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Federal Income Tax in Relation to Consumer Cooperatives

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THE FEDERAL INCOME TAX IN RELATION TO CONSUMER COOPERATIVES

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If a man buys what his neighbor buys for less than his neighbor pays, does he thereby realize income within the reach of the Sixteenth Amendment? Without doubt he enjoys an economic advantage; he is relatively better off after the transaction than before. But that is not enough: "admittedly not all economic gain . . . is taxable income."[1] The question is whether the *kind* of economic gain which results from a bargain purchase is income in the constitutional sense.

Beyond question the man in the street would never suppose he had realized taxable income from a purchase below the going price. He derives no income in the sense in which that term is commonly used and understood. He therefore realizes nothing which can be taxed under the Sixteenth Amendment for the common meaning of income and its constitutional meaning are identical,[2] the Supreme Court "[having] consistently refused to enter into the refinements of lexicographers or economists and [having] approved . . . what it believed to be the commonly understood meaning of the term which must have been in the minds of the people when they adopted the Sixteenth Amendment."[3]

The authorities are in agreement that income is not derived from buying under the market.[4] The Supreme Court has said:

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1 Helvering v. Horst, 61 S. Ct. 144, 146 (1940). Accord: Helvering v. Bruun, 309 U. S. 461, 469 (1940).

2 Eisner v. Macomber, 252 U. S. 189, 206 (1920) (". . . we require only a clear definition of the term 'income,' as used in common speech, in order to determine its meaning in the [16th] Amendment"); Merchants' Loan & Trust Co. v. Smietanka, 255 U. S. 509, 519 (1921); Irwin v. Gavit, 268 U. S. 161, 166 (1925); United States v. Kirby Lumber Co., 284 U. S. 1, 3 (1931) ("The [taxpayer] has realized . . . an accession to income, if we take words in their plain popular meaning, as they should be taken here"); Helvering v. Horst, 61 S. Ct. 144 (1940) ("Common understanding and experience are the touchstones for the interpretation of the revenue laws"); United States v. Oregon-Washington R. & Nav. Co., 251 Fed. 211, 212 (1918) (". . . the meaning of [income] is not to be found in its bare etymological derivation. Its meaning is rather to be gathered from the implicit assumptions of its use in common speech"); 1 Paul & Mertens, Law of Federal Income Taxation (1934) §5.02, p. 104 (". . . as used in the 16th Amendment and all statutes enacted in pursuance thereof, the word 'income' has been employed in its common and ordinary meaning and not in its technical or economic sense").

3 Merchants' Loan & Trust Co. v. Smietanka, 255 U. S. 509, 519 (1921).

4 Miles v. Safe Deposit Co., 259 U. S. 247 (1922); Palmer v. Comm., 302 U. S. 63 (1937); Mayer v. Comm., 302 U. S. 647 (1937); Rose v. Trust Co., 28 F. (2d) 767 (C. C. A. 5th, 1928); Taplin v. Comm., 41 F. (2d) 454 (C. C. A. 6th, 1930); Durkee v. Welch, 49 F. (2d) 339 (S. D. Cal. 1931); Comm. v. Van Vorst, 59 F. (2d) 677 (C. C. A. 9th, 1932); Helvering v. Bartlett, 71 F. (2d) 598 (C. C. A. 4th, 1934); Omaha Nat. Bank v. Comm., 75 F. (2d) 434 (C. C. A. 8th, 1935); Salvage v. Comm., 76 F. (2d) 112 (C. C. A. 2d, 1935) aff'd 297 U. S. 106 (1936); Comm. v. Cummings, 77 F. (2d) 670 (C. C. A. 5th, 1935); Bothwell v. Comm.,

> . . . one does not subject himself to income tax by the mere purchase of property, even if at less than its true value, . . .[5]

Professor Magill says:

> Although it is possible for one's economic worth to increase as the result of a fortunate purchase, as well as through a sale, to treat a gain as realized at that time would be contrary to the theoretical premises adopted by our courts and the practice of business men alike. Gains from property have been thought to arise . . . when the investment is terminated by the disposition of the *res*, and not through the increase in value of the *res* over the money spent for it. By the same token, income does not arise when the *res* is first acquired. Similarly, from the point of view of the accountant or business man, income would not be regarded as accruing simply from a purchase, even a bargain purchase. Essentially, this result is based on practical considerations: the possibility that the "bargain" will in reality prove to be a poor one; and the fact that the net result of the transaction can be better measured at a later date. Since in legal theory the gain is not yet realized, and the practical considerations support the same result, the doctrine is well established here that gain is not realized from a bargain purchase, if it is free from other factors indicating the likelihood of compensation for services or a distribution of profits.[6]

The leading text on federal income taxation states that

> The rule is well settled that income results from the *sale*, not the *purchase*, of property. Purchases even at a bargain price do not create taxable income.[7]

Conversely deductible losses are not incurred by buying above the market.[8]

Practical considerations not only support this result; they require it. The administrative difficulties which would attend any attempt

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77 F. (2d) 35 (C. C. A. 10th, 1935); Rossheim v. Comm., 92 F. (2d) 247 (C. C. A. 3rd, 1937); Hadley Falls Trust Co. v. U. S., 110 F. (2d) 887 (C. C. A. 1st, 1940); Manomet Cranberry Co., 1 B. T. A. 706 (1925); Morgan J. McMichael, 4 B. T. A. 266 (1926); Luther Elkins, 12 B. T. A. 1058 (1928); W. L. Dunn, 14 B. T. A. 13 (1928); James William Everhart, 26 B. T. A. 318 (1932); Albert Russel Erskine, 26 B. T. A. 147 (1932); Delbert B. Geeseman, 38 B. T. A. 258 (1938); Gordon M. Evans, 38 B. T. A. 1406 (1938); Electric Storage Battery Co., 39 B. T. A. 121 (1939) and Charles E. Adams, 39 B. T. A. 387 (1939), all acquiesced in 1939-1 (Part 1) C. B. 1, 11; Herbert A. Springford, 41 B. T. A. 1001 (1940); Holmes, Federal Taxes (6th ed.) 551; 1 Paul & Mertens, Law of Federal Income Taxation (1934) §6.40, p. 180; Magill, Taxable Income (1936) 120; Paul, Studies in Federal Taxation (3rd series, 1940) 394; Bastedo, Taxing Employees on Stock "Purchases" (1941) 41 Col. L. Rev. 239 (". . . It is [a] fundamental principle that income does not arise from the purchase of property . . ."). Accord: Bowers v. Kerbaugh-Empire Co., 271 U. S. 170, 175 (1926) (". . . mere diminution of loss is not gain, profit or income"); Jones v. U. S., 60 Ct. Cl. 552, 577 (1925) (". . . a *saving* . . . of itself is not income"). Cf. Reg. 77, 74, Art. 51; Reg. 69, 65, Art. 31, with Reg. 103, §19.22 (a)-1; Reg. 101, Art. 22(a)-1, and with Reg. 94, 86, Art. 22(a)-1, as amended by T. D. 4879, 1939-1 C. B. 159.

5 Palmer v. Comm., 302 U. S. 63, 69 (1937).

6 Taxable Income (1936) 120. As to transactions which, though phrased in terms of purchase, are of an essentially different nature, see (Notes) Avoidance of Income Tax Through Purchase (1937) 50 Harv. L. Rev. 500.

7 1 Paul & Mertens, loc. cit. supra note 4.

8 Grigsby v. Comm., 87 F. (2d) 96 (C. C. A. 7th, 1937) cert. den. 301 U. S. 690; W. L. Dunn, 14 B. T. A. 13 (1928); T. H. Symington & Son, Inc., 35 B. T. A. 711 (1937); 3 Paul & Mertens, Law of Federal Income Taxation (1934) §26.37 ("It should be hardly necessary to state that no loss is sustained on a *purchase* of property. . . . Payments resulting in the acquisition of property do not make deductible losses.")

to track down and assess the economic gain accruing from a good buy are obvious and overwhelming.

Both legal and practical considerations, then, require the answer that a man who buys what his neighbor buys for less than his neighbor pays, does not thereby realize income within the reach of the Sixteenth Amendment.

