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THE LAW OF INCOME TAXATION AND CORPORATE DISTRIBUTIONS*

The law of income taxation, interesting as it may be to the expert, may be a complex subject even to him, if it is utilized to the fullest extent. It, as we know, is derived from all opinion peculiar to taxing income. This opinion, however, has not been clearly organized into a category, separate and distinct from other opinion which, though availed of in administering income taxes, is common to other branches of law. And it has not been generalized and reduced to a unified, workable system of rules such as that which may be found in a textbook on an older title of law.

As men of the law profession have learned, the process of generalization is not always easy, and there are phases of it which may extend over a long period of time. Indeed, due to our progress in the law, the work may never be

* The author emphasises that this discussion represents his own personal views and is not to be interpreted in any sense as the official opinion of the Treasury Department or any unit thereof.

1 In my article Developing a Law of Income Taxation, 32 TAXES 546 (1954), I have attempted to explain this more fully.
finished. I feel sure however that in a democracy such as ours we will continue to strive for perfection, though it may be beyond our reach. Even in taxation, that spark within us, which some men call conscience, may not let us completely ignore our inner urge to distinction in some fashion.

Simplicity,² despite every device employed against it, marks a path most conducive to keeping in sight of this goal in income tax law. This is true because general income taxation, which is our chief form of taxing income, offers many opportunities for complexity. This form of taxation is aimed at income from all sources,³ and has its impact upon every kind of income-producing activity. It is measured by the net income which remains after deducting allowable expenses and other charges, including in some instances expenditures incurred for purely personal reasons. Hence, due to its scope, it presents a wide variety of problems, such as, those which arise in determining what is income, what is deductible, how are taxpayers or items of their income and deduction to be classified, and as of what time shall an accounting be made for such items, no one of which may be adequately solved until all of the refinements are made once the general standards have been fixed. Most likely, however, none of these issues will seriously trouble the administration of a special tax on

² Simplification has been a subject of considerable discussion from the outset of federal income taxation, following the adoption of the Sixteenth Amendment to the Constitution. Congress, by the Revenue Act of 1921, § 1327, 42 STAT. 317, established in the Treasury Department a Tax Simplification Board which functioned until December 31, 1924. One duty of the Joint Congressional Committee on Internal Revenue Taxation as created by the Revenue Act of 1926, § 1203 (c) (4), 44 STAT. 127, was "... to investigate measures and methods for the simplification of such taxes, particularly the income tax,"—a duty which has been continued by the Int. Rev. Code of 1939, § 5011 (b) (1), 53 STAT. 505 (now Int. Rev. Code of 1954, § 8022 (2) (a)).

³ Because of constitutional difficulties, a federal income tax can not reach all income if it is not apportioned among the states to comply with the restriction on direct taxation; and in the case of any general income tax, policy may call for exemptions of some kind.
income. This being the case, a general income tax may bring the law of income taxation into operation in many ways which are not essential in applying a special tax.

Even so, there appears to be no valid reason for unduly complicating general income taxing statutes with a mass of new rules. This is to say, it is not essential that a new and distinct rule shall be brought into operation at every step taken in the course of taxing income. In many instances, the general tax rules and the rules of other branches of law may be availed of in administering the tax. Ordinarily, this process may be acceptable, except where distinct rules are for good reason deemed necessary in classifying taxpayers or their incomes and deductions (as, for example, to promote uniformity of federal taxation on a nation-wide basis) or where special rules are otherwise necessary in dealing with distinctive income tax problems in a generally satisfactory manner. Once we go beyond the scope of this exception to put into operation a rule peculiar to income taxation, it seems that we have to keep on making income tax law instead of leaning on the past, and that we can never count on a final prediction respecting all of its ramifications.

On the other hand, if we make a reasonable effort to promote a seemingly simple philosophy, general income taxation need not be excessively complicated, even if a new and distinct rule is applied occasionally. It is contemplated by this philosophy that a rule of this kind shall for the most part be applied only where the need for it is generally apparent. In such case, the chief complication, if it is a complication, is due to the necessity for all persons concerned to be cognizant of a rule which serves income

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4 A special income tax as that term is here used includes inter alia a tax levied only on dividends received, one on dividends and interest, or a tax on mining royalties.

5 For a comprehensive discussion of theories of simplification which we encounter when we depart from the simple approach, see Blum, *Simplification of the Federal Income Tax Law*, 10 Tax L. Rev. 239 (1954).
taxation, but not other purposes. However, since the rule should be directed by reason\textsuperscript{6} and our general desire for an ideal system of income tax rules,\textsuperscript{7} it most likely will stand out clearly; and its application should be reasonably predictable by persons moderately experienced in income taxation, and should be even more easily foretold by the experts.

