate indenture see, *Wall Street Journal* (Aug. 10, 1936) p. 1, col. 6.

the ruling that the charter of a corporation does not constitute a contract within the meaning of the Act.<sup>9</sup> Such an interpretation would foreclose the only potential avenue of escape provided in the Act for a corporation which began the taxable year with an operating deficit, which made earnings during the taxable year, and which is prohibited from paying out such by a state statute prohibiting distributions which result in an impairment of capital.<sup>10</sup> A charter expressly subjecting the corporation to present and future state laws relating to corporations might be held to include as one of its terms a statutory prohibition on distributions. In technical legal contemplation such a charter is a contract with the state.<sup>11</sup> On the other hand the trend of decisions, while still referring to the charter as a contract with the state, is to regard the relation between the corporation and the state as one primarily of status.<sup>12</sup> Accordingly the inclusion of statutory provisions within the meaning of the term "contract" demands a somewhat tenuous and legalistic interpretative tour de force. The Treasury interpretations unfortunately appear better grounded. Obviously no corporate taxpayer can afford to predicate an action upon the possibility of error in this interpretation. It is to be regretted that express provision was not made in the Act for such a situation.

This restrictive interpretation of the term "contract," however, possesses less validity when applied to the relations between the corporation and its shareholders. Thus a covenant in the corporate charter for a preferred stock sinking fund which specifically limited the payment of common dividends, while certain amounts of preferred remained outstanding, would seem within the meaning of the Act.

Such agreements may be embodied in a charter for convenience; they hold a separable contractual status regardless of the

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9. Art. 26-3 (a).

10. The hardship imposed by this ruling is illustrated by the dilemma in which the International Paper & Power Co. appears to be placed. *Wall St. Journal* (Aug. 25, 1936) p. 6, col. 1.

11. *Trustees of Dartmouth College v. Woodward*, 4 Wheat. 518 (1819); *Miller v. New York*, 15 Wall. 478 (1873).

12. *Calder v. Michigan*, 218 U. S. 591, 31 S. Ct. 122, 54 L. ed. 1163 (1910), and cases cited therein at 599; *Greenwood v. Union Freight R. Co.*, 105 U. S. 13, 26 L. ed. 961 (1882); Schmidt, *Constitutional Limitations Upon Legislative Power to Alter Incidents of the Shareholder's Status in Private Corporations* (1935) 21 ST. LOUIS L. REV. 12.

document in which embodied.<sup>13</sup> It is likely that the Treasury ruling implies a distinction between the provisions of a charter which define the relations between the corporation and the state, and contracts between the corporation and a preferred stockholder which fortuitously happen to be included in the former.

Whether an indenture executed by a parent company having to do with profits and dividends on a consolidated basis would be considered a contract "executed" by its subsidiary, is not certain but on principle the answer would appear to be in the negative. Until the matter is clarified, intercorporate relations of this type may suffer from dislocations to such an extent as to add a further spur to reorganization.<sup>14</sup>

### *B. Sinking Fund Provisions*

Credit is given for "*an amount equal to the portion of the earnings and profits of the taxable year which is required (by a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the disposition of earnings and profits of the taxable year) to be paid within the taxable year in discharge of a debt, to the extent that such amount has been so paid or set aside.*"<sup>15</sup> It may be seen that a nice phraseology likewise characterizes this section. The same restrictive adherence to the letter appears in the Regulations.<sup>16</sup> According to the Regulations the requirements of the section are not met if the sinking fund agreement merely requires the corporation to retire a certain percentage of such bonds annually or to maintain a fund adequate to retire such bonds on maturity, or to pay into the fund specified sums per unit of lumber cut, or coal mined, or an amount equal to a percentage of gross sales or gross income.<sup>17</sup>

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13. *Yoakam v. Providence Biltmore Hotel Co.*, 34 F. (2d) 533 (D. C. D. R. I., 1929); and cases *supra*, note 12.

14. An opposite pull, however, is exerted by the difficulties put in the way of new sinking funds by sec. 26(c) (2), *infra* p. 6; and by the imponderabilities of sec. 27(f), *infra* p. 23. A similar problem would be presented by an indenture which used consolidated figures as a yardstick; such may forbid dividend declarations unless a two to one consolidated current asset ratio is preserved. Difficulties would arise if one company had this ratio, another did not. See Seidman, *Undistributed Profits Tax Problems* (1936) 14 T. M. 453.

15. Sec. 26(c) (2).

16. Art. 26-3.

17. Art. 26-3(c). It has been argued that dispositions of "gross income"

The requirement that the percentage of earnings and profits be actually set aside during the current year may conflict with such indentures as allow a period after the year's close for determination of the year's profits and prescribe that the appropriation be made upon such a determination.<sup>18</sup>

Ruling has been made that the term "debt" does not include an obligation to a shareholder as such; thus preferred stock sinking funds are excluded from the benefit of the section.<sup>19</sup> Such an interpretation results easily from the well-defined legal characteristics of the usual preferred issue.<sup>20</sup> Difficulties, however, may more readily surround the status of hybrid types of securities, the legal nature of which are more protean.<sup>21</sup>

The terminology of the statute appears to justify the conclusion drawn by the Regulations that refunding operations entered into after April 30, 1936, do not receive the protection of the credit.<sup>22</sup> This is one of the most widely, and perhaps justifiably, criticized sections of the Act. It requires careful attention by all corporations weighing the factors involved in proposed refinancing and reorganization schemes. Unless modified, the section may have a tendency to act as a fiscal brake upon corporate debt readjustments.<sup>23</sup>

or "gross sales" in effect might be considered "expressly to deal" with at least a *portion* of the earnings and profits of the taxable year. Hendricks, *The Surtax on Undistributed Profits of Corporations* (1936) 46 *Yale L. J.* 19, at 29. The Treasury ruling, however, appears justifiable. It is further provided that contractual provisions dealing with earnings and profits "in terms of 'net income', 'net earnings', or 'net profits'" fall within the scope of the statute. Art. 26-3(c).

18. *Supra*, note 15. See Seidman, *Undistributed Profits Tax Problems* (1936) 14 *T. M.* 453 for a discussion of this problem.

19. Art. 26-3(c).

20. See *Atlantic City Electric Co. v. Commissioner*, 288 *U. S.* 152, 156, 53 *S. Ct.* 383, 77 *L. ed.* 667 (1933); *In re Culbertson's*, 54 *F. (2d)* 753 (*C. C. A.* 9, 1932); *Hazel Atlas Glass Co. v. Van Dyk & Reeves*, 8 *F. (2d)* 716 (*C. C. A.* 2, 1925); *Yoakum v. Providence Biltmore Hotel Co.*, 34 *F. (2d)* 533 (*D. C. D. R. I.*, 1929).

21. Income bonds, participating operation certificates, participating bondholders, irredeemable bonds, trade certificates, represent some of the products of legal and financial ingenuity which may prove embarrassing in the present situation. For a holding as to the nature of participating operation certificates see *In re Hawkeye Oil Co.*, 19 *F. (2d)* 151 (*D. C. D. Del.* 1927); *U. S. & Mexican Oil Co. v. Keystone Auto Gas & Oil Service Co.*, 19 *F. (2d)* 624 (*D. C. W. D. Pa.*, 1924). For an able general discussion of these types see *Hazel Atlas Glass Co. v. Van Dyk & Reeves*, 8 *F. (2d)* 716 (*C. C. A.* 2, 1925); *Comment Status of Holders of Hybrid Securities: Stockholders or Creditors?* (1936) 45 *Yale L. J.* 907.