Suppose a man paints his own house or washes his own automobile or does for himself any of the things he ordinarily pays another to do for him. Does that result in income? Or suppose he raises chickens (for his own use) or has a garden. As in the case of a bargain purchase he is better off, to that extent, than the man next door who doesn't know how to do these things or hasn't time or doesn't want to be bothered. But neither he nor anyone else would ever suppose that he is taxable on this relative improvement in his net economic situation. It simply isn't income in any "commonly understood meaning" of that term. Hence, like "the rental value of [a] building used by the owner [it] does not constitute income within the meaning of the Sixteenth Amendment."[9]

The legal and practical difficulties in the way of subjecting it to income taxation are similar to and, if anything, greater than in the case of a bargain purchase. If *A* and *B* together make a good buy and share the resultant saving it is obvious neither receives taxable income any more than if each had effected the same saving independently. Similarly, if *A* and *B* are joined by others to get the benefit of lower prices on larger purchases. The advantage to them—a net increase in the purchasing power of their dollars—is in no way different from that accruing to a single individual from an isolated bargain. Necessarily, therefore, no income is derived.

So, also, if *A* and *B*, instead of pooling their purchasing power, pool their time and skill and share enjoyment of the product. And this is true whether *A* and *B*, owners of a double house, together give the house a coat of paint, or are joined by however many others in the production of any article or service so long as those who contribute the labor consume the product. To the extent that they themselves consume ratably what they create they are not accountable to the Treasury.

In short, there is no doubt income is not derived from getting for less money what costs another more, whether in the case of a single consumer or an association of consumers acting in concert to reduce the cost of living. ". . . a *saving* . . . of itself is not income."[10]

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[9] Helvering v. Independent Life Ins. Co., 292 U. S. 371, 379 (1934). See Magill, Taxable Income (1936) 198 ("So long as a farmer raises his own food, he realizes no income; . . ."). Cf. Reg. 103, §19.22 (a)-7 (gross income of farmers).

[10] Jones v. U. S., 60 Ct. Cl. 552, 577 (1925).

But suppose a man pays for what he buys at the same rate as any other and later on enjoys the benefit of a rebate or refund of part of the purchase price. Some years ago a large automobile manufacturer announced a substantial retroactive price reduction on its cars. All who had bought within the period covered received back a generous portion of the price paid. It was a windfall for them. Was it income? Without doubt, no.[11] It has long been recognized that ". . . a return of cost of property or capital invested in property has an exempt status resting in 'fundamental law'."[12] Dividends received by policyholders in mutual insurance companies are in this category. The Regulations provide: ". . . amounts received as a return of premiums paid under life insurance, endowment or annuity contracts, and the so-called 'dividend' of a mutual insurance company which may be credited against the current premium, are not subject to tax."[13]

So it is irrelevant that one participating in an unincorporated consumer cooperative enterprise gets the benefit of resulting economies not initially in the form of lower prices but later on in the form of a rebate or refund, known as a patronage dividend. The necessities of the case require this method. For the over-all cost to a consumer cooperative association, which is to be shared ratably by all having a part in the undertaking, cannot be known in advance. The transactions involved necessarily entail expense—an unpredictable item—and may encounter losses. Hence it is convenient if not essential to go through the form of a purchase and sale at going prices from the association to the individual cooperator, the latter taking what he wants from the common store as if he were buying in the open market and contributing to the common fund what he would pay if he were buying in the open market. Subsequently the combined savings are divided as patronage dividends among the contributors in proportion to the dollar value of what each has taken for himself.[14]

By this procedure (which has been a feature of consumer cooperation since the days of the Rochdale pioneers) the difficulty is overcome of equitably and ratably apportioning both cost and saving, which it is the distinctive purpose and function of a consumer cooperative to do.[15]

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11 Borin Corp. v. Comm., C. C. A. 6th, Feb. 14, 1941; Rosenwald & Weil, Inc., 11 B. T. A. 921 (1928); John D. Fackler, 39 B. T. A. 395 (1939); A. L. Killian Co., B. T. A., Apr. 10, 1941; 1 Paul & Mertens, Law of Federal Income Taxation (1934) §5.19, p. 119. Accord: Doyle v. Mitchell Bros. Co., 247 U. S. 179 (1918); Burnet v. Sanford & Brooks Co., 282 U. S. 359, 364 (1931) (". . . the cost of [capital investments] if converted, must first be restored from the proceeds before there is a capital gain taxable as income").

12 1 Paul & Mertens, loc. cit. supra note 11.

13 Reg. 103, §19.22 (a)-12. To the same effect: Reg. 101, 94, 86, Art. 22 (a)-12; Reg. 77, 74, Art. 62; Reg. 69, Art. 47; Reg. 65, 62, Arts 47, 72.

14 Warbasse, Cooperative Democracy (1936) 14-18.

15 Potter (Webb) The Cooperative Movement in Great Britain (10th ed. 1930) ch. III;

The resultant lag in the individual enjoyment of cooperative benefits obviously has no bearing on federal income tax liability. A discount or price reduction is not income. If received after a purchase has been made it is a return of cost—a capital item. That is what a patronage dividend is—a return, pursuant to antecedent understanding, of all or part of the excess of amounts put out for goods or services over the actual cost thereof as finally determined. The man in the street would never call that income; the House of Lords sees eye to eye with him. In a leading case Lord Watson declared:

> When a number of individuals agree to contribute funds for a common purpose, . . . and stipulate that their contributions, so far as not required for that purpose, shall be repaid to them, I cannot conceive . . . why contributions returned to them should be regarded as profits.[16]

Nor can it make any difference that the surplus over cost of operations of a consumer cooperative association is not returned to the pockets of the individual contributors but, by common consent, is held in a common fund for their common benefit. That is no less irrelevant than the question whether they keep their money in the bank or under the mattress. There is no "sound distinction," the House of Lords has ruled, between patronage dividends received individually and patronage dividends retained and held in common to advance the common purpose.[17] In the case announcing that result it was sought to tax a cooperative association formed to indemnify its members against liability for fatal accidents to their workmen. The tax was based on the excess of member contributions over amounts paid out for the stated purpose. This surplus was not returned annually to the members *pro rata;* instead it was held as a reserve for indemnity payments the association might be called on to make in the future. The challenged tax was defended on the ground that amounts thus reserved were income to the association. The House of

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Warbasse, loc. cit. supra note 14; Kallen, The Decline and Rise of the Consumer (1936) 156-159; Webb, The Discovery of the Consumer (pamphlet published by The Cooperative League) 12-14 ("These unlettered flannel weavers . . . began to sell groceries to themselves, partly to free themselves from the toils of 'truck,' but also with the idea of accumulating a capital fund from which they might realize their ideal of self-employment in flannel weaving, very much as the congregation of a chapel organizes a bazaar to raise money for buying an organ. In order to attract purchasers to their store, they pressed each new customer to become a member of their society, and, as such, entitled to share in its management and in its accumulating capital. In order to secure continuous membership, they invented the device of 'dividend on purchase,' whereby the margin between the cost of the article and the retail selling price was returned to the purchaser himself as a sort of deferred rebate or discount on his purchases—a sum of money which each purchasing member found automatically put to his credit in the books of the society until this credit amounted to the £1 qualifying share. . . . [This] so-called 'dividend on purchase' [was] merely a device for returning to the consumer the whole of what proved to have been charged in excess of the cost of retailing, and of carrying on and developing the common services rendered by the society to its members.")

[16] New York Life Ins. Co. v. Styles, 14 App. Cas. 381, 394 (1889).

[17] Jones v. South-West Lancashire Coal Owners' Ass'n. [1927] A. C. 827, 832. Accord: Board of Fire Underwriters of Duluth, 26 B. T. A. 860 (1932).

Lords rejected the contention. It adhered to its prior decision that patronage dividends are not income and held it immaterial that the funds available for patronage dividends are kept in reserve for members' benefit instead of being divided ratably among them.[18]

In either case, whether the economies of consumer cooperation are enjoyed individually by those whose cooperative enterprise makes the savings possible or are enjoyed collectively in the form of assets held in common with their consent and for their benefit, what they have gotten is simply more for their money. They have been able to buy what their neighbors buy for less than their neighbors pay. That isn't income.

II.

But suppose a consumer cooperative association finds it convenient to incorporate? Does that make a difference? Can it be said that the increased purchasing power of the cooperators which, before incorporation, was not income, now can be taxed in the name of the corporation as income of the corporation?

First. What is a corporation, bearing in mind that "taxation is an intensely practical matter"[19] little concerned with "refinements of title"[20] and "attenuated subtleties?"[21] Is it really "an artificial being, invisible, intangible, and existing only in contemplation of law"[22]—a mystical something apart from shareholders? Or is it no more than an aggregation of human beings making common cause under a particular form of organization?

