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TAXATION - INCOME TAX - SURTAX ON INCOME OF CORPORATION WHERE PROFITS ARE ACCUMULATED TO AVOID SURTAX ON INCOME OF ITS SHAREHOLDERS - CONSTRUCTION

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TAXATION — INCOME TAX — SURTAX ON INCOME OF CORPORATION WHERE PROFITS ARE ACCUMULATED TO AVOID SURTAX ON INCOME OF ITS SHAREHOLDERS — CONSTRUCTION — Section 104 of the Revenue Act of 1928¹ imposed a surtax on the net income of any corporation "formed or availed of for the purpose of preventing the imposition of the surtax on its shareholders through the medium of permitting its gains and profits to accumulate instead of being divided and distributed," and provided that "the fact that the gains or profits are permitted to accumulate beyond the reasonable needs of the business shall be prima facie evidence of a purpose to escape the surtax." Defendant corporation was formed in 1911 with \$200,000 capital stock all owned by Kohl. In 1931 the net profits of the corporation were more than \$682,000 and it had a surplus of nearly \$8,000,000. Its excess of cash on hand over accounts payable was \$1,136,820. It had declared no dividends since 1919 when the high personal surtaxes went into effect. If it had declared dividends of profits in each of those years the additional surtax paid by Kohl would have been \$1,240,852 and if it had declared all of its 1931 profits in dividends Kohl's additional surtax for the year would have been more than \$115,000. During the past seven years Kohl had borrowed \$610,000 from the corporation. *Held*, the corporation was liable for the surtax imposed by section 104. The tax is constitutional, and is applicable to a legitimate business corporation availed of for the forbidden purpose. There was ample evidence that the surplus accumulated was in excess of the reasonable needs of the business; and, even without the aid of the presumption, there was sufficient evidence to show that the corporation was availed of to withhold dividends to defeat the surtax on the stockholder. *Helvering v. National Grocery Co.*, 304 U. S. 282, 58 S. Ct. 932 (1938), rehearing denied 59 S. Ct. 56.

Although this or a similar section has been included in every Revenue Act since 1913,² the tax had its first judicial interpretation in 1933.³ Previous to that time there had been considerable doubt as to its applicability.⁴ Even today there have been very few cases decided under the section.⁵ In all but two

¹ 45 Stat. L. 814 (1928).

² Tariff and Revenue Act of 1913, § 2A, subdiv. 1, 38 Stat. L. 166 (1913); Revenue Act of 1916, § 3, 39 Stat. L. 758 (1916); Revenue Act of 1919, § 220, 40 Stat. L. 1072 (1919). In these laws the tax was laid on the shareholder. In all the later laws the tax is laid on the corporation. Revenue Act of 1921, § 220, 42 Stat. L. 247 (1921); Revenue Act of 1924, § 220, 43 Stat. L. 277 (1924); Revenue Act of 1926, § 220, 44 Stat. L. 34 (1926); Revenue Act of 1928, § 104, 45 Stat. L. 814 (1928); Revenue Act of 1932, § 104, 47 Stat. L. 195 (1932); Revenue Act of 1934, § 102, 48 Stat. L. 702 (1934); Revenue Act of 1936, § 102, 49 Stat. L. 1676 (1936); Revenue Act of 1938, Sec. 102.

³ *United Business Corp. v. Commr.*, (C. C. A. 2d, 1933) 62 F. (2d) 754.

⁴ See Graves, "Should Section 220 Be Retained in the Revenue Law?" 6 NAT. INCOME TAX MAG. 7 (1928); Dohr, "Section 220—Should Corporations Worry?" 6 *ibid.* 169 (1928); Baar, "Taxable Accumulation of Corporate Surplus," 7 *ibid.*, 339 (1929).

⁵ *United Business Corp. v. Commr.*, (C. C. A. 2d, 1933) 62 F. (2d) 754; *United States v. R. C. Tway Coal Sales Co.*, (C. C. A. 6th, 1935) 75 F. (2d) 336; *Keck Investment Co. v. Commr.*, (C. C. A. 9th, 1935) 77 F. (2d) 244; A. D.