22. Art. 26-3(c).

23. See *Wall Street Journal* (Sept. 10, 1936) p. 1, col. 6; (Oct. 22, 1936) p. 1, col. 6.

The scope of credits is further curtailed by the provision that where credit may be had both under the restrictions of dividends clause and under the sinking fund clause, only the greater shall be counted.<sup>24</sup>

In general, however, it may be observed that the restrictive provisions of this section will not press upon the average corporation as severely as do those of Sec. 26(c) (1); for in cases where the sinking fund represents the application of sums reserved for depreciation and deducted from earnings before calculating the net corporate income subject to tax, the necessity of invoking the section will be avoided.<sup>25</sup>

It can be seen that exemptions based upon contractual inability to distribute income are narrowly conceived and restrictedly interpreted so as to serve only a limited number of situations. Added to this narrowness of scope are the individual problems of interpretation noted above, which ultimately may be resolved only in litigation. Consequently, rather than rely upon these exemptions it is advisable for the corporate taxpayer to seek relief under the category of dividends paid credits. Where the corporation is prevented by contract or law from distributing a portion of its earnings, it prudently should hedge against the possibility of such being entirely disallowed as credits, by distributing the remainder of its income in accordance with the more liberal dividends paid provisions, to be discussed below. Where the entirety of its income is frozen by contractual or legal obstacles, the taxpayer stands in a more serious dilemma; it is neither certain of obtaining exemptions in its present condition, nor able to ensure such by positive action. In such a case the only antidote would appear to consist in removing the obstacles to distribution; in the cases of capital deficits the knot occasionally may be cut by a shifting of book entries.<sup>26</sup> Corporate liquidations and reorganizations may also relieve the difficulty; there is, however, in the resort to such expedients, the danger of falling under an even more hazardous and uncharted section of the Act.<sup>27</sup>

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24. Sec. 26(c) (3).

25. See Graham, *The Undistributed Profits Tax and the Investor* (1936) 46 *Yale L. J.* 1, at 13.

26. *i. e.* by such dubious expedients as writing up tangible assets, reducing certain reserves. The reduction of capital stick is a more respectable device. In such cases, however, the cure might be more harmful than the malady. See Prentice-Hall 1936 Federal Tax Service Vol. I, para. 34.

27. *Infra* p. 23.



These credits, then, contain serious lacunae; they create, in effect, a taxable limbo in which a corporation which is unable to comply with the rule of conduct urged by the Act suffers an unavoidable penalty.<sup>28</sup> It is to be hoped that revisions of the law will extend the scope of exemptions to include all bona fide cases where the taxpayer is legally or contractually unable to declare out earnings in dividends. There is some indication that this revision is not far away.<sup>29</sup>

## II. DIVIDENDS PAID CREDITS

In sharp contrast to the credits dealt with above are those allowed under this head. Here we are dealing with what are in effect stimuli to a desired cause of action. Difficulties arise not so much from a restrictive statutory and administrative policy as from what may prove in some cases to be a too facile invitation to act. The law provides for a number of dividend policies whereby a corporation may avoid the incidence of the tax; a few such policies are sketched by the Act and regulations; others may be deduced from the broad and liberal terminology employed by the statute. All credits, however, are made expressly subject to the requirement that the distribution constitute taxable income in the hands of the distributee.<sup>30</sup> Thus the Act, in a manner perhaps unique to American jurisprudence, embodies by reference a great mass of case law dealing with the definition of the meaning of "income" as used in the Sixteenth Amendment. Thus in place of the niceties of statutory interpretation we are confronted with the less predictable niceties of constitutional law. A study of this constitutional background is necessary to an evaluation of the dividend choices open to the corporate taxpayer. Upon such a background the laws and regulations are projected. This background becomes particularly pertinent in the case of stock

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28. Consult Wall Street Journal (Aug. 25, 1936) p. 6, col. 1; (Aug. 10, 1936) p. 1, col. 6.

29. Wall Street Journal (Oct. 22, 1936).

30. Sec. 27(h) "If any part of a distribution (including stock dividends and stock rights) is not a taxable dividend in the hands of such of the shareholders as are subject to taxation under this title for the period in which the distribution is made, no dividends paid credit shall be allowed with respect to such part." Sec. 115(f)(1) provides "A distribution made by a corporation to its shareholders in its stock or in rights to acquire the stock shall not be treated as a dividend to the extent that it does not constitute income to the shareholder within the meaning of the Sixteenth Amendment to the Constitution." For a delimitation of taxable income, see Sec. 115(a); (b); (c); (d); (e); (f); Art. 27-8.

dividends proper—a type which will appear most attractive to corporations which desire to capitalize and retain their current earnings.<sup>31</sup>

### A. *Stock Dividends*

Constitutional inhibitions upon the taxability of stock dividends arose early in the history of the amendment when the Court, in the case of *Eisner v. Macomber*<sup>32</sup> (against Holmes' succinct objection that the purpose of the amendment had been to get rid of such "nice questions,")<sup>33</sup> held that an operation, whereby a corporate surplus was transferred to capital and distribution thereof made by issuing new common stock as a dividend upon the outstanding common, did not constitute taxable income within the meaning of the Amendment. The decision was based chiefly upon the reasoning that (1) the transaction was a mere bookkeeping device whereby the corporation relinquished nothing and the stockholder gained nothing for his separate use, and that (2) the pre-existing proportionate interests of the stockholder were in no wise altered by the distribution; for immediately following the dividend he held precisely the same interests in the corporate assets as before; the evidences of his ownership had been multiplied, their sum remained constant.<sup>34</sup> Certain limitations upon the rule were hinted at in the majority opinion, but, with occasional exceptions, were subsequently ignored or overlooking by the Treasury Department and lower courts; and for a period of many years the taxability of all stock dividends was held suspect.<sup>35</sup> Close upon *Eisner v. Macomber*, however, followed a series of Supreme Court decisions which gave greater effect to the qualifications of the rule than to the

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31. See Wall Street Journal (Oct. 22, 1936 p. 1, col. 6, p. 2, col. 6 (Greyhound Corp.); (Aug. 10, 1936) p. 1, col. 6; 143 Comm. & Fin. Chron. 2201, 2669 (Caterpillar Tractor); 143 Comm. & Fin. Chron. 2360 (Chesapeake & Ohio Ry.).

32. 252 U. S. 189, 40 S. Ct. 189, 64 L. ed. 521 (1920).

33. *Ibid.* at 220.

34. For a thorough discussion of this case, see Magill, *Realization of Income Through Corporate Distributions* (1936) 36 Col. L. Rev. 519; Magill, *Taxable Income* (1936) at 29 ff. In general consult Seligman, *Effects of the Stock Dividend Decision* (1921) 21 Col. L. Rev. 313; Maggs, *Computation of Income* (1924) 13 Calif. L. Rev. 12; Note, *Taxability of Stock Dividends as Income* (1936) 45 Yale L. J. 1122; Powell, *Income from Corporate Dividends* (1922) 35 Harv. L. Rev. 363.