Mr. Morawetz wrote in the preface of his well-known work that he

> . . . was of the opinion, that the law relating to private business corporations could not be clearly understood, unless the fact were recognized that such a corporation is really an association formed by the agreement of its shareholders, and that the existence of a corporation as an entity, independently of its members, is a fiction; and that . . . it is . . . essential to bear in mind distinctly that the rights and duties of an incorporated

[18] Parliament later (in 1933) provided that the savings effected by consumer cooperation, over and above patronage dividends distributed, should be taxed. Carr-Saunders et al., Consumers' Co-operation in Great Britain (1938) 464-468; Redfern, The New History of the C. W. S. (1938) 479-483. But that in no way diminishes the force of the House of Lords' decisions to the effect that these savings are not income in any commonly understood meaning of the term. On the contrary this legislation merely expresses a power (not shared by Congress under the 16th Amendment) to tax them anyhow.

[19] Farmers Loan & Trust Co. v. Minnesota, 280 U. S. 204, 212 (1930); Harrison v. Schaffner, 61 S. Ct. 759 (1941).

[20] Corliss v. Bowers, 281 U. S. 376, 378 (1930); Griffiths v. Helvering, 308 U. S. 355, 357 (1939); Harrison v. Schaffner, 61 S. Ct. 759 (1941).

[21] Lucas v. Earl, 281 U. S. 111, 114 (1930); Helvering v. Horst, 61 S. Ct. 144 (1940); Harrison v. Schaffner, 61 S. Ct. 759 (1941).

[22] Dartmouth College v. Woodward, 17 U. S. 518, 636 (1819).

association are, in reality, the rights and duties of the persons who compose it, and not of an imaginary being.[23]

In a penetrating analysis of the "Nature of Stockholders' Individual Liability for Corporation Debts" Professor Hohfeld said in part:

> . . . transacting business under the forms, methods, and procedure pertaining to so-called corporations is simply another mode by which *individuals* or *natural persons* can enjoy their property and engage in business. . . . When all is said and done, a corporation is just an association of natural persons conducting business under legal forms, methods, and procedure that are *sui generis*. The only conduct of which the state can take notice by its laws *must* spring from natural persons—it cannot be derived from any abstraction called the "corporate entity." . . . ultimately the responsibility for all conduct and likewise the enjoyment of all benefits must be traced to those who are capable of it, that is to *real* or *natural* persons. When therefore, in accordance with the customary terminology, we speak of the corporation, as such, as contracting in the corporate name, as acquiring, holding, and transferring property, and as suing and being sued, and when we speak of stockholders as mere claimants against the corporation, holding stock, which is a species of personal property,—and so on indefinitely—we are merely employing a short and convenient mode of describing the complex and peculiar process by which the benefits and burdens of the corporate members are worked out. If, for example, we say that XYZ, a corporation, has entered into a certain contract with A, we mean that, as to form and procedure, this transaction has been carried out *as if* the XYZ association of individuals were a single person having XYZ as his name. Similarly, it is no doubt true, according to a number of decisions, that a perfect *legal* title to land cannot be transferred merely by all the stockholders' joining in a conveyance. This obviously does not indicate that the stockholders as such are not the exclusive holders of the legal rights, powers, liberties, etc., relating to that land: it shows merely that the form and method of transferring title to this particular land is different from that which would be sufficient if, e.g., the owners were ordinary joint tenants or tenants in common. The transfer must, in accordance with the forms prescribed by law, be made *as if* the corporation were itself a single natural person owning the land and acting through certain representatives. In short, corporate "ownership" is *sui generis;* and the form and method of conveyance are likewise *sui generis.*[24]

The American Law Institute is on record to the same effect. It approved Tentative Draft No. 3 of the Restatement of Business Associations after hearing the following explanation from its Director, William Draper Lewis:

> . . . As far as those of us who have been working on this subject are concerned, there is practical unanimity in the idea that a corporation is an association or group of persons who, by complying with certain statutory requisites, have certain legal relations to themselves inter se and to third persons which they would not otherwise have if it had not been for a statute. Therefore, we start out in the first Tentative Draft defining [a] corporation . . . as an association of persons who by law have the right

23 Private Corporations (2d ed. 1886) p. III. Accord: Paul v. Virginia, 75 U. S. 168, 181 (1868); Upton v. Englehardt, 3 Dill. 496, 497 (1874).

24 Fundamental Legal Conceptions (1923) pp. 197-201.

> to sue and be sued in a common name, to convey and hold property in a common name, to have limited liability, to be managed by a board of directors, etc. When you have those incidents you have a corporation, but the corporation is conceived of, not as some nebulous thing in the air, but as the association which is clothed with these peculiar rights. . . . after very considerable argument, the great majority of my Advisors and, as far as they expressed their opinion, the members of the Council came to the conclusion that this theory . . . fits in with the decisions and is correct.[25]

So, as a leading case has pointed out, to say "that a corporation is to be regarded as a legal entity, existing separate and apart from the natural persons composing it, . . . is a mere fiction, existing only in idea" and this "is well understood, and not controverted by any one who pretends to accurate knowledge on the subject."[26]

In short "the word 'corporation' is but a collective name for the corporators or members who compose an incorporated association; and where it is said that a corporation is itself a person, or being, or creature, this must be understood in a figurative sense only"[27]—as a metaphor indicating certain distinctive legal relations of people in respect to activities undertaken in concert under an incorporation statute.

Second. What, then is the effect of incorporating a consumer cooperative association on the federal income tax liability of the cooperators?

A. The Revenue Act of 1913 and all succeeding acts in the main have treated corporations as taxpayers in their own right, distinct from and independent of their shareholders. This is an established feature of the federal income tax system.[28] That it is a *necessary* feature, however, Congress has repeatedly denied. The Income Tax Act of 1864 treated corporations substantially as partnerships are treated now; that is, corporate income was taxed to the individual shareholders *pro rata*, not to the corporation as such.[29] Congress has never since gone as far as that, but it has again and again affirmed its *power* to do so by identifying corporation and shareholders in the case of certain types or conditions of corporate enterprise and laying the tax accordingly. Under the Revenue Acts of 1913, 1916, 1917 and 1918 corporate earnings and

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25 X Proceedings, American Law Institute (1932) 186, 254.

26 State, ex rel. Att'y Gen. v. Standard Oil Co., 49 Ohio St. 137, 177, 30 N. E. 279 (1892). Accord: Cincinnati Volksblatt Co. v. Hoffmeister, 62 Ohio St. 189, 200, 56 N. E. 1033 (1900) ("Stripped of misleading verbiage, the corporation is a device created by law whereby an aggregation of persons who may avail themselves of its privileges by organization, are permitted to use their property in a way different from that which is permitted to others who do not so organize, and with certain special advantages, . . . With this conception of a corporation, it would seem to follow as matter of course, that the property of a corporation, although subject under some conditions to rights of creditors, is, in the last analysis, that of the stockholders, . . .").

27 Morawetz, Private Corporations (2d ed. 1886) §1.

28 1 Paul & Mertens, Law of Federal Income Taxation (1934) §53.21.

29 §117; Magill, Taxable Income (1936) 295.

profits accumulated to prevent imposition of the surtax on shareholders, were taxable directly to the latter in proportion to their holdings.[30] Under the Revenue Acts of 1918 and 1921 the individual shareholders of a "personal service corporation"[31] were required to account ratably for the undistributed corporate net income in the same manner as the members of a partnership.[32] Under the Revenue Acts of 1918 "affiliated corporations" were required to file a consolidated return and were taxed on their combined net income, as a unit, without regard to the separate corporate existence of the component companies.[33] The corporate reorganization provisions of the various acts[34] and the provisions for non-recognition of gain or loss from transfers to a controlled corporation in exchange for its stock[35] proceed on the same line giving effect, within prescribed limits, to the actual oneness of a corporation and its shareholders.[36]

Similarly in determining whether a corporation is a "personal holding company" shares therein held by another corporation are considered as owned proportionately by the individual shareholders of the latter.[37] The same test is prescribed in the case of a "foreign personal holding

[30] §II-A (2) Act of 1913; §3, Acts of 1916 and 1917; §220, Act of 1918; 5 Paul & Mertens, Law of Federal Income Taxation (1934) §48.24; Brewster, Is the Undistributed Income of Foreign Personal Holding Companies Taxable to United States Stockholders? (1938) 16 Tax Mag. 69, 70-71; cf. United Business Corp. v. Comm., 62 F. (2d) 754, 756 (1933). Corresponding provisions of subsequent acts have been conditioned on the consent of the shareholders. 5 Paul & Mertens, op. cit. supra, §48.33; Brewster, loc. cit. supra.

[31] §200, Act of 1918; §200 (5) Act of 1921.