When viewed in this manner, the history of federal income taxation reveals one thing, if no other, which we may say is certain\textsuperscript{8} — that is, in dealing with corporate distributions, the Act of 1913 was the epitome of statutory simplicity!

In that Act,\textsuperscript{9} as in the Civil War and also the 1894 income taxing acts,\textsuperscript{10} the entire matter was covered by a single word. Logically enough, the word used was dividends. And, important as it is, it appeared in the statute only as a designation of one of the several items which a taxable person was required to include in his taxable income.

Thus, strange as it may seem to us now, the draftsmen in 1913 evidently believed that this one word in the

\textsuperscript{6} According to Sir Edward Coke (1551-1634), whose rough temper and staunch support of constitutional liberties brought him disfavor by King James and his courtiers: "Reason is the life of the law; nay, the common law itself is nothing else but reason."

\textsuperscript{7} "History," says Professor Goble, "reveals a heavy mortality rate among so-called 'absolute and infallible' principles of law—both moral and scientific." Goble Nature, Man and Law: The True Natural Law, 41 A.B.A.J. 403, 407 (1955). But history has not put an end to our quest for infallible law.

\textsuperscript{8} Of course you may disagree with this, if you agree with Voltaire that "no general statement is true, not even this one."

\textsuperscript{9} The Revenue Act of 1913, § II B, 38 Stat. 167, provided that "the net income of a taxable person shall include gains, profits, and income derived from salaries, wages, or compensation . . . , or from professions, vocations, businesses, trade, commerce, or sales, or dealings in property . . . also from interest, rent, dividends . . ." (Emphasis added).

\textsuperscript{10} Provisions similar to those in the 1913 Act were contained in the Revenue Act of 1894, § 27, 28 Stat. 553, which act was declared unconstitutional in Pollock v. Farmers' Loan and Trust Co., 158 U.S. 601 (1895); in the Revenue Act of 1864, § 116, 13 Stat. 281; in the Revenue Act of 1862, § 90, 12 Stat. 473; and, in the Revenue Act of 1861, § 49, 12 Stat. 309.
statute accomplished all that was needed in taxing corporate distributions. Hence, no elaboration was made for the purpose of defining what was meant by the term "dividends." And there were no special provisions relating to distributions out of pre-March 1, 1913 surplus, liquidating distributions, distributions "essentially equivalent to a dividend," collapsible corporations, preferred stock "bail-outs," or to any transaction which today causes sufficient concern to warrant specialized statutory consideration.

In short, the treatment of dividends in the Act of 1913 was not designed to force into operation a substantial number of rules of law peculiar to income taxation. This is not to say that no distinctive tax rules may be needed in taxing dividends under an act such as that of 1913. A proper interpretation would have to be made to prevent the taxation of those distributions which are satisfactorily shown to be out of capital receipts. And distinct rules of some kind might be necessary to conform the administration of the tax to our standards of justice.

Nevertheless, if current tax experts are to judge our efforts in 1913, perhaps they will think we were then too naive in believing that the application of a general income tax to corporate distributions may be so simple. But, the most likely result, despite all of the statutory ramifications enacted later, is that the time may come, if it has not been with us from the outset, when little difficulty should be encountered in applying the tax to these distributions. Indeed, when you come to think of it, except perhaps for some vestige of the stock dividend controversy, it may be clear that American stockholders are on the whole decidedly unmoved by the questions which supposedly

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11 This was not unusual at that time, for the entire concept of taxing income was then simpler than it is today. Indeed, beginning with its origin in antiquity, in Sumeria and in ancient Egypt, which was millennia prior to federal income taxation, the income tax was truly a simple tax. It, however, took on complexities when the general income tax was inaugurated in England in 1798, but not as many as we now have. H. C. Adams, *The Science of Finance* 477 (1899); Seligman, *The Income Tax* 57 (1914).
trouble them, and certainly puzzle the experts. Where there is concern, we may find that it is in the main aimed at those distributions which are so planned by closely held corporations that they are more akin to tax saving devices than to pure dividend policy or stern business decisions.