35. See 26 U. S. C. A. sec. 115 (f) (1934): "A stock dividend shall not be subject to tax." And Regs. 86 (1934 Act) Art. 115-7, 115-8. And see cases and rulings cited in notes 48, 88, 96, 97, *infra*.

rule itself. These, for the most part, dealt with exchanges in connection with reorganizations, then taxable.<sup>36</sup> A common stockholder who was given new common in his reorganized company was held to have received a taxable change in his proportionate interest by reason of the fact that the new corporate charter was obtained in a different state from that of the original incorporation, and hence was subject to different corporation laws which gave different legal attributes to the securities.<sup>37</sup> And the fact that the new corporation had a greater capitalization than the old was held to create a possibility of new interests entering the picture—and thus to alter the old shareholder's proportionate interest.<sup>38</sup> These holdings indicated a readiness on the part of the Court to give effect to even slight alterations of proportionate balance. On the other hand it had already held that dividends in the stock of a different corporation constituted a severance of assets from the declaring corporation.<sup>39</sup> This rule was reiterated in the *Pipe Line* decisions which followed *Eisner v. Macomber*.<sup>40</sup> The progress toward a liberalization of the *Eisner* rule, however, was not constant; the case of *Weiss v. Stearn*,<sup>41</sup> decided as late as 1924, serves as a warning that the former decision has been distinguished but not overruled. In May of the present year the Supreme Court, in *Koshland v. Helvering*<sup>42</sup> took occasion to clarify its stand upon stock dividends apart from corporate reorganization. The taxpayer was the holder of 7% non-voting cumulative preferred, upon which dividends were payable, at the option of the corporation, in either cash or common stock. During the years 1925 to 1928 dividends were paid in common shares. In 1930 the preferred stock was redeemed. In computing gain the commissioner treated the com-

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36. *United States v. Phellis*, 257 U. S. 156, 42 S. Ct. 63, 66 L. ed. 180 (1921); *Rockefeller v. U. S.*, 257 U. S. 176, 42 S. Ct. 68, 66 L. ed. 186 (1921); *Cullinan v. Walker*, 262 U. S. 134, 43 S. Ct. 495, 67 L. ed. 906 (1923); *Marr. v. United States*, 268 U. S. 536, 45 S. Ct. 575, 69 L. ed. 1079 (1925).

37. *United States v. Phellis*, *supra*, note 36; *Marr v. United States*, *supra*, note 36.

38. *United States v. Phellis*, *supra*, note 36; *Marr v. United States*, *supra*, note 36; and consult Magill, *Taxable Income* (1936) at 52 ff.

39. *Peabody v. Eisner*, 247 U. S. 347, 38 S. Ct. 546, 62 L. ed. 1152 (1918).

40. *Rockefeller v. United States*, *supra*, note 36; *Cullinan v. Walker*, *supra*, note 36.

41. 265 U. S. 242, 44 S. Ct. 490, 68 L. ed. 1001 (1924)

42. 56 S. Ct. 767, 80 L. ed. 845 (May 18, 1936).

mon dividends as non-taxable distributions of capital and allocated to them a proportionate part of the cost of the preferred stock, thus reducing the cost basis of the preferred. It was held that the common dividends constituted income and could not be treated as returns of capital. The Court pointed out that *Eisner v. Macomber* "affected only the taxation of dividends declared in the same stock as that presently held by the taxpayer";<sup>43</sup> reference was made to the reorganization cases noted above;<sup>44</sup> and the distinction was pointed between a stock dividend which conferred "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, \* \* \*" and one which gave the stockholder "an interest different from that which his former stock holdings represented \* \* \*."<sup>45</sup> The latter is taxable. The language of this opinion has been embodied verbatim in the Regulations applicable to the dividends paid credit provisions of the Act.<sup>46</sup> It is perhaps chiefly with this decision in mind that the Act and Regulations provide in general terms for credits equal to taxable dividends distributed by a corporation. We can now examine some of the alternatives open to the corporate taxpayer in the light of this constitutional background.

### 1. Common on Common

It is perhaps unnecessary to remark that this most convenient and frequently employed form of dividend can, under the decisions, afford no basis for a dividends paid credit. The ruling of *Eisner v. Macomber* as applied to such distributions stands fortified by the distinctions made by the Court in *Koshland v. Helvering*.<sup>47</sup> For the purposes of this tax, it is unfortunate that the inexorabilities of constitutional law foreclose a type of dividend which in most cases would create less difficulties in corporate financial structure than those to which, under present circumstances, the corporate taxpayer will be compelled to resort.

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43. 80 L. ed. 845, at 847.

44. *Ibid.* at 847.

45. *Ibid.* at 847, 848.

46. Art. 115-3.

47. "Under our decisions the payment of a dividend of new common shares, conferring no different rights or interests than did the old \* \* \* does not constitute the receipt of income by the stockholder." *Koshland v. Helvering*, 80 L. ed. 845, at 847.

## 2. Common Stock Solely Outstanding, Preferred Declared as Dividend

Where the sole stock outstanding is common and it is proposed to create and issue as dividends upon the common a preferred issue, it is by no means certain that this constitutes distribution taxable to the recipient. A long line of Board decisions, tacitly assuming that such were nontaxable, appears of little value in light of the misapprehension of *Eisner v. Macomber* until recently held by the Treasury Department and lower courts.<sup>43</sup> They acquire a reflected importance, however, from a recent decision which held that a preferred dividend upon common is taxable where both common and preferred were at the time outstanding, and which distinguished these prior holdings on the ground that they involved situations where only common was outstanding at the time of the preferred dividend.<sup>49</sup> It is also significant that the Regulations to the 1936 Act give as an example of a taxable distribution the declaring of a preferred dividend on common where both common and preferred are outstanding.<sup>50</sup> The omission of our present situation may at least indicate doubt. On the other hand, if the broad dictum that *Eisner v. Macomber* affected only "the taxation of dividends declared in the same stock as that presently held by the taxpayer"<sup>51</sup> is to be carried to its linguistic conclusion, there would be justification for including our present type of distribution among the list of dividends taxable to their recipient. However, it is submitted that this dictum should be qualified by the further distinctions drawn by the Court between dividends which work a change in the proportionate interest of the stockholder and those which do not.

Upon this basis it may be reasoned that a common stockholder who receives a preferred dividend, retains the same proportionate interest in the corporation as before; his right to receive dividends remains in the same proportion as before; the fact that a portion of his share is to be paid upon his preferred stock does

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43. *Commissioner v. Brown*, 69 F (2d) 602 (C. C. A. 7, 1934); *Alfred A. Laun*, 26 B. T. A. 764 (1932); *Gertrude B. May*, 26 B. T. A. 1413 (1932); *Louis Rorimer*, 27 B. T. A. 871 (1933); *T. Pierre Champion*, 27 B. T. A. 1312 (1933); *Annie Watts Hill*, 27 B. T. A. 72 (1932); and consult note 35, *supra*.

49. *H. C. Gowran*, 32 B. T. A. 820 (1935).

50. Art. 115-3, example (3).

51. *Koshland v. Helvering*, 80 L. Ed. 845, at 847 (1936).

not alter the percentage of corporate income flowing to him; his voting rights remain the same, as does his right to participate in the assets upon dissolution. In answer it has been urged that, granting that prior to the issuance of preferred the stockholders acting in unison had precisely the same rights which they now enjoy separately as preferred shareholders, nevertheless, after the distribution each shareholder possesses certain preferred preferences regardless of the action of the other shareholders, whereas formerly he only possessed these in unison with his fellows.<sup>52</sup> The difficulty with this argument is that it proves too much; for similar reasoning might be applied to the receipt of common stock by a common shareholder.<sup>53</sup>

Obviously, therefore, a distribution, the unsolved nature of which depends upon the subtleties of constitutional dialectics, cannot serve as a practical implement upon which a corporate taxpayer desiring a dividend paid credit can rely.