[32] §218 (e) Act of 1918; §218 (d) Act of 1921; Holmes, Federal Taxes (6th ed.) §115; cf. §725, Int. Rev. Code. This provision of the 1921 Act expired by its terms on December 31, 1921, and an alternative tax on the corporation was provided by §1332 applicable in case the tax on the shareholders should be held invalid. Sen. Rep. No. 275, 67th Cong., 1st Sess., p. 34.

[33] §240; 4 Paul & Mertens, Law of Federal Income Taxation (1934) §38.02. Under subsequent acts filing of consolidated returns was permissive rather than mandatory. This option was withdrawn by the 1934 Act. Under that and later acts the "privilege of making a consolidated return" has been confined to railroads and (since 1939) pan-American trade corporations. Ibid. §141, 152, Int. Rev. Code.

[34] §202 (b) Act of 1918; §202 (c) (2) Act of 1921; §203, Acts of 1924 and 1926; §112, Acts of 1928, 1932, 1934, 1936 and 1938 and the Int. Rev. Code; Miller, Hendricks and Everett, Reorganizations and other Exchanges in Income Taxation (1931) ch. 3, 9; Magill, Taxable Income (1936) 123-131.

[35] §202 (c) (3) Act of 1921; §203 (b) (4) Acts of 1924 and 1926; §112 (b) (5) Acts of 1928, 1932, 1934, 1936 and 1938 and the Int. Rev. Code; Miller, Hendricks and Everett, op. cit. supra note 34, ch. 6.

[36] Ibid. §60 (Prior to the 1921 Act ". . . exchange of property for the stock of a corporation was regarded as a closed transaction . . ., the former owner of the property realizing gain or loss in the amount of the difference between the fair market value of the stock and the adjusted basis of the property. The theory behind realization was that the corporation was a separate entity from its stockholders"); 2 Paul & Mertens, op. cit. supra note 33, §17.45.

Similarly the corporate reorganization provisions represent a statutory modification of the rule developed by the Supreme Court in United States v. Phellis, 257 U. S. 156 (1921); Rockefeller v. United States, 257 U. S. 176 (1921); Cullinan v. Walker, 262 U. S. 134 (1923); and Marr v. United States, 268 U. S. 536 (1925) which stemmed from the same root, being fundamentally an expression of the separate entity rationale.

[37] §351 (b) (1) Act of 1934; §354 (a) (1) Act of 1936 (as amended by §1, 1937 Act, §404 (a) (1) Act of 1938; §503 (a) (1) Int. Rev. Code.

company;"[38] likewise in respect of the disallowance of losses on transactions between a corporation and a person owning directly or indirectly more than half of its outstanding stock.[39]

Under the Revenue Act of 1937 the undivided net income of a "foreign personal holding company"[40] is required to be included in the gross income of its "United States shareholders" just as if they had received it in dividends.[41] This requirement "which treats the income of the foreign corporate entity as the income of the shareholders within the jurisdiction of the United States," said the Ways and Means Committee, "is justifiable on all grounds, including constitutional grounds."[42] The Committee on Finance of the Senate expressed its concurrence by incorporating the report of the Ways and Means Committee in its own report on the bill.[43]

There is no question, therefore, that Congress has consistently asserted that it has power under the Constitution to take account of the factual identity of a corporation and its shareholders and to impose income tax liability accordingly. From first to last[44] every revenue act without exception has contained provisions affirming or reaffirming this power, sometimes explicit, as in the case of personal service corporations and foreign personal holding companies, sometimes implicit, as in the case of non-taxable exchanges and consolidated returns.

B. Corporations exist only by virtue of statute, that is, local or state law.[45] Local law cannot determine the incidence of federal taxes. "Congress establishes its own criteria and the state law may control only when the federal taxing act by express language or necessary implication makes its operation dependent upon state law."[46]

The Supreme Court has held:

> Neither the conception of unincorporated associations prevailing under the local law, nor the relation under that law of the association to its shareholders, nor their relation to each other and to outsiders, is of legal significance as bearing upon the power of Congress to determine how and at what rate the income of [a] joint enterprise shall be taxed.[47]

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38 §201, Act of 1937; §333 (a) (1) Act of 1938 and the Int. Rev. Code.

39 §24 (b) (2) (A) Act of 1936 (as amended by §301 (a) 1937 Act); §24 (b) (2) (A) Act of 1938 and the Int. Rev. Code.

40 §331, Acts of 1936 (as amended by §201, 1937 Act) 1938 and the Int. Rev. Code.

41 §337, Acts of 1936 (as amended by §201, 1937 Act) 1938 and the Int. Rev. Code; Brewster, Is the Undistributed Income of Foreign Personal Holding Companies Taxable to U. S. Stockholders? (1938) 16 Tax Mag. 69; Krichman, Are U. S. Stockholders Taxable for the Undistributed Income of Foreign Personal Holding Companies? (1938) Ibid. at 712.

42 House Rep. No. 1546, 75th Cong., 1st Sess. (1937) pp. 13-14.

43 Sen. Rep. No. 1242, 75th Cong., 1st Sess. (1937) p. 16.

44 Beginning with the 1864 Act.

45 Paul v. Virginia, 75 U. S. 168, 181 (1868); Voeller v. Neilston Warehouse Co., 61 S. Ct. 376 (1941).

46 Lyeth v. Hoey, 305 U. S. 188, 194 (1938). Accord: Morgan v. Comm., 309 U. S. 78, 80 (1940).

47 Burk-Waggoner Oil Ass'n. v. Hopkins, 269 U. S. 110, 114 (1925).

No reason appears why that shouldn't equally be true of *incorporated* associations: and in *Collector v. Hubbard*[48] the Supreme Court had no difficulty in sustaining the Income Tax Act of 1864, which proceeded on that basis.

In *Eisner v. Macomber*,[49] however, it was said that the *Hubbard* case had been overruled by *Pollock v. Farmers Loan & Trust Co.*[50] The intervening adoption of the Sixteenth Amendment was regarded as irrelevant.[51] The majority in *Eisner v. Macomber* took their stand on this resounding declaration:

> We have no doubt of the power or duty of a court to look through the form of the corporation and determine the question of the stockholder's right, in order to ascertain whether he has received income taxable by Congress without apportionment. But, looking through the form, we cannot disregard the essential truth disclosed; ignore the substantial difference between corporation and stockholder; treat the entire organization as unreal; look upon stockholders as partners, when they are not such; treat them as having in equity a right to a partition of the corporate assets, when they have none; and indulge the fiction that they have received and realized a share of the profits of the company which in truth they have neither received nor realized. We must treat the corporation as a substantial entity separate from the stockholder, not only because such is the practical fact but because it is only by recognizing such separateness that any dividend —even one paid in money or property— can be regarded as income of the stockholder. Did we regard corporation and stockholders as altogether identical, there would be no income except as the corporation acquired it; and while this would be taxable against the corporation as income under appropriate provisions of law, the individual stockholders could not be separately and additionally taxed with respect to their several shares even when divided, since if there were entire identity between them and the company they could not be regarded as receiving anything from it, any more than if one's money were to be removed from one pocket to another.[52]

Read literally that appears to require that corporations *must* be treated as wholly separate and apart from their shareholders. If that be so Congress has gone out of bounds every time it has gone behind the corporate facade in framing income tax legislation, as it has done in one way or another in every act. Yet none of these excursions has been held improper. The provisions governing exchanges in kind are favorable to taxpayers and hardly would be questioned. The others mentioned, however, must have operated many times to impose or increase tax liability. Yet not one has been brought to book. On the contrary, the validity of the 1918 provision requiring affiliated corporations

48 79 U. S. 1 (1870).
49 252 U. S. 189 (1920).
50 158 U. S. 601 (1895).
51 252 U. S. at 219.
52 Ibid. at 213.

to file a consolidated return was assumed without question in *Atlantic City Electric Co. v. Commissioner.*[53]

There has been no out-and-out test of congressional power to deal with shareholders as owners of the corporate assets and income. To be sure, the books are full of cases on the question whether, in particular circumstances, the so-called corporate entity may be disregarded under this or that provision of the various revenue acts. There are plenty of decisions both ways.[54] Almost without exception, however, they go only to the question whether a given transaction is within the scope of a particular enactment.

Thus in *New Colonial Co. v. Helvering*[55] the assets of an insolvent corporation were taken over by a new company formed for that purpose. The new corporation assumed the obligations and continued the business of the old, and claimed the right to deduct a net loss suffered by its predecessor. This, the Court held, was not warranted by section 204 (b) of the 1921 Act notwithstanding the shareholders of the two corporations were substantially the same, saying:

> As a general rule a corporation and its stockholders are deemed separate entities and this is true in respect of tax problems. Of course, the rule is subject to the qualification that the separate entity may be disregarded in exceptional situations where it otherwise would present an obstacle to the due protection or enforcement of public or private rights. But in this case we find no such exceptional situation—nothing taking it out of the general rule.[56]

But such decisions do no more than give a negative answer to the question whether Congress has covered the case. They have no bearing on the extent of congressional power. Contrary decisions, however, are very much to the point for in refusing to treat incorporation as giving birth to a distinct legal personality insulated by the Constitution from the members that compose it, they necessarily affirm that it is competent for Congress to do the same.