Be that as it may, the assumption in 1913 must have been that corporation law respecting corporate distributions generally would be availed of for the purpose of applying the tax. In brief, the 1913 Act anticipated no additional complication such as that derived from applying new and distinct rules of law in determining whether, without regard to corporation law, a distribution constitutes ordinary dividend income within the meaning of the taxing act. If the distribution constituted a dividend properly paid according to corporation law in that it was not an unlawful impairment of capital,\(^{12}\) it was considered to be dividend income. Moreover, there was not then, and does not appear at any other time to have been, any widespread practice by stockholders or income tax officials to question the legality of dividends paid. Thus, where stock was redeemed or liquidated, if the distribution exceeded the capital paid-in in respect of the part of the stock redeemed or liquidated, only the excess was classed as an ordinary dividend—and each other distribution was in substance and effect presumed to be a dividend properly declared and paid, subject of course to an adjustment of some kind in the occasional case where the distribution was repaid because it had been illegally made. In short, the ordinary, common concept of dividend income was employed for the purposes of the tax.

This simple approach in the 1913 Act served to synchronize income taxation of corporate distributions with business views and corporation law. By the law which safe-

\(^{12}\) Not all distributions out of capital receipts are unlawful. For example, under the wasting asset doctrine, a corporation owning a natural resource may distribute dividends out of its depletion reserve.
guards creditors of a corporation, they are entitled to rely upon corporate capital to assure payment of their claims; and distributions may not lawfully be made to stockholders out of capital receipts in violation of creditors' rights. The capital of a corporation may be legitimately dissipated by losses due to businesslike operations, but our system of law does not permit corporate capital to be impaired to the detriment of the creditors by distributions to stockholders. Though the volume of literature on the subject of taxing liquidating distributions perhaps is ample to warrant a naive impression that distributions of this kind are rather common business transactions, the liquidation of a corporate business seldom is planned for business purposes. Unfortunately, it occurs more frequently in case of extreme financial difficulty in meeting the demands of creditors. In other words, even liquidations may be unlawful, if they improperly jeopardize the interests of the creditors. On the other hand, stock dividends, which are somewhat common and have caused considerable tax controversy, do not impair the capital of a corporation, for a dividend of this character may be out of surplus created by the questionable device of revaluing capital assets and hence does not effect the earnings or profits, or it may capitalize earnings and profits and thus prevent them from being available for

13 Business accounting, where properly applied to corporations, is geared to corporation law so that the amount safely considered to be available for dividend distribution without impairing capital may be readily ascertained. Cf. 2 KESTER, ACCOUNTING THEORY AND PRACTICE 428 (1921); FINNEY, PRINCIPLES OF ACCOUNTING 10-13 (1928).

14 But it may be that subsequent earnings must be applied to restore capital if the value of the assets is not equal to the amount of capital.


16 In some cases, a liquidation may not jeopardize the interests of unpaid creditors if either before or in the course of the liquidation the stockholders guarantee payment of the corporate liabilities in a manner which fully protects the creditors. But these steps generally may be taken only by a closely held corporation.
distribution to stockholders as ordinary dividends.\textsuperscript{17}

Thus, if the directors of a corporation never act unlawfully, every distribution made to stockholders is legal; and, when received by them, it constitutes dividend income within the general conception of that term, excepting, however, that part which is properly paid out of capital receipts. In administering an income tax, we however should not lightly presume that a distribution is illegally made. It is appropriate, and simpler, to presume that every distribution to a stockholder is lawfully made and represents dividend income for income tax purposes except to the extent that it is made out of capital receipts, leaving to the stockholder the opportunity to deny the legality of the distributions, if he boldly believes that he has no right to it.

Under a scheme of this kind, it is unnecessary for a tax official or a stockholder or the corporation in which he holds stock, to assume an extensive burden of tracing the source of corporate distributions to ascertain whether they are out of "earnings or profits" within the meaning assigned to the term by corporation law or as specially defined for income tax purposes. Or to put it this way, the burden which later developed in this connection\textsuperscript{18} was not anticipated when the Act of 1913 was drafted. Sim-

\textsuperscript{17} Gibbons v. Mahon, 136 U.S. 549 (1890). See also note 88 infra.

\textsuperscript{18} All taxing acts subsequent to the Act of 1913 in effect place this duty upon the administrative official, as well as upon the stockholder, in that dividends include distributions out of earnings or profits earned since March 1, 1913. With the exception that in the case of the 1936 Act and subsequent enactments, they also include distributions which are not in excess of current earnings or profits. See Revenue Act of 1916, § 2(a), 10, 39 Stat. 757, 765; Revenue Act of 1916, § 31 (which was added by the Revenue Act of 1917, § 1211, 40 Stat. 327); Revenue Act of 1918, § 201, 40 Stat. 1059; Revenue Act of 1921, § 201, 42 Stat. 228; Revenue Act of 1924, § 201, 43 Stat. 254; Revenue Act of 1926, § 201, 44 Stat. 10; Revenue Act of 1928, § 115, 45 Stat. 822; Revenue Act of 1932, § 115, 47 Stat. 203. In the case of the acts after 1936, they also include distributions which are not in excess of current earnings or profits. Revenue Act of 1936, § 115, 49 Stat. 1687; Int. Rev. Code of 1939, § 115(a), 53 Stat. 46; Int. Rev. Code of 1954, § 312(g) (1) § 316(a) (2), and § 363, 68 A Stat. 95.
plicity was inherent in the opinion of that time, as is evidenced by the fact that the theory adopted had long been employed in administering the English taxing act.\(^9\)