A corporation which desires to issue a stock dividend, and which has only common outstanding, must take care to avoid a distribution subject to the pitfalls inherent in the type here discussed. An awareness of this difficulty is displayed in the plan early adopted by the Caterpillar Tractor Company, which has outstanding only common shares.<sup>54</sup> Preferred is to be created, and an option (of a sort to be discussed hereafter) given the common shareholders to obtain either cash or the new preferred as a dividend. When, by this method, a portion of the preferred has become outstanding, the corporation will pay the remainder of the earnings on which it desires a dividends paid credit in the form of a second dividend, this time solely in the preferred issue. It would appear expedient for a corporation, which is similarly circumstanced and which desires to issue preferred dividends, to take these two steps. As will appear hereafter, a dividends paid credit would result merely from the cash option offered by Caterpillar Tractor. A corporation desiring, however, to insure retention of the major part of the cash earnings will do well to

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52. Magill, *Taxable Income* (1936) at 48.

53. So reasoned Judge Hand in *Towne v. Eisner*, 242 Fed. 702, 708 (D. C. S. D. N. Y., 1917): "the stockholder has received new shares, *representing a permanent interest in the company, not subject to abatement by dividend distributions* which have a value capable of realization in cash."

54. 143 Comm. & Fin. Chron. 2201, 2669.

use the cash option only as a means to pave the way toward a larger dividend entirely in stock, as was done in this case.<sup>55</sup>

### 3. Common and Preferred Outstanding, Preferred Declared as a Dividend on Common

This distribution more evidently alters the proportionate interests of the shareholders by bettering the common shareholder at the expense of the existing holders of preferred. The old preferential interests are spread thinner; the common shareholder by becoming the holder of preferred, encroaches upon the priority of the older preferred. Conversely the common now has a larger amount of preferred outstanding ahead of it. This conclusion finds support in recent Board decisions<sup>56</sup> and is further approved by the Regulations to the 1936 Act which give the above distribution as an example of one entitling the corporation to a dividends paid credit.<sup>57</sup>

Despite occasional dissent,<sup>58</sup> this type of distribution seems to afford a safe and practical means of securing a dividends paid credit. There are indications that it will receive widespread attention from corporations seeking nontaxable methods of retaining their current earnings in cash.<sup>59</sup>

### 4. Preferred Receives Common Dividend

The taxability of this distribution has been directly ruled upon and sanctioned by *Koshland v. Helvering*.<sup>60</sup>

### 5. Preferred Receives Preferred Dividends

This alters the proportionate status of the preferred stockholder by securing to him an extension of his priority at the expense of the common shares. Although direct adjudications are wanting, it appears to come safely within the rule of *Kosh-*

55. Even here, however, there exists a possible danger that the two steps might be regarded as mere incidents in a single transaction whereby the holders of common in effect receive dividends in preferred stock. This ignoring of intermediate steps is characteristic of the treatment of reorganization plans by the taxing authorities. See *West Texas Refining Co. v. Commissioner*, 68 F. (2d) 77 (C. C. A. 10, 1933).

56. *H. C. Gowran*, 32 B. T. A. 820 (1935); *James H. Torrens*, 31 B. T. A. 787 (1934); and see *Annie M. Pfeiffer*, Docket No. 82616 (Memo B. T. A. decision).

57. Art. 115-3, example (3).

58. See dissent in *H. C. Gowran*, 32 B. T. A. 820, at 831 (1935).

59. *Supra*, notes 31 and 54.

60. *Supra*, note 42.

*land v. Helvering*.<sup>61</sup> From the point of view of conservative corporate finance, it will probably in most cases be more desirable to satisfy preferred dividend requirements by common rather than preferred shares. On the other hand, inasmuch as in most cases the payment of a stock dividend depends upon the voluntary acceptance of such in lieu of cash by the preferred holders, a dividend in preferred stock may be more readily absorbed by such shareholders. A corporation which in any event intends to issue and distribute preferred shares to its common stockholders may find it convenient to use the same issue for preferred holders. It is believed that such a distribution would be taxable to both classes of recipients.<sup>62</sup> Any doubts as to such could be removed by creating, where possible, a preferred of a different degree of preference or priority from that outstanding.<sup>63</sup> Consequently, this type may receive some attention from corporations thus situated.

#### 6. Dividends in Treasury Stock

Care must be used in interpreting the portion of the Act and regulations dealing with this subject. The Act specifically includes among "dividends in kind" the distribution of "*stock of the corporation if held by the corporation as an investment.*"<sup>64</sup> The Regulations add that "Unless shown to the contrary, shares of capital stock once issued but thereafter acquired by the corporation in any manner whatsoever, but not retired, shall be deemed to be held by the corporation as an investment."<sup>65</sup> The context makes it clear that the purpose is not so much to indicate that all such distributions entitle the corporation to a dividends paid credit, as to fix the basis to be used in the computation of the credit, in the event that a treasury stock dividend is given this effect.

There appears little reason to support a distinction between the alteration in the proportionate interests of a stockholder wrought by the receipt of a dividend from treasury stock and that

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61. *Supra*, note 42; and consult Magill, *Taxable Income* (1936) at 48.

62. For even though common and preferred stockholders receive dividends in the same stock medium, the relative priorities of the preferred and common holder in the usual case will be to some degree altered.

63. See *Marr v. United States*, 268 U. S. 536, 45 S. Ct. 575, 69 L. ed. 1079 (1925).

64. Sec. 27(c).

65. Art. 27-3.



wrought by the receipt of stock never hitherto outstanding. The fact that existing shareholders are generally held to possess no right of preemption as to treasury shares does not seem a sufficient peg upon which to hang a separate treatment of distributions of such stock.<sup>66</sup> It may be concluded that a stock dividend of a type non-taxable to the recipient will not be made taxable by the mere fact that it has been declared out of treasury stock. This conclusion has judicial support.<sup>67</sup>

### 7. Miscellaneous Types

The preceding discussion, for purposes of simplicity, has for the most part assumed a clear-cut dichotomy of stock issues into common and preferred. Actually, however, the picture is complicated by the existence of various classes of common and various degrees of preference and priority among the preferred. These hybrid issues, however, in general do not constitute a separate problem, but may be fitted into the categories already constructed in outline.<sup>68</sup>

#### *B. Stock Rights*

For the purpose of dividends paid credits, the distribution of stock rights, insofar as such rights possess a market value, should receive the same treatment as that which would be accorded the actual distribution of the shares into which the rights are convertible. This, in effect, has been the holding of the cases involving the question.<sup>69</sup>

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66. See *Borg v. International Silver Co.*, 11 F. (2d) 143, 147 (C. C. A. 2, 1925); *Levy, Purchase by a Corporation of Its Own Stock* (1930) 15 Minn. L. Rev. 1; *Frey, Shareholders' Preemptive Rights* (1929) 38 Yale L. J. 563.

67. *I. T.* 2449, VIII-1 C. B. 101; *James Kay*, 28 B. T. A. 331 (1933); *J. S. Hatcher*, 18 B. T. A. 632 (1930), *Acq.* IX, 2 C. B. 25. But see *Justice Brandeis' dissent in Eisner v. Macomber*, 252 U. S. at 228 (1920).