Thus the Supreme Court early held (prior to *Eisner v. Macomber* and in line with *Collector v. Hubbard*) that a dividend paid by a wholly-owned subsidiary to the parent corporation was not income to the

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53 288 U. S. 152 (1933).

54 Finkelstein, The Corporate Entity and the Income Tax (1935) 44 Yale L. J. 436.

55 292 U. S. 435 (1934).

56 Ibid. at 442. Accord: Dalton v. Bowers, 287 U. S. 404 (1932); Burnet v. Clark, 287 U. S. 410 (1932); Burnet v. Commonwealth Imp. Co., 287 U. S. 415 (1932).

latter.[57] That was not followed after *Eisner v. Macomber.*[58] In 1938, however, the Supreme Court said the owner of a business can not by conducting it as a corporation prevent Congress, if it chooses to do so, from laying on him individually the tax on the year's profits.[59] Since then the Court has again upheld the Commissioner in determining tax liability without reference to transactions between a corporation and the sole owner of its shares.[60]

In *Griffiths v. Helvering*[61] a unanimous court treated a payment made to and received by a corporation as if it had been made directly to Griffiths, the corporation's sole shareholder. One Lay had palmed off on Griffiths some nearly worthless stock which Griffiths subsequently sold to a controlled corporation at a heavy loss. This he was allowed to deduct on his income tax return. Later on Griffiths learned he had been taken in by Lay and undertook to recover what he had paid for the stock. Lay was willing to restore the purchase price and a settlement was concluded essentially as follows: Griffiths reacquired the stock and transferred it to a wholly-owned corporation newly created for the purpose. The corporation then sold the stock to Lay at the same price Griffiths had paid for it originally. $15,000 of this sum was used by the corporation to satisfy a personal debt owed by Griffiths. The balance it agreed to pay Griffiths in annual installments for 40 years with interest on the deferred payments. Griffiths contended he was taxable under section 44 of the 1932 Act only on these installments as received by him. The lower court's judgment for the Commissioner was affirmed on the ground that "What Lay gave, Griffiths in reality got, and on that he must be taxed."

The Court rightly saw in the handling of the settlement a "scheme . . . to disguise by intervening elaborations what in fact was a rescission of the original purchase by Griffiths . . . made more manifest by these facts: Griffiths personally reacquired and transferred the shares to Lay without revealing the existence of the new corporation, gave Lay a

57 Southern Pacific Co. v. Lowe, 247 U. S. 330 (1918) ("We base our conclusion . . . upon the fact that the Central Pacific and the Southern Pacific were in substance identical because of the complete ownership and control which the latter possessed over the former, as stockholder and in other capacities. While the two companies were separate legal entities, yet in fact, and for all practical purposes they were merged, the former being but a part of the latter, acting merely as its agent and subject in all things to its proper direction and control. And, besides, the funds represented by the dividends were in the actual possession and control of the Southern Pacific as well before as after the declaration of the dividends"); Gulf Oil Corp. v. Lewellyn, 248 U. S. 71 (1918).

58 See United States v. Phellis, Rockefeller v. United States, Cullinan v. Walker, Marr v. United States, all supra note 36.

59 Helvering v. National Grocery Co., 304 U. S. 282, 288 (1938).

60 Griffiths v. Helvering, 308 U. S. 355 (1939); Higgins v. Smith, 308 U. S. 473 (1940); cf. Sampsell v. Imperial Paper and Color Corp., U. S. Sup. Ct., April 28, 1941.

61 308 U. S. 355 (1939).

personal release of all claims against him, and personally received from Lay [the amount paid in settlement] which he then turned over to the corporation."

Still the corporation as such, acting through Griffiths as agent, did sell the stock to Lay. And it was as the corporation's agent that Griffiths received Lay's payment therefor. The corporation got the money. All the formalities were punctiliously observed. The arrangement, said the Court, was "technically elegant." Nevertheless the Court held Congress didn't intend to permit a corporation to be used in that way. "Legislative words are not inert, and derive vitality from the obvious purposes at which they are aimed, particularly in the provisions of a tax law like those governing installment sales in Section 44 of the Revenue Act of 1932."

But Griffiths' corporation *was* a corporation, as much so as any other;[62] and, so far as the law of corporations is concerned, though the sole shareholder, Griffiths was still only a shareholder.[63] He had no command over the corporate property except in that capacity.

Yet the Court identified him with the corporation and treated payment to the corporation as payment to him. It did so to avoid frustration of the legislative purpose.

That can mean only one thing, that Congress has power to recognize that a corporation is no more than a name for the shareholders collectively, that the corporate income is *their* income. In *Higgins v. Smith*[64] the Court held the taxpayer not entitled to deduct the loss on a sale by him to his solely-owned corporation. "It is clear," it said, "that an actual corporation existed." Title, it assumed, passed from the taxpayer to the corporation. The Court held, nevertheless, that there was "no loss in the statutory sense" because "the taxpayer retained the control" of the securities transferred to the corporation, "through . . . the exercise of shareholders' rights"—*not by reason of anything extrinsic, but solely by reason of his status as shareholder.* But that is only another way of saying that he and the corporation were in fact one and might be so regarded for income tax purposes.

These cases contradict and therefore overrule *Eisner v. Macomber* to the extent it holds Congress bound by the Constitution, in the field of revenue legislation, to treat a corporation as a separate legal personality wholly distinct from its members—which was the cornerstone

62 Cannon Mfg. Co. v. Cudahy Packing Co., 267 U. S. 333 (1925); Burnet v. Commonwealth Improvement Co., 287 U. S. 415 (1932); 4 Cook, Corporations (8th ed. 1923) §709, p. 2914-2917 ("One person may own all the stock, and yet the existence, relations, and business methods of the corporation continue"); 1 Fletcher, Cyclopedia Corporations (perm. ed. 1931) §§25, 27.

63 Ibid.

64 308 U. S. 473 (1940).

of that famous case.[65] The decision itself in *Eisner v. Macomber* has been denied authority beyond the precise factual situation there involved, by the holding in *Koshland v. Helvering*[66] and *Helvering v. Gowran*[67] that a stock dividend is taxable if the dividend shares differ at all from those in respect of which they are declared and paid. Theretofore *Eisner v. Macomber* had been accepted as exempting all stock dividends.[68] The sweep thus given to the decision in that case was of course due to the breadth and inclusive character of the underlying reason from which it issued, namely, that the Constitution binds Congress to distinguish between a corporation and its shareholders in laying taxes under the Sixteenth Amendment.[69]

The foundation of *Eisner v. Macomber* has thus been undermined both by giving effect to the factual identity of a corporation and its shareholders, as in *Higgins v. Smith* and *Griffiths v. Helvering,* and by refusing to admit conclusions which it was thought for many years necessarily would follow were they separate and distinct, as in *Koshland v. Helvering* and *Helvering v. Gowran.*

The spell of *Eisner v. Macomber* has been broken. It must be regarded as having joined the increasing company of precedents that used to be.[70]

C. In 1870 in the *Hubbard* case a unanimous court held:

> Regarded as an incident to the shares [of a corporation] undivided profits are property of the shareholder, . . .[71]

They could therefore be taxed to him.

In 1920 in his dissenting opinion in *Eisner v. Macomber* Mr. Justice Brandeis said:

> The government urges that it would have been within the power of Congress to have taxed as income of the stockholder his *pro rata* share of undistributed profits earned, even if no stock dividend representing it had been paid. Strong reasons may be assigned for such a view. . . . The undivided share of a partner in the year's undistributed profits of his firm is taxable as income of the partner, although the share in the gain is not evidenced by any action taken by the firm. Why may not the stockholder's

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65 Mr. Arthur A. Ballantine argued in 1921 that "the courts should sustain against constitutional attack the right of Congress in framing tax laws reasonably to draw the veil between the corporation and the stockholders." Corporate Personality in Income Taxation, (1921) 34 Harv. L. Rev. 573.

66 298 U. S. 441 (1936).

67 302 U. S. 238 (1937).

68 Koshland v. Helvering, 298 U. S. 441, 444-445.

69 252 U. S. 189, 208 (1920) ("Can a stock dividend, considering its essential character, be brought within the definition [of income]? To answer this, regard must be had to the nature of a corporation and the stockholder's relation to it").

