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TAXATION - FEDERAL INCOME TAX - CONSTRUCTIVE RECEIPT OF INCOME BY LESSOR CORPORATION WHEN RENTS PAID DIRECTLY TO LESSOR'S STOCKHOLDERS

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TAXATION — FEDERAL INCOME TAX — CONSTRUCTIVE RECEIPT OF INCOME BY LESSOR CORPORATION WHEN RENTS PAID DIRECTLY TO LESSOR'S STOCKHOLDERS — In 1864 the Joliet and Chicago Railroad Company made a perpetual lease without a defeasance clause of all of its property to another railroad company. Under the state law, the lease was a conveyance in fee. The lessee agreed to pay as rental an annual dividend of seven dollars a share on the then outstanding stock of the lessor, these payments to be made directly to the shareholders. The dividends paid by the lessee for the years 1931 to 1934 were taxed as income to the lessor, who now sues to recover the tax. *Held*, payments to the lessor's stockholders constituted income to the lessor. *United States v. Joliet & Chicago R. R.*, (U. S. 1942) 62 S. Ct. 442.

In those cases involving long-term leases where the rent is paid by the lessee to the lessor's stockholders, the decisions are almost unanimous in holding that the rent is taxable income to the lessor corporation.¹ The basis for these decisions is that there has been no assignment of the rents to those who were

¹ *Blalock v. Georgia Ry. & Electric Co.*, (C. C. A. 5th, 1917) 246 F. 387; *West End St. Ry. v. Malley*, (C. C. A. 1st, 1917) 246 F. 625; *Anderson v. Morris & Essex R. R.*, (C. C. A. 2d, 1914) 216 F. 83; *Rensselaer & Saratoga R. R. v. Irwin*, (C. C. A. 2d, 1918) 249 F. 726; *Gold & Stock Telegraph Co. v. Commissioner of Internal Revenue*, (C. C. A. 2d, 1936) 83 F. (2d) 465; *United States v. Northwestern Telegraph Co.*, (C. C. A. 2d, 1936) 83 F. (2d) 468; *Pacific & Atlantic Telegraph Co. of the United States v. Commissioner of Internal Revenue*, (C. C. A. 2d, 1936) 83 F. (2d) 469.

stockholders at the time of the lease,² since the stockholder cannot dispose of his share of the rents without disposing of his shares of stock. In the principal case the lessor had no future control over the income-producing property because the lease amounted to a conveyance in fee simple.³ However, this would seem to be no real distinction, because the reversion in long-term leases is of negligible value.⁴ Furthermore, it is well settled that the lessor would receive taxable income if the rents had been paid directly to its bondholders in discharge of its legal obligations;⁵ although stockholders are proprietors rather than creditors, they have an equitable right to earnings under certain circumstances.⁶ Thus it can be argued that the payment of dividends can be taxed as income because the equitable duty of the lessor to distribute earnings has been satisfied.⁷ Although a corporation is a juristic person, it is also an association of natural persons who have chosen the corporate form for their convenience, and it is upon the basis of this convenience that Congress taxed the corporation at higher rates.⁸ The stockholders continued to enjoy the advantages of corporate form, such as the transferability of shares on the corporation books and the payment of rent only to those who remain or become members of the association. Thus it has been suggested that the rent should be taxed at the corporation tax rates.⁹ It has also been argued that if the lessor is not taxable in such cases, an opportunity is presented to evade the income tax law through the use of dummy corporations.¹⁰

² This reasoning was rejected and the lessor corporation held not taxable under the Wisconsin income tax law in *Northwestern Telegraph Co. v. Wisconsin Tax Commission*, 212 Wis. 219, 248 N. W. 164 (1933).

³ *Huck v. Chicago & Alton R. R.*, 86 Ill. 352 (1877); *Chicago, B. & Q. Ry. v. Boyd*, 118 Ill. 73, 7 N. E. 487 (1886).

⁴ In *Rensselaer & Saratoga R. R. v. Irwin*, (C. C. A. 2d, 1918) 249 F. 726, the lease was for 500 years. A 999-year lease was involved in *Pacific & Atlantic Telegraph Co. of the United States v. Commissioner of Internal Revenue*, (C. C. A. 2d, 1936) 83 F. (2d) 469.

⁵ Profits which would constitute income if paid directly to a person are also income to him if paid pursuant to his agreement to a third person to discharge a legal obligation to such third person. *Old Colony Trust Co. v. Commissioner of Internal Revenue*, 279 U. S. 716, 49 S. Ct. 499 (1929); *United States v. Boston & M. R. R.*, 279 U. S. 732, 49 S. Ct. 505 (1929).

⁶ *Raynolds v. Diamond Mills Paper Co.*, 69 N. J. Eq. 299, 60 A. 941 (1905); *Dodge v. Ford Motor Co.*, 204 Mich. 459, 170 N. W. 668 (1919).

⁷ A possible answer to this argument is that the corporation's obligations to the stockholders have been satisfied by the lease arrangement itself rather than by the payments under the lease.

⁸ *Anderson v. Morris & Essex R. R.*, (C. C. A. 2d, 1914) 216 F. 83; *Blalock v. Georgia Ry. & Electric Co.*, (C. C. A. 5th 1917) 246 F. 387. See Judge Learned Hand's concurring opinion in *Harwood v. Eaton*, (C. C. A. 2d, 1933) 68 F. (2d) 12 (suit by United States against stockholders to collect taxes assessed against the corporation).

⁹ Many courts have stressed the necessity of disregarding the corporate entity in tax cases. See Finkelstein, "The Corporate Entity and the Income Tax," 44 *YALE L. J.* 436 (1935).

¹⁰ "A possible arrangement would consist of a lease of the property of one corporation to another corporation organized for the purpose at a rental that would preclude profit to the latter. The only taxable income would be the payment to the stockholders of the dummy lessor." 41 *YALE L. J.* 130 at 131, note 11 (1931).

In view of the arguments for taxing the lessor and the liberal construction given section 22a¹¹ in recent cases,¹² the decision in the principal case¹³ occasions no surprise.

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¹¹ Sec. 22(a) of the Revenue Act of 1934, 48 Stat. L. 686 (1934), 26 U. S. C. (1934), § 22(a), includes within "gross income" all "gains, profits, and income derived . . . from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever." Like definitions of income are contained in § 22(a) of previous Revenue Acts: 45 Stat. L. 797 (1928); 47 Stat. L. 178 (1932).

¹² *Helvering v. Clifford*, 309 U. S. 331, 60 S. Ct. 554 (1940); *Helvering v. Eubank*, 311 U. S. 122, 61 S. Ct. 149 (1940); *Helvering v. Horst*, 311 U. S. 112, 61 S. Ct. 144 (1940); *Commissioner of Internal Revenue v. Barbour*, (C. C. A. 2d, 1941) 122 F. (2d) 165.

¹³ The Treasury Regulations for a number of years have provided that the income is taxable to the lessor corporation. TREAS. REG. 74, art. 70 (1931); TREAS. REG. 77, art. 70 (1933); TREAS. REG. 86, art. 22(a)-20 (1935); TREAS. REG. 33, art. 102 (1918).