68. Consult also note 21, *supra*. By substituting these abnormal restricted and preferential issues for the usual type of preferred, generally the same results will be obtained in the equations we have constructed between preferred and common and preferred and preferred. And see p. — *supra*.

69. *Miles v. Safe Deposit & Trust Co.*, 259 U. S. 247, 42 S. Ct. 483, 66 L. ed. 923 (1922); *Board v. Commissioner*, 51 F. (2d) 73 (C. C. A. 6, 1931); *Moran v. Lucas*, 36 F. (2d) 546 (D. C. App., 1929); *Metcalfe's Estate v. Commissioner*, 32 F. (2d) 192 (C. C. A. 2, 1929).

The entire subject of stock rights, however, should be approached with caution. It will be remembered that the Treasury Department in its former rulings did not follow the method of computation approved in *Miles v. Safe Deposit & Trust Co.*, *supra*. See Reg. 86, Art. 22(a)-8; and consult *Montgomery, Federal Tax Handbook: 1934-35*, at 197. The law has since been changed; see sec. 27(e); 115(f) (2), but the corresponding Regulations under the new law are not yet available.

More doubt surrounds the issuance of rights to convertible bonds. In one instance the holder of common stock was given the right to purchase bonds convertible into common, at his option, on or after a certain date in the future. At the time of the issuance of the right the stock of the company possessed market value so far in excess of the valuation at which the bonds were convertible as to render the rights of value. It was held that the distributee could not be taxed upon the receipt of these rights; it was reasoned that insofar as the rights possessed a market value it was because of the conversion features of the bonds, a fact which led the Board to treat the situation as one analogous to a non-taxable stock dividend.<sup>70</sup> However debatable the logic behind these holdings, it will be well for a corporation seeking dividends paid credits to avoid distributions leading to such dialectical entanglements.

*C. Dividends in Kind, in Obligations of the Corporation, in Cash*

In this category are embraced a wide group of distributions, the taxability of which, as income to the distributee, is subject to little or no constitutional inhibitions. The Act and Regulations make abundant provision for such as dividends paid credits.<sup>71</sup> It was early decided that the declaration of a cash dividend out of earnings and profits, however extraordinary in amount, constituted income to the shareholder.<sup>72</sup> Before *Eisner v. Macomber*, the Supreme Court made a similar ruling as to a dividend declared in the stock of another corporation;<sup>73</sup> such was held equivalent to a distribution in specie;<sup>74</sup> so with securities held in the corporate treasury;<sup>75</sup> so with accounts receivable;<sup>76</sup> so with assets

70. *T. I. Hare Powel*, 27 B. T. A. 55 (1932) Acq. XIII-2 C. B. 15; *Robert C. Cooley*, 27 B. T. A. 986 (1933).

71. Sec. 27(a); (c); (d); Art. 27-3; 27-4.

72. See *Lynch v. Hornby*, 247 U. S. 339, 38 S. Ct. 543, 62 L. ed. 1149 (1918).

73. *Peabody v. Eisner*, 247 U. S. 347, 38 S. Ct. 546, 62 L. ed. 1152 (1918).

74. *Ibid.*

75. *Arthur Curtis James*, 13 B. T. A. 764 (1928); *Henry L. Erlewine*, 19 B. T. A. 253 (1930).

76. *Deposit Trust & Savings Bank, exe'r.*, 11 B. T. A. 706 (1928); and see *Duffin v. Lucas*, 55 F. (2d) 786 (C. C. A. 6, 1932), cert. den. 287 U. S. 611 (1932). So with forgiveness of a debt due corporation from stockholder. *J. E. Brading*, 17 B. T. A. 436 (1929); *Fitch v. Commissioner*, 70 F. (2d) 583 (C. C. A. 8, 1934); but contra, where the transaction can be shown to be an integral part of a non taxable stock dividend plan. *Teehan v. United States*, 25 F. (2d) 884 (D. C. D. Mass., 1928). In the latter case stock was distributed in return for a note executed by the stockholder; later a divi-

of a tangible nature.<sup>77</sup> In all these cases there is a severance of assets from the declaring corporation sufficient to meet the first test of *Eisner v. Macomber*.<sup>78</sup> So the distribution of a promise to pay on the part of the corporation not only severs assets but results in an alteration of the proportionate interests of the stockholder.<sup>79</sup> On principle, a bond dividend should not lose its taxability to the recipient by the presence of a stock conversion right unless a portion of the value of the bond is ascribable to a right of conversion into a stock which would constitute a non-taxable stock dividend.<sup>80</sup>

The issuance of bond dividends in many cases may prove an excellent policy on the part of a corporate taxpayer which desires to retain its cash earnings and yet is unable, or unwilling, to increase its capitalization at the present time. It possesses the added factor of greater predictability as to the credit allowable, for the market value of such an obligation (if it be above par) may be better ascertained in advance than that of a stock issue, particularly in the case of a corporation, the securities of which are infrequently traded in.<sup>81</sup> These advantages, however, may be counterbalanced where, as in states such as Missouri, there exist ad valorem property taxes applicable to bonds, but not to stocks.<sup>82</sup> This may cause a decided preference on the part of the corporation's stockholders for a stock distribution.

#### *D. Cash Options*

This method of securing a dividends paid credit will commend itself to many taxpayers as an orthodox form of corporate dis-

dividend was declared and credited to the stockholder as part payment of his note. He was held not to have received taxable income.

77. *Castle*, 9 B. T. A. 931 (1927).

78. *Supra*, note 32.

79. *United States v. Fuller*, 42 F. (2d) 471 (D. C. E. D. Pa., 1930); *Doerschuck v. United States*, 274 Fed. 739 (D. C. E. D. N. Y., 1921).

80. For the legal status of convertible bonds see *Berle, Convertible Bonds and Stock Purchase Warrants* (1926) 36 *Yale L. J.* 649, at 657. But see note 70, *supra*, for treatment of rights to purchase bonds convertible into stock which, if distributed, would be non taxable. At the very least, however, it would seem that a partial credit should be obtainable in such a case. See sec. 27(h) ("If any *part* \* \* \* is not a taxable dividend \* \* \* no \* \* \* credit shall be allowed with respect to such *part*."). It remains to be seen, however, whether the Treasury Department will so hold. In the meantime such distributions should be avoided.

81. Consult *infra*, p. 29.

82. See *Neuhoff, Missouri Property Taxes and the Merchants' and Manufacturers' License* (1929) 14 *ST. LOUIS L. REV.* 157.

tributions which will require less departure from traditional policies than some of the stock dividends discussed above. At the same time, the form and circumstances under which such an option is given demand equally careful attention if the distribution is to be taxable to the recipient. The Act, in a manner characteristic of its policy of encouraging dividend disbursements, defines cash options liberally:

*Whenever a distribution by a corporation is, at the election of any of the shareholders (whether exercised before or after the declaration thereof), payable either (A) in its stock or in rights to acquire its stock, of a class which, if distributed without election would be exempt from tax under paragraph (1),\* or (B) in money or any other property (including its stock or rights to acquire its stock, of a class which if distributed without election would not be exempt from tax under paragraph (1), then the distribution shall constitute a taxable dividend in the hands of all shareholders, regardless of the medium in which paid.*<sup>83</sup>

The Regulations further liberalize the formula by providing that the option may not only be exercised but exercisable *before* the declaration, and that the declaration may provide for payment in one medium with the burden on the stockholder to request payment in a different medium.<sup>84</sup>

This formula represents an appreciable step beyond prior Treasury rulings and Court decisions. In charting a plan of corporate action under it, the following judicial and administrative history becomes of first importance. In *Eisner v. Macomber* occurred dicta to the effect that "An actual cash dividend, with a real option to the stockholder either to keep the money for his own or to reinvest it in new shares, would be as far removed as possible from a true stock dividend \* \* \*."<sup>85</sup> Accordingly, a number of Board and lower court decisions have held that where there is a declaration of an actual cash dividend and the stockholder voluntarily applies this to the purchase of stock, he is taxable as upon the receipt of a cash disbursement.<sup>86</sup> It is im-

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\* i. e. not taxable income to the recipient.