70 This, of course, has no effect on the common-meaning concept of income nor on the closely-connected requirement of realization, both of which originated before Eisner v. Macomber and have been affirmed and re-affirmed many times since. See note 2, supra.

71 79 U. S. 1, 18 (1870).

> interest in the gains of the company? The law finds no difficulty in disregarding the corporate fiction whenever that is deemed necessary to attain a just result. . . . The stockholder's interest in the property of the corporation differs, not fundamentally but in form only, from the interest of a partner in the property of the firm. There is much authority for the proposition that, under our law, a partnership or joint stock company is just as distinct and palpable an entity in the idea of the law, as distinguished from the individuals composing it, as is a corporation. No reason appears why Congress, in legislating under a grant of power so comprehensive as that authorizing the levy of an income tax, should be limited by the particular view of the relation of the stockholder to the corporation and its property which may, in the absence of legislation, have been taken by this court.[72]

In 1938 in *Helvering v. National Grocery Co.*, speaking now for the Court, Mr. Justice Brandeis declared:

> . . . the sole owner of the business could not by conducting it as a corporation, prevent Congress, if it chose to do so, from laying on him individually the tax on the year's profits. If it preferred, Congress could lay the tax on the corporation, as was done by Sect. 104.[73]

In 1940 in *Higgins v. Smith* the Court held:

> A taxpayer is free to adopt such organization for his affairs as he may choose and having elected to do some business as a corporation, he must accept the tax disadvantages.
>
> On the other hand, the Government may not be required to acquiesce in the taxpayer's election of that form for doing business which is most advantageous to him. The Government may look at actualities and upon determination that the form employed for doing business or carrying out the challenged tax event is unreal or a sham may sustain or disregard the effect of the fiction as best serves the purposes of the tax statute.[74]

But to call a corporation used to save taxes "unreal or a sham" and to argue that *therefore* it may be ignored, would beg the question. It cannot be unreal or a sham if it is a corporation and a corporation is indeed a distinct legal personality whose integrity as a separate and independent being is underwritten by the Constitution. So the reference to sham and unreality must be taken as having to do with utilization of the corporate form of doing business *solely* as an escape from taxation. But if it may be put aside then, why not in other cases? Whatever a corporation is, it is notwithstanding the uses to which it may be put. Whatever the legal relations between corporation and shareholder, they do not vary with the shareholder's motives for being a shareholder.

In any case, whatever such legal relations may be and however they may be classified, they are made by the law of the state of incorporation —not by the Constitution. And the Supreme Court has affirmed and reaffirmed that state law cannot give immunity from federal taxes.[75] "The

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72 252 U. S. 189, 230 (1919).

73 304 U. S. 282, 288 (1937).

74 308 U. S. 473, 477 (1939).

75 United States v. Pelzer, 61 S. Ct. 659 (1941).

state law creates legal interests, but the federal statute determines when and how they shall be taxed."[76]

If "the conception of *unincorporated* associations prevailing under the local law" has *no* "bearing upon the power of Congress to determine how and at what rate the income of [a] joint enterprise shall be taxed," as the Court unanimously held in 1925,[77] on what ground can it be argued that the conception of *incorporated* associations prevailing under the local law not only has a bearing upon the power of Congress to determine how and at what rate the income of the joint enterprise shall be taxed but affords a *constitutional refuge* into which Congress may not reach? "Congress establishes its own criteria;"[78] it's not hog-tied by criteria established by state law for *other* purposes.

Of course, what a man holds in the corporate form of ownership he does not own in the same way or as completely as if unrestricted legal title were vested in him. He may no longer plead, however, as in the heyday of *Eisner v. Macomber,* that what he has in the corporate form of ownership he really doesn't have at all. And income tax liability "does not have to rest upon the enjoyment by the taxpayer of all the privileges and benefits enjoyed by the most favored owner at a given time or place. . . . Government in casting about for proper subjects of taxation is not confined by the traditional classification of interests or estates. . . . Liability may rest upon the enjoyment by the taxpayer of privileges and benefits so substantial and important as to make it reasonable and just to deal with him as if he were the owner, and to tax him on that basis. A margin must be allowed for the play of legislative judgment."[79]

Regard for the so-called corporate entity is, without doubt, an established feature of the federal income tax system. But it is a *legislative* feature, not a *constitutional* feature. Congress is free to tax corporate income to the corporation as such,[80] or to tax it twice, that is, both to the corporation and to the shareholders individually when distributed to them;[81] so also as regards the income of an unincorporated joint stock association or business trust.[82] It should be, formerly was and now again is equally free to tax corporate income exclusively to the share-

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[76] Burnet v. Harmel, 287 U. S. 103, 110 (1932); Heiner v. Mellon, 304 U. S. 271, 279 (1938); Morgan v. Comm., 309 U. S. 78, 80 (1940).

[77] Burk-Waggoner Oil Ass'n v. Hopkins, 269 U. S. 110, 114 (1925).

[78] Lyeth v. Hoey, 305 U. S. 188, 194 (1938).

[79] Burnet v. Wells, 289 U. S. 670, 678 (1933).

[80] Helvering v. National Grocery Co., 304 U. S. 282, 288 (1938).

[81] Welch v. Henry, 305 U. S. 134, 143-144 (1938).

[82] Burk-Waggoner Oil Ass'n v. Hopkins, 269 U. S. 110 (1925); Morrissey v. Comm., 296 U. S. 344 (1935); Smith v. Comm., 69 F. (2d) 911 (C. C. A. 3rd, 1934) cert. den. 293 U. S. 561 (1934).

holders even though not enjoyed by them in the form of dividends.[83] But, of course, an *income* tax can be laid only on *income* and "Congress cannot make a thing income which is not so in fact."[84]

III.

What, then, is the effect on federal income tax liability of incorporating a consumer cooperative association?

First. No statutory exemption or other special treatment has been accorded consumer cooperatives as such.[85]

Incorporation has obscured the fact that the united efforts of the cooperators result only in the satisfaction of certain of their individual economic needs for less in terms of money than one must give who bargains alone. Under the pervasive influence of *Eisner v. Macomber* (notwithstanding the discussion in that case was expressly limited to corporations "organized for profit")[86] it has been taken for granted that, in their corporate aspect, they may and must be treated as a separate taxable entity.[87] So regarded a successful consumer cooperative association has what superficially resembles a profit, that is, an excess of receipts over cost of operations. Accordingly it has been assumed that these non-profit, mutual-benefit undertakings are subject to the income tax imposed on corporations generally.[88] An administrative practice of

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83 An argument must be met based on the 5th Amendment. Thus it will be contended that it is arbitrary and unreasonable to tax minority shareholders on undistributed corporate earnings, particularly in the case of large corporations whose stock is widely distributed. It is not within the scope of this paper to consider that in detail. It may be pointed out, however, that "in entrusting their capital to the corporation [shareholders] accept the disadvantages of the corporate system along with its advantages" and the "disadvantage here [resulting from the accumulation of corporate earnings] is a necessary concomitant of the system and its most distinctive attribute—representation of the collective interest of shareholders by selected corporate management." Voeller v. Neilston Warehouse Co., 61 S. Ct. 376 (1941).

The particular point, certain to be stressed (cf. Eisner v. Macomber, 252 U. S. at 213) that, without disposing of capital assets, the shareholders may not have the wherewithal to pay the tax has been disposed of by such cases as Koshland v. Helvering, 298 U. S. 441 (1936); Helvering v. Gowran, 302 U. S. 238 (1937); and Helvering v. Bruun, 309 U. S. 461 (1940).

How far to *utilize* the power to tax shareholders on undistributed corporate income is a question of policy to be considered and decided as such.

84 Burk-Waggoner Oil Ass'n. v. Hopkins, 269 U. S. 110, 114 (1925). Accord: Hoeper v. Tax Commission, 284 U. S. 206, 215 (1931).

85 Co-operative Oil Ass'n., Inc. v. Comm., 115 F. (2d) 666 (C. C. A. 9th, 1940); Cooperative Central Exchange, 27 B. T. A. 17 (1932); 3 Paul & Mertens, Law of Federal Income Taxation (1934) §32.41, p. 615; cf. §101, Int. Rev. Code, exempting inter alia mutual savings banks, fraternal beneficiary societies, domestic building and loan companies, nonprofit cemetery companies, benevolent life insurance associations, mutual or cooperative telephone companies, certain mutual insurance companies or associations, and finally, agricultural associations, organized on a cooperative basis to market the products of their members and/or purchase supplies and equipment for them.