of the cases,⁶ the government has been successful in proving the purpose of the corporation to accumulate profits to prevent the imposition of the surtax on shareholders. In every one of these cases the stock of the corporation so taxed was all or nearly all held by one shareholder, and in the majority of cases the corporation was formed by the sole stockholder, who transferred to it property and securities owned by him in exchange for the stock of the corporation. In one of the cases refusing to apply the tax the distinction is made that in the cases where the tax is upheld the corporations are mere dummies formed by the stockholders and not legitimate business corporations.⁷ That this distinction is no longer valid is apparent from the principal case, where the corporation was engaged in the successful operation of a chain of grocery stores. Although it was stated in the Treasury Regulations issued under the Revenue Act of 1918 that in order to impose the tax there had to be both the purpose to escape surtax and an accumulation of surplus beyond the reasonable needs⁸ of the business, this misconception of the act has been pointed out by writers⁹ and departed from in later cases.¹⁰ It is now held that unreasonable accumulation of surplus is merely evidence of the purpose to avoid the imposition of surtax on shareholders. Even if there has been no such accumulation of surplus, if the purpose can be proved by other means the corporation is liable to the tax.¹¹ Likewise, even though there has been a large accumulation of surplus, if the corporation can show that the purpose was something other than to escape the surtax on shareholders it is not liable to the surtax.¹² This surtax does not apply to personal holding companies as defined in the Revenue Act.¹³ Whether it will

Saenger, Inc. v. Commr., (C. C. A. 5th, 1936) 84 F. (2d) 23; R. & L., Inc. v. Commr., (C. C. A. 5th, 1936) 84 F. (2d) 721; Commr. v. Cecil B. DeMille Productions, Inc., (C. C. A. 9th, 1937) 90 F. (2d) 12; Almours Securities, Inc. v. Commr., (C. C. A. 5th, 1937) 91 F. (2d) 427; Williams Investment Co. v. United States, (Ct. Cl. 1933) 3 F. Supp. 225.

⁶ United States v. R. C. Tway Coal Sales Co., (C. C. A. 6th, 1935) 75 F. (2d) 336; Commr. v. Cecil B. DeMille Productions, Inc., (C. C. A. 9th, 1937) 90 F. (2d) 12.

⁷ United States v. R. C. Tway Coal Sales Co., (C. C. A. 6th, 1935) 75 F. (2d) 336.

⁸ Regulations 45, issued under the Revenue Act of 1918, Article 352. This was changed in the Regulations issued under the Revenue Act of 1921. Regulations 62, art. 352. And see dissent in United Business Corp. v. Commr., 19 B. T. A. 809 (1930), for a statement of this point of view.

⁹ Baar, "Evasion of Surtax—the First Precedent," 8 NAT. INCOME TAX MAG. 325 (1930).

¹⁰ United Business Corp. v. Commr., (C. C. A. 2d, 1933) 65 F. (2d) 754; Williams Investment Co. v. United States, (Ct. Cl. 1933) 3 F. Supp. 225; and see the principal case.

¹¹ A. D. Saenger, Inc. v. Commr., (C. C. A. 5th, 1936) 84 F. (2d) 23.

¹² Commr. v. Cecil B. DeMille Productions, Inc., (C. C. A. 9th, 1937) 90 F. (2d) 12.

¹³ Sec. 102 of the Revenue Act of 1938 provides for this surtax on "every corporation (other than a personal holding company . . . or a foreign personal holding company. . . ." 52 Stat. L. 483, 26 U. S. C. A. (Supp. 1938), § 104.

be extended to apply to corporations with widely held stock now that personal holding companies are subject to a special surtax¹⁴ remain to be seen. With the recent virtual repeal of the undistributed profits tax, it seems probable that an attempt may be made to enforce this section more widely. Where the majority of the stock is not held by one shareholder it will undoubtedly be more difficult to prove the purpose for the accumulation of the surplus. The new Revenue Act of 1938¹⁵ continues this tax in section 102, placing on such corporations surtaxes of twenty-five per cent of the undistributed net income not in excess of \$100,000, plus thirty-five per cent of the undistributed net income in excess of \$100,000. The new act also makes proof of the purpose to avoid the imposition of surtaxes on shareholders easier by providing that the fact that earnings are permitted to accumulate beyond the reasonable needs of the business, instead of being prima facie evidence, shall be determinative of the purpose to avoid surtaxes upon the shareholders unless the corporation by the "clear preponderance of the evidence shall prove to the contrary." The fact that any corporation is a mere holding or investment company continues to be only prima facie evidence of a purpose to avoid the surtax on shareholders.

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¹⁴ Revenue Act of 1937, 50 Stat. L. 813 (1937), and §§ 405, 407 of the Revenue Act of 1938, 52 Stat. L. 560 (1938), 26 U. S. C. A. (Supp. 1938), §§ 335, 336a.

¹⁵ The sections of the Revenue Acts of 1936 and 1937 which are added to or changed by the Revenue Act of 1938 are set forth in the Statute Supplement of U. S. LAW WEEK (May 17, 1938).