83. Sec. 115(f) (2).

84. Art. 115-4.

85. 252 U. S. 189, at 215 (1920).

86. *Lonsdale v. Commissioner*, 32 F. (2d) 537 (C. C. A. 8, 1929), cert. den. 280 U. S. 575 (1929). (This case might have been decided on other grounds, i. e. that in any event the stock disbursed was of a taxable nature); *Luthe Hardware Co.*, 6 B. T. A. 53 (1927); *J. W. Hunt*, 5 B. T. A.

portant to note, however, that in most of these cases the actual mechanics not only of a cash declaration, but also of a cash *distribution* were performed.<sup>87</sup> Treasury rulings were early adopted to the effect that in order to render the transaction taxable to one who took stock there must have been at some time during the proceedings an actual declaration of a *cash dividend* in his favor which created the relationship of creditor and debtor between the corporation and the shareholder. Thus if a dividend were declared payable in stock unless by a certain date shareholders filed notice of election to take cash, it was held that a shareholder who elected to take stock was not taxable on its receipt because not until the record date did the right to receive cash dividends become fixed, and consequently, the stockholder who elected to take stock never acquired the status of a creditor of the declarant corporation.<sup>88</sup> The present Act attempts to dispense with this unduly technical requirement that a dividend in cash be at one time unconditionally declared in favor of the shareholder before his election to take stock can become taxable. Instead, it is provided that the option may be exercised not only after but *before* the declaration,<sup>89</sup> and that the recipient is taxed whether he elects the medium of cash or stock. The Regulations add the term "exercisable" evidently intending to cover the situation where the resolution provides that the dividend is to be payable in one medium *unless* before a certain date, stockholders notify of an election to take another form of distribution—a method which, if safe, would be of great practical advantage to a corporation desiring to increase its chances of retaining cash by declaring a dividend in stock and putting on the shareholders an affirmative burden to notify it of an election to take cash.<sup>90</sup>

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356 (1926); Eugene E. Paul, 2 B. T. A. 150 (1925); Amy H. Crellin, 12 B. T. A. 234 (1928), but see Crellin v. Commissioner, 51 F. (2d) 650 (C. C. A. 3, 1931) holding that under the facts no right to receive cash existed.

87. *Supra*, note 86.

88. G. C. M. 6709, C. B. Dec. 1929, p. 132; and see IX-1 C. B. p. 144.

89. Sec. 115(f)(2). Since under the wording of the section an option is good if exercised *before* the *declaration*, a fortiori it would be good if elected *after* the *declaration* but *before* the books were closed. Thus the Regulations requiring an unconditional declaration in cash in favor of the shareholder are obviously overruled. It is difficult, however, to understand how an option can be exercised *before* a *declaration*. An option exercised before it is granted is a novelty. Might it occur where the shareholders made an offer to the corporation? And consult note 102 *infra*.

90. Until there appears further justification for the term "exercisable," as used by the Regulations, great caution should be used in this matter.

This action of the 1936 law in dispensing with the earlier requirements that a technical cash dividend be declared and payable to the recipient and by him used to purchase stock, and substituting the simpler formula that the shareholder need be given merely an option as to which he will take, would appear to be justified by three lines of reasoning. In the first place it might be argued that this is in effect a stenographic way of performing the same operation which was done in a more circuitous manner in the old form as sanctioned by *Eisner v. Macomber*.<sup>91</sup> Again, where in fact some shareholders take cash, the proportionate interests of the stockholders appear to be altered.<sup>92</sup> And even where all take stock, the option to take cash conceivably might be regarded as a constructive severing of corporate assets—although it must be confessed that in this case the argument for severance can be made more effectively where the debtor-creditor relationship at one stage of the proceedings actually existed.

Until the matter has been clarified, however, it will be best for a corporation, which believes that the majority of its shareholders will select stock, to follow the older formula and declare an unconditional cash dividend, attaching thereto the right to apply such to the purchase of stock; for there exists the possibility that in such a situation the proportionate interests of the stockholders would not be sufficiently altered to justify regarding the distribution as taxable to the recipients where a mere option was offered.<sup>93</sup>

Some evidence that the framers of this section relied chiefly for its justification upon the element of disturbance of proportionate interests may be afforded by the provision making the option operative if given to "*any of the shareholders*."<sup>94</sup> An option thus given to only a portion of common stockholders would obviously upset proportionate interests. However, such a procedure should be adopted with grave caution; for, even if the term "any" is used in a distributive sense, there is the probability that the

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91. *Supra*, note 85.

92. Joseph Paper, 29 B. T. A. 523 (1933). The earlier cases appear oblivious of the change in proportionate interests affected even where no true cash option existed; this may be because of the fact that where concerted plans to take stock existed there was very little change in proportionate interests—almost none took cash. Consult note 96, *infra*.

93. *i. e.* in the event all chose stock.

94. Sec. 115(f)(2).

clause is nullified by the controlling clause in Sec. 27 (g) which declares that no dividends paid credit shall be allowable in cases where one shareholder is given a preference over another of the same class.<sup>95</sup>

Whether the corporation adopts the older plan of declaring an outright cash dividend, or creates an option under the terms of the 1936 Act, it is equally important that the shareholders be given an actual and bona fide opportunity to secure the cash or other taxable medium. It is possible to specify certain pitfalls which, on the basis of existing decisions, should be avoided. Where a cash declaration is made in accordance with an actual agreement between the shareholders and the corporation that the cash dividend is purely a matter of form and that stock will in fact be received, it has with some qualifications been held that the transaction amounts to a pure stock dividend.<sup>96</sup> And the fact that it may have been legally impossible for a corporation validly to have issued a pure stock dividend will not necessarily alter the case.<sup>97</sup> Where at the date of declaration the corporation was not possessed of sufficient cash earnings to discharge a cash dividend obligation, it has frequently been decided that a stock rather than a bona fide cash distribution was intended.<sup>98</sup> Accordingly, a corporation desiring to receive credit under the option formula cannot afford to rely upon having merely sufficient cash or liquid assets to pay a predictable percentage of shareholders desiring cash. Unless it is possessed of sufficient to pay *all* in cash there exists some possibility, however, slight, of the transaction's being considered suspect under the above decisions. It will be prudent to have at least borrowed cash on hand for the duration of the option. The same considerations of course apply

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95. One authority, consulted privately, has expressed the opinion that an option given to some but not to all the stockholders of the same class would probably constitute a "preference" within the meaning of sec. 27 (g).

96. *United States v. Mellon*, 281 Fed. 645 (C. C. A. 3, 1922); *United States v. Davison*, 1 F. (2d) 465 (D. C. W. D. Pa., 1924) (really transactions involving refinancing operations); *Irving v. United States*, 44 F. (2d) 246 (Ct. Cl. 1930); *Deitz v. United States*, 6 F. Supp. 944 (D. C. S. D. W. Va. 1933); *Theresa Zellerback*, 2 B. T. A. 1076 (1925).