86 252 U. S. at 208.

87 E. g. Farmers' Union Co-op. Co. v. Comm., 90 F. (2d) 488 (C. C. A. 8th, 1937). Contra: Garden Homes Co. v. Comm. 64 F. (2d) 593 (C. C. A. 7th, 1933); Board of Fire Underwriters of Duluth, 26 B. T. A. 860 (1932); cf. Consolidated Indiana Coal Co. v. Nat'l. Bituminous Coal Comm., 103 F. (2d) 124 (C. C. A. 7th, 1939).

88 E.g., Co-operative Oil Ass'n., Inc. v. Comm., 115 F. (2d) 666 (C. C. A. 9th, 1940).

long standing, however, permits exclusion or deduction of patronage dividends actually distributed.[89]

That, briefly, is how the matter stands. But the question remains whether the tax consumer cooperatives are presently required to pay is authorized by the Sixteenth Amendment.

Second. A purely mutual consumer cooperative association doesn't make a *profit* for anybody.[90] The apparent profit, that is, the surplus from operations, is the aggregation of collectively-held capital savings effected by the cooperators through buying or other activities undertaken in concert. When this surplus is divided among those who have contributed to build it up, each receives his proportionate share of the combined savings, determined *solely* by the volume of his individual purchases in relation to total purchases and *wholly without regard to stock holdings.*[91]

That a surplus exists at all is due to one fact alone, namely, that each cooperator has paid in more than enough to cover the cost of the

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[89] G. C. M. 17895, 1937-1 C. B. 56 ("So-called patronage dividends have long been recognized by the Bureau to be rebates on purchases . . . when paid with respect to purchases made by . . . the distributees. For the purposes of administration of the Federal income tax laws, such distributions have been treated as deductions in determining the taxable net income of the distributing cooperative organization. Such distributions, however, when made pursuant to a prior agreement between the cooperative organization and its patrons are more properly to be treated as exclusions from the gross income of the cooperative organization. (I. T. 1499, C. B. I-2, 189; S. M. 2595, C. B. III-2, 238; G. C. M. 12393, C. B. XII-2, 398.) It follows, therefore, that such patronage dividends, rebates, or refunds due patrons of a cooperative organization are not profits of the cooperative organization notwithstanding the amount due such patrons cannot be determined until after the closing of the books of the cooperative organization for a particular taxable period."); Fruit Growers' Supply Co. v. Comm., 56 F. (2d) 90 (C. C. A. 9th, 1932); Cooperative Oil Ass'n., Inc. v. Comm., 115 F. (2d) 666 (C. C. A. 9th, 1940); Farmers Union Cooperative Exchange, 42 B. T. A. 1200 (1940); cf. Uniform Printing and Supply Co. v. Comm., 88 F. (2d) 75 (C. C. A. 7th, 1937) (sum refunded to patrons held not income to the cooperative); Gallatin Farmers Co. v. Shannon, 109 Mont. 155, 93 P. (2d) 953 (1939); State v. Morgan Gin Co., 189 So. 817 (Miss. 1939).

[90] Garden Homes Co. v. Comm., 64 F. (2d) 593, 598 (C. C. A. 7th, 1933); Board of Fire Underwriters of Duluth, 26 B. T. A. 860 (1932).

[91] Warbasse, Cooperative Democracy (1936) 14-18. Of course dividends are not infrequently paid on stock issued to provide working capital. This is the only practical method of financing open to the cooperatives. For, in general, their credit will not support borrowing in sufficient volume to meet their needs. Moreover interest on indebtedness must be paid at all events and that entails risks which are avoided by issuing capital stock. Cf. Brandeis dissenting in Frost v. Corporation Comm., 278 U. S. 515, 536-546 (1929). In a typical consumer cooperative, however, share dividends are limited to not more than the legal rate of interest. Warbasse, Cooperation as a Way of Peace (1939) 13. They represent merely the price of the cooperative's capital requirements and "should be considered as interest rather than dividends." Garden Homes Co. v. Comm., 64 F. (2d) 593, 598 (C. C. A. 7th, 1933). Hence payment of limited share dividends should have no more bearing on income tax liability than rental or salary payments or any other item of expense. Ibid.; cf. Comm. v. Nat'l Grange Mut. Liability Co., 80 F. (2d) 316 (C. C. A. 1st, 1935). Contra: Farmers Union Co-op. Co. v. Comm., 90 F. (2d) 488 (C. C. A. 8th, 1937); cf. Baker's Mut. Cooperative Ass'n. v. Comm., C. C. A. 3rd, Jan. 7, 1941. In any case payment of such dividends can affect only so much of a cooperative's net receipts as is used for that purpose since in no event can shareholders, as such, be enriched by the balance.

products he has taken for himself. Such payments must "be considered as capital contributions and not as profit to" the association.[92]

If and to the extent that the surplus thus accumulated is apportioned among the contributors, the distribution is a return of capital and nothing more.[93] In that event, under the authorities already noted,[94] no tax would apply. But suppose this surplus is not apportioned among the contributors but by common consent is retained and held in the corporate name as working capital or otherwise to advance the common purpose. Is Congress free under the Constitution to tax the cooperators on the aggregate of their contributions over total cost, that is, on their combined capital savings, by calling it income to the corporation into which they have formed themselves as a convenient means to a common end, which is only to get what they need for less?

To tax a corporation is to tax the shareholders.[95] It is they and they alone "who ultimately bear the burden," as the Supreme Court has pointed out on more than one occasion.[96] Thus a corporation income tax is simply a way of getting at the recipients, collectively, of the corporate income, that is, the shareholders. It follows that only that may be taxed by this means which properly could be taxed to the shareholders individually if they had not incorporated. Otherwise the shareholders, who bear the burden, would be subjected to an income tax on what is not income.

Moreover it is settled that what is taxable to shareholders in the corporate name, again is taxable to them when enjoyed in the form of dividends.[97] So to hold that incorporation somehow warrants taxation of shareholders collectively on that which otherwise would be beyond

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92 Garden Homes Co. v. Comm., 64 F. (2d) 593, 598 (C. C. A. 7th, 1933). Accord: 874 Park Ave. Corp., 23 B. T. A. 400 (1931, Acq.); cf. Duffy v. Mut. Benefit Life Ins. Co., 272 U. S. 613, 620 (1926) ("These payments [the excess over the 'natural' premium paid by policyholders in a mutual life insurance company] were intended for investment, and were invested, to increase the resources of the company and thereby reduce the cost of the insurance; and it requires no stretch of the imagination to say that . . . the fund which they created is invested capital" within the meaning of the Rev. Act of 1917 imposing a war excess profits tax. The Court further pointed out that "it is . . . proper to designate the several interests in a common fund as 'shares' "); I. T. 3208, 1938-2 C. B. 127; see Reg. 103, §1922 (a)-17 (contributions to corporations by shareholders).

93 Cf. Weaver v. Comm., 58 F. (2d) 755 (C. C. A. 9th, 1932); Warner v. Comm., 66 F. (2d) 407 (C. C. A. 2d, 1933); George P. Pitkin, 31 B. T. A. 403 (1934); R. O. Holton & Co., B. T. A., Apr. 17, 1941; S. M. 4447, V-1 C. B. 168 (1926).

94 See note 89, supra.

95 See Learned Hand concurring in Harwood v. Eaton, 68 F. (2d) 12, 14 (C. C. A. 2d, 1933) (". . . a corporation, however completely it is a juristic person, is also an association of persons who have chosen the corporate form for their convenience; and it is upon the basis of that convenience that Congress has imposed upon them collectively a higher rate.") Accord: Collector v. Hubbard, 79 U. S. 1, 18 (U. S. 1870); Helvering v. Nat'l Grocery Co., 304 U. S. 282, 288 (1938).

96 Handy & Harman v. Burnet, 284 U. S. 136, 140 (1931); Atlantic City Electric Co. v. Comm., 288 U. S. 152, 154 (1933).

97 Welch v. Henry, 305 U. S. 134, 143-144 (1938).

the sweep of the Sixteenth Amendment, would subject them individually as well to an income tax on that which isn't income.

There is no escape from the conclusion that incorporation does not extend the reach of the Sixteenth Amendment.

The further fact that unincorporated joint stock associations and business trusts are taxable precisely as corporations are,[98] points in the same direction for it shows that incorporation is not at all what is decisive.[99] No decision of the Supreme Court is to the contrary.