97. *B. R. Norvell*, 6 B. T. A. 56 (1927); *W. C. Weiss*, 7 B. T. A. 467 (1927).

98. *Crellin v. Commissioner*, 51 F. (2d) 650 (C. C. A. 3, 1931); *Irving v. United States*, 44 F. (2d) 246 (Ct. Cl. 1930); *United States v. Mellon*, 281 Fed. 645 (C. C. A. 3, 1922); *United States v. Davison*, 1 F. (2d) 465 (D. C. W. D. Pa. 1924).

in the case of such options to receive distributions in kind or in taxable stock as, for the purposes of the formula, are equivalent to cash.<sup>99</sup> Likewise, should be avoided a cash option the coming into effect of which is conditioned upon a certain percentage of the shareholders' consenting to accept, or subscribe to, new stock. Although there is some apparent support to the proposition that such constitutes a bona fide option,<sup>100</sup> it is believed that in effect this is no option at all.<sup>101</sup> Insofar as the 1936 Act seems to sanction such a procedure as constituting an option it should be regarded as suspect.<sup>102</sup> Although the plan may appeal to a corporation desirous of ensuring that it will in no event have to distribute more than a certain percentage of cash dividends, such benefits are more than authorized by its potential hazards.

Although there appears no objection to weighting an option in favor of the stock, it is possible that an extreme disparity between the value of the stock and the cash offering might be regarded as destructive of the bona fide optional nature of the transaction.<sup>103</sup>

#### *E. Distributions in Liquidation*

The subject of corporate liquidations and reorganizations involves matters of too broad a scope to permit of inclusion in this article. It is, however, proposed to outline briefly the problems of interpretation inherent in this section of the Act.

The provision dealing with this complex subject is so succinct as to create serious exegetical problems:

*In the case of amounts distributed in liquidation the part of such distribution which is properly chargeable to the earnings or profits accumulated after February 28, 1913, shall, for the purposes of computing the dividends paid credit under this section, be treated as a taxable dividend paid.*<sup>104</sup>

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99. See sec. 115(f) (2).

100. *Lonsdale v. Commissioner*, 32 F. (2d) 537 (C. C. A. 8, 1929); cert. den. 280 U. S. 575 (1929), held such a plan to result in a taxable dividend. It has been remarked, however, that this case involved the issuance of a type of stock probably taxable in its own right, regardless of the supposed option. *Mrs. Frank Andrews*, 26 B. T. A. 642 (1932).

101. See *George T. Smith*, 21 B. T. A. 782 (1930).

102. The provision that the option may be exercised before the declaration might be construed to extend to such a case. Sec. 115(f) (2).

103. Consult *Magill, Taxable Income* (1936) 44, citing *Commissioners of Inland Revenue v. Wright*, 1 K. B. 333 (C. A., 1927).

104. Sec. 27(f).



The definition of amounts properly chargeable to earnings and surplus does not present great difficulty.<sup>105</sup> More troublesome is the attempt on the part of the Regulations to confine the scope of this section to cases where under Sec. 115(c) the amounts distributed in liquidation are treated as received in payment for the stock, and under Sec. 112 of the Act the gain or loss, if any, from such an exchange is recognized.<sup>106</sup> By this interpretation the dividends paid credit is made to apply only to cases where the transferee in liquidation is immediately taxable in the event the transaction results in a gain to him.<sup>107</sup> Such an interpretation would exclude from the dividends paid credit many corporate reorganizations and such attractive and, for tax purposes, desirable expedients as the liquidation of subsidiaries into parent companies.<sup>108</sup> It may be, however, that the Regulations do not intend to exclude the situations under Sec. 112 where gains as to certain parts of non-taxable reorganizations are rendered taxable.<sup>109</sup> The reasoning assigned by the Regulations is that, *first*, "certain transactions described in Sec. 112 and 115 of the Act are treated for the purposes of the Act, not as distributions to the shareholders of earnings or profits, but as transfers of such earnings or profits intact to another corporation in whose hands such earnings or profits, being available for distribution by it as dividends to its shareholders, have essentially the same status for the purposes of the Act as earnings or profits derived from its own operations"; and, *second*, "Characteristic of these transactions is the circumstance that the gain or loss realized from the receipt by the shareholders of property is not recognized by the Act."<sup>110</sup> In answer to the first argument it may be observed that the dividends paid credit section does not demand that the transaction be one "treated for the purposes of the Act \* \* \* as distributions to the shareholders of earnings or profits," but merely states that such part of the liquidation which is chargeable to earnings and profits be treated as a taxable divi-

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105. Art. 27-6(b).

106. Art. 27-6(a).

107. *Ibid.*

108. Secs. 112(b) (3); (4); (5); (6).

109. See sec. 112(c) (1), (2); compare with sec. 27(h) which refuses a dividend paid credit to the "part" of a distribution which is not a taxable dividend to the distributee.

110. Art. 27-6(a).

dend paid—the section merely sets a basis of computation as to amount. The second reason is indubitably, (and inconclusively) debatable. Should Sec. 27(f) be considered modified by Sec. 27(h) which disallows dividend paid credits in the case of distributions which do not constitute taxable dividends to the recipient, or shall Sec. 27(f) which has reference to a particular situation, control over the more general section? Arguments of policy assist little. On the one hand it may be considered that the provision was intended to facilitate reorganizations and liquidations and consequently that the dividends paid credit applies to all such transactions regardless of whether taxable to the distributee. On the other hand if such non-taxable transfers are given credit a fertile field will be opened for easy evasion of the undistributed profits tax.

Assuming for the moment that the Regulations correctly interpret the law, and that a corporation possessing undistributed earnings for the current year liquidates into a parent company, the further problem is presented as to whether the parent company is liable for the undistributed profits tax upon the earnings of the subsidiary, which retain their character as such in the transferee's hands.<sup>111</sup> It would seem that, inasmuch as the transfer does not constitute income to the transferee the latter would not come within the provisions of the surtax. Under this interpretation, however, a transferor which had not distributed its earnings in advance of the transaction would be compelled to pay a tax. The harshness of this ruling is partially ameliorated by the further ruling that, subject to the approval of the Commissioner, a transferor and transferee corporation may agree to allocate a portion of the dividends subsequently paid by the latter in the taxable year to the former's use in computing dividends paid credit.<sup>112</sup> This ruling, however, is a gratuitous undertaking on the part of the Department, and in view of the dubious dialectic state of the Treasury interpretations, as well as of the unpredictable discretion invested in the Commissioner's hands, it would seem only prudent for the corporate taxpayer to place little reliance upon the obtaining of such an allocation, but rather to protect itself by making distributions in advance of the liquidation.

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111. See *Commissioner v. Sansome*, 60 F. (2d) 931 (C. C. A. 2, 1932); and *Seidman*, *Undistributed Profits Tax Problems* (1936) 14 T. M. 453 ff.

112. Art. 27-6(c).

It is perhaps apparent that the provisions herein discussed at present represent an uncharted sea, into which a corporate taxpayer should only venture where necessity, or the lack of a safer means of obtaining a dividends paid credit so impel. For the latter purpose it may prove in some cases useful.<sup>113</sup>

#### F. Dividends Defined

Prior to 1936 a dividend, for the purposes of the Act, was simply defined as "*any distribution made by a corporation to its shareholders, whether in money or in other property, out of its earnings or profits accumulated after February 25, 1913.*"<sup>114</sup> The present Act adds:

*"or (2) out of the earnings and profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made."*<sup>115</sup>

The new clause serves to clarify the position of a corporation which begins a taxable year with no accumulated earnings on hand from prior years, or, indeed, with a deficit, and which makes dividend disbursements out of sources which at the time are not earnings and profits. These disbursements will be considered taxable dividends to the recipient, and the corporation accordingly will be given a "dividends paid credit" therefor to the extent that they are covered by the actual earnings, if any, which the corporation may realize by the end of the year. A corporation seeking "dividends paid credit" thus will be relieved from the necessity of showing that at the time of each distribution there actually existed earnings and profits accumulated since February 28, 1913.<sup>116</sup>

#### G. Preferences

No dividends paid credit is allowable for any distribution which is not "*pro rata, equal in amount, and with no preference to any share of stock as compared with other shares of the same class.*"<sup>117</sup> The Regulations appear properly to construe the sec-

113. *Supra*, p. 7.

114. Sec. 115(a).

115. *Ibid.*

116. Art. 115-1. And see *Report of Senate Committee on Finance on H. R. 12395*, 74th. Cong., 2nd Sess. (1936) at p. 18.

117. Sec. 27(g).

tion as extending to distributions "regardless of the medium in which \* \* \* made," thus including distributions in kind, in stock, in obligations; distributions in liquidation also belong in its scope.<sup>118</sup> It is also proper to conclude that the "disallowance of the dividends paid credit, where any preference or inequality in fact exists, extends to the entire amount of the distribution and not merely to a part of such distribution."<sup>119</sup> This occurs regardless of the fact that the preference was created with the consent of all shareholders and the amounts received by preferred stockholders were taxable to them as dividends.<sup>120</sup>

These provisions evidently are intended to inhibit a device often employed by close corporations to prevent the very result which the Act is intended to bring about—the receipt by large shareholders of dividend disbursements which enlarge their personal income. It has been possible, with the consent of all shareholders, to distribute the income of a closely held corporation, not in accordance with the pro rata holdings of the members, but to suit the exigencies of their personal income tax computations. Since the present clause is thus peculiarly essential to the furtherance of the ultimate purpose of the Act, it will in all probability be strictly enforced. In this respect a corporate taxpayer will do well to avoid the shadow of suspicion. Consequently, distributions in different media of equal value, although not expressly interdicted, should be avoided, for the danger exists that a mistake in valuation might be held to give rise to a preference. Thus where stockholders in the same class are given in some cases, cash, and in other cases obligations of the corporation of equal face value, there can be no positive assurance that the market value of the obligations is equal to the cash received by other shareholders. Where an option is given, of course, the objects of choice need not be equal.<sup>121</sup>

A recent ruling provides that where, in accordance with "standard practice" in a stock distribution, fractional shares are issued in the form of bearer scrip certificates not entitled to dividends nor voting power until combined as a whole share, no preference is created. The ruling also applies to the making of

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118. Art. 27-7.

119. *Ibid.*

120. *Ibid.*

121. But see note 103, *supra*.

cash adjustments in the case of extremely small fractional shares.<sup>122</sup>

### *H. Date of Dividend Payment*

The dividends paid credit is to apply only to such parts of a distribution as are taxable in the hands of the shareholders "for the period in which the distribution is made."<sup>123</sup> Further provisions forbid use of the accrual method in computing dividends paid credits.<sup>124</sup> The Regulations, perhaps not unfairly, demand that a corporation desiring a dividends paid credit for a particular year show actual receipt of the distribution by the shareholder within that year.<sup>125</sup> The mailing of a check, payable in the current year, at such a time as ordinarily to reach the shareholder during the taxable year creates a presumption of timely payment.<sup>126</sup>

A corporation desiring to await the last moment before computing its current earnings would do well to have its shareholders appoint an agent authorized to receive disbursements. The Regulations permitting the crediting of the accounts of the shareholder to serve in place of direct payment are so restrictively phrased as to render it prudent for a corporation actually to issue obligations rather than rely upon a dubious permission.<sup>127</sup> The shares of a stock dividend must be registered on the corporate books in the shareholder's name within the current year; delivery of the certificate constitutes prima facie evidence of payment.<sup>128</sup> Where the dividend is payable in obligations of the corporation they should be entered or registered on the corporate books within the taxable year and, in the case of bearer obligations, should be actually received by the shareholder or his transferee or nominee.<sup>129</sup> Adequate records must be kept.<sup>130</sup>

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122. 4 U. S. Law Week 17 (Oct. 27, 1936) reprinting I. T. Mimeograph Coll. No. 4514 (Oct. 17, 1936). Incidentally, the fact that it was thought necessary to explain that cash substitutes for fractional shares were not preferential may indicate that payments in different media of equal market value are normally considered preferential.

123. Sec. 27(h).

124. Sec. 43.

125. Art. 27-1(b).

126. Art. 27-1(b).

127. *Ibid.* And see Hendricks, *The Surtax on Undistributed Profits of Corporations* (1936) 46 *Yale L. J.* 19, at 32, 33.

128. Art. 27-1(b).

129. *Ibid.*

130. Art. 27-1(c); (d).

The corporate taxpayer thus unnecessarily, it would seem, is placed in a dilemma in which it must attempt to avoid the Scylla of a premature estimate of its current earnings and the Charybdis of delaying its estimate until it is too late to distributions actually receivable within the allotted time. Any revision of the Act could, without great difficulty, include a rectification of this mechanical problem.<sup>131</sup> Some relief against an overly optimistic estimate of current earnings is provided by a dividend carry over mechanism.<sup>132</sup>

### I. Computation of Credits

A further ingredient in any proposed plan of corporate conformance with the Act is introduced by the varying bases of dividends paid credits. It is important to note that credits are based, not upon the medium in which the dividend is declared, but upon that in which it is actually "paid."<sup>133</sup> Thus if a dividend is declared in cash but satisfied in stock the latter will form the basis of credit computations.<sup>134</sup> For dividends paid in kind, including treasury stock held as an investment, the corporate taxpayer will receive a credit based upon either the "adjusted basis" of the property in its hands, or the "fair market value" at the time of payment—whichever is lower.<sup>135</sup> Distributions of obligations of the corporation receive credit equal to the lower of two amounts—their par, or their fair market value at the time of the payment.<sup>136</sup> Stock rights and stock dividends are credited at their "fair market value."<sup>137</sup> It is believed that where a cash-stock option is offered, the dividends paid credit in the case of stock distributions would likewise be measured by their market value.<sup>138</sup>

The relative desirability of alternate methods of distribution is thus conditioned by an additional factor. No general rule of

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131. Graham, *The Undistributed Profits Tax and the Investor* (1936) 46 Yale L. J. 1, at 18, suggests that 25% of the total dividends paid credit be allowed for distributions made within sixty days of the close of the taxable year.

132. Sec. 27 (b).

133. Sec. 27 (c); (d); (e).

134. Art. 27-3.

135. Sec. 27 (c) and Art. 27-3.

136. Sec. 27 (d). Art. 27-4.

137. Sec. 27 (e).

138. This would perhaps follow from the fact that the medium in which the dividend is paid controls. *Supra*, note 133.

behavior can be charted. In certain cases, however, obvious advantages can be obtained from careful attention to these varying credits. Not least among the imponderables with which the corporate plan must deal is the estimation of the value which will be placed by the market upon its proposed issues.