To be sure the Court recently has said that "a taxpayer . . . having elected to do . . . business as a corporation . . . must accept the tax disadvantages."[100] But it did not detail the disadvantages; and, in any case, the question there involved had to do solely with the deductibility of a claimed loss on a transaction with the taxpayer's corporate self—a loss which, by ignoring the fiction, the Court found had not been sustained. The language of the opinion must be read against that background. Many times the Court has admonished that "general expressions, in every opinion, are to be taken in connection with the case in which those expressions are used."[101]

It is likewise true that in *Burnet v. Commonwealth Improvement Co.*[102] the Supreme Court turned its bad ear to the contention that no profit accrued to the taxpayer corporation from an exchange of securities with the sole owner of its shares. But the Court found it necessary to bolster its judgment by quoting with approval what the Board had "well said" in deciding for the Commissioner:

> If [the corporation's] contention [that it and the estate which owned all of its stock, were "the same entity"] were logically applied it would follow that all income received by the corporation since its organization was properly taxable as income of [the decedent, who formed the corporation] and his estate and should have been added to any other income which [he] and his estate received during these years and taxed at the rates applicable to individuals rather than returned by the [corporation] and taxed at the rates fixed for corporations. . . . But [the corporation] does not seek to carry its contention to such a conclusion. Having enjoyed the benefits which resulted from its separate existence, it seeks to perpetuate those benefits and asks that the separate existence and tax liability of [itself] and its single stockholder be overlooked only with respect to transactions which take place between them. That this is an afterthought is plainly evidenced by the action of [the corporation] in claiming a deduction upon this same transaction when it believed a deductible loss had been sustained.[103]

[98] See note 82, supra.

[99] See Reg. 103, §19.3797-1,-2,-3,-4.

[100] Higgins v. Smith, 308 U. S. 473, 477 (1940).

[101] Cohen v. Virginia, 19 U. S. 264, 399 (1821); Bramwell v. U. S. Fidelity Co., 269 U. S. 483, 489 (1926); Humphrey's Executor v. United States, 295 U. S. 602, 626-627 (1935); Wright v. United States, 302 U. S. 583, 593-594 (1938).

[102] 287 U. S. 415 (1932).

[103] Ibid. at 418-419.

The Court added, dryly:

> While unusual cases may require disregard of corporate form, we think the record here fails to disclose any circumstances sufficient to support the [corporation's] claim.[104]

It is apparent, therefore, that that case cannot properly be generalized to uphold the taxability as income of what is not, simply because the recipients have formed themselves into a corporation.

On the other hand the Supreme Court has held that a dividend paid by a wholly-owned subsidiary is not income to the parent corporation.[105] And the cases so holding, although restricted in application, as the *Commonwealth Improvement Co.* case itself must be, by the declaration in the latter that they "cannot be regarded as laying down any general rule authorizing disregard of corporate entity in respect to taxation,"[106] nevertheless continue to speak with recognized authority.[107]

There is no magic in a corporate charter to transform into income that which is not income.

When all is said "the word 'corporation' is but a collective name for the corporators or members who compose an incorporated association;"[108] and "transacting business under the forms, methods, and procedure pertaining to . . . corporations is simply another mode by which *individuals* or *natural persons* can enjoy their property and engage in business."[109]

The character of the surplus from operations of a consumer cooperative association is, therefore, not at all altered by incorporating. As the House of Lords has ruled,[110] it is not made taxable simply by obtaining a charter.

A consumer cooperative is simply the cooperators in their capacity as participants in the common enterprise. It is themselves organized to satisfy certain of their needs more economically by pooling their resources. A surplus of corporate intake over outgo is merely the measure of their success, representing the extent to which they have been able

104 Ibid. at 419. In short, a taxpayer cannot have his cake and eat it.

105 Southern Pacific Co. v. Lowe, 247 U. S. 330 (1918); Gulf Oil Corp. v. Lewellyn, 248 U. S. 71 (1918).

106 287 U. S. at 420.

107 As in Helvering v. Nat'l. Grocery Co., 304 U. S. 282, 288 (1938); Continental Oil Co. v. Jones, 113 F. (2d) 557, 562 (C. C. A. 10th, 1940); Campana Corp. v. Harrison, 114 F. (2d) 400, 408 (C. C. A. 7th, 1940).

108 Morawetz, Private Corporations (2d ed. 1886) §1. Accord: Hale v. Hardon, 95 Fed. 747, 752 (C. C. A. 1st, 1899) (". . . the stockholders in the primary and in the ultimate sense are the corporation. The corporation is the enterprise of the stockholders. . . . The business is the business of the stockholders, and the profits, where there are profits, belong to the stockholders").

109 Hohfeld, Fundamental Legal Conceptions (1923) 197. Accord: Upton v. Englehart, 3 Dill. 496, 497 (1874) ("The shareholders are the real parties in interest; the incorporating statute empowering them to contract and be contracted with through the medium of a corporate representative").

110 New York Life Ins. Co. v. Styles, 14 App. Cas. 381 (1889); Jones v. South-West Lancashire Coal Owners' Ass'n. [1927] A. C. 827.

to buy what their neighbors buy for less than their neighbors pay. That the amount and manner in which income is received and held may authorize corresponding variations in the *time* and *rate* of taxation, is no longer open to question.[111] But the manner of receiving or holding that which is *not* income cannot possibly sanction the imposition of an *income* tax upon it.[112] "Congress cannot make a thing income which is not so in fact."[113]

Conclusion

The taxation of consumer cooperative associations has proceeded on an erroneous assumption deriving from *Eisner v. Macomber.* Contrary to that assumption, so long as these non-profit, mutual-benefit undertakings confine themselves to their proper functions they have no income[114] under the Sixteenth Amendment and cannot validly be required to pay an income tax.

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111 Burk-Waggoner Oil Ass'n. v. Hopkins, 269 U. S. 110 (1925); Morrissey v. Comm., 296 U. S. 344 (1935); Helvering v. Nat'l Grocery Co., 304 U. S. 282 (1938); Welch v. Henry, 305 U. S. 134 (1938).

112 Garden Homes Co. v. Comm., 64 F. (2d) 593, 598 (C. C. A. 7th, 1933) ("Respondent contends that petitioner's entity as a corporation must be preserved, and on that premise he insists that all funds received by it, less the amounts deducted for expenses, must be considered as profit to petitioner . . ., and hence is taxable as income to petitioner. We quite agree that ordinarily the entity of a corporation should be recognized and preserved, but if by so doing the plain and lawful intention of the parties will become frustrated and of no effect, we conceive it to be the court's duty to have regard for the substance of the transactions rather than to the form, and to grant such relief under the law and the facts as will preserve and give effect to the intentions of the parties"); Board of Fire Underwriters of Duluth, 26 B. T. A. 860 (1932) (Petitioner was an incorporated salvage corp. "Its only receipts came by requisition from the National Board of Fire Underwriters [which owned all of its stock] and any excess of receipts over disbursements was deducted in arriving at future [estimated requirements]. It is difficult for us to see how such operations could result in the receipt of income, . . .

"The petitioner was merely an agent through which the National Board of Fire Underwriters carried out one of its functions requiring the expenditure of money which was furnished to the petitioner. We are of the opinion that the petitioner was not in receipt of taxable income . . ."); cf. State v. St. Paul Union Depot Co., 42 Minn. 142, 145-146, 43 N. W. 840, 842 (1889) (". . . the sole and only function performed by the defendant corporation is to furnish, at cost, a union depot and terminal facilities for the common use of these different railway companies, and . . . the scheme of forming a corporation for that purpose, and issuing stock, is but a more convenient and economical method of holding the property and managing the business than it would be to hold and manage it as tenants in common. . . . We cannot see what difference it can make whether they hold the depot property as tenants in common, or put it in the name of a trustee to hold and manage for their common use, or, as in this case, organize a corporation for the same purpose, as a more economical and convenient method of holding the property, managing the business and apportioning the expenses among themselves. The state plants itself on the technical ground that defendant is a separate and independent legal entity, and that we have no right to consider the functions which it performs, or the relations which it bears to the railway companies who own its stock and use its depot. We think this is too narrow and technical a view of the case. When evasions have been resorted to by railway companies or others to escape taxation, we have unhesitatingly looked through the external form or dress to the substance of the transaction, and the same rule should be applied against the state.")

113 Burk-Waggoner Oil Ass'n. v. Hopkins, 269 U. S. 110, 114 (1925). Accord: Hoeper v. Tax Commission, 284 U. S. 206, 215 (1931).

114 I.e., from *operations*. That which is income (interest, for example, or rent) is not the less income because received by a cooperative. Penn Mut. Life Ins. Co. v. Lederer, 252 U. S. 523, 534 (1920); New York Life Ins. Co. v. Styles, 14 App. Cas. 381 (1889).