But the situation soon changed. Beginning with the Act of 1916\(^{20}\) and continuing down to the present time, we have from time to time inflated the statutory provisions respecting the taxation of corporate distributions until today they constitute more than twenty-five sections\(^{21}\) in the Internal Revenue Code of 1954,\(^{22}\) all in contrast to one meaningful word of common usage in the Act of 1913.\(^{23}\)

Now this feature of the 1954 Code, which some critics allege to be a frustrating one, is not an imperfection in the law of income taxation. It reflects a development which has been under way for many years. This is to say, if the new Code contains complexities, and I do not maintain

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\(^9\) Konstam, Income Tax § 327 (12th ed. 1952), and the cases cited therein. Canada employs a simple method, similar to that in our Act of 1913, in the treatment of ordinary dividends. Canadian Income Taxing Act, § 6(a), CCH CAN. TAX REP. 10-425. But see section 81 of the Canadian Act respecting stock dividends, undistributed corporate income and liquidating dividends. CCH CAN. TAX REP. 14-775. See also note 29 infra, respecting the rule applied under the Wisconsin income taxing acts of 1911 and 1913.

\(^{20}\) See the definition of dividends in the Revenue Act of 1916, § 2(a) and 10, 39 Stat. 757 and 765.

\(^{21}\) See INT. REV. CODE OF 1954, §§ 301-395 (Subchapter C).


\(^{23}\) Indeed, our system of tracing the source of corporate distributions and its method of classifying and taxing distributions is more elaborate and in some respects more artificial than that employed in any other country. Generally speaking, the British philosophy, see note 17 supra, prevails in India where income tax legislation is as old as 1860; in Canada, see note 19 supra, and in Australia. For statutes typical of the continental approach, see the translations in Joint Comm. on INT. REV. TAXATION, U.S. DEP’T OF TREASURY, INCOME TAX LAWS OF FRANCE AND THE GERMAN INCOME TAX LAWS (1938).
that it typifies simplicity at its best, it is the result of complex thinking over a long period of time.\textsuperscript{24}

The thoughts which culminated in the extensive provisions in the 1954 Code therefore pose the question whether income tax simplification may be achieved unless we first generally accept a simple philosophy which may be implemented by clear, concise rules. Even then, it perhaps may obtain only if the justness of the tax does not require complications of some sort. On the other hand, this I know—it certainly is difficult for us to reduce a confusion of theories to a plain statement of rules which may be easily understood and explained. And the task is even more difficult where there is substantial disagreement on the manner in which conflicting intricate theories are to be applied.\textsuperscript{25}

Out of necessity then, the provisions in the 1954 Code respecting corporate distributions had to be extensive, if they were to reflect the current mixture of opinion. If they are not satisfactory—if they are too complicated—the fault lies in the opinion and conflicting views from which they spring. This is to say, the complexity of the 1954 Code is no new or novel circumstance. It is derived from complicated theories which we have developed during the past four decades.

For these reasons, the complexity as dramatically formalized in the 1954 Code is no ground for criticising legislative efforts. On the contrary, it is just cause for us to make a general review of our own thinking. Such review, if it achieves its objective, should disclose any divergence which may be found between the law of income

\textsuperscript{24} This reminds me of what James Russell Lowell once said: "All free governments, whatever their name, are in reality governments by public opinion; and it is on the quality of this public opinion that their prosperity depends."

\textsuperscript{25} For example, the complexities allegedly existing in the Internal Revenue Code of 1954 pertain for the most part to matters as to which we long have been in disagreement and perhaps even now have not reached any general agreement as to how they should be treated.
taxation and other branches of law pertaining to these distributions, to the end that we may generally agree upon the extent to which a divergence of this kind properly should be applied in the practical administration of the tax. In this discussion, I however do not propose to examine the merits of any policy matter as to how a given distribution should be taxed. No matter what the policy decision may be, chances are that corporate distributions which are within the universal concept of dividend income will with some exception be taxed as dividend income. My sole purpose is to try to show that, whatever the exceptions may be, the basic structure of the statute may be simple, with the exceptions added to it, instead of burdening every one concerned with a complex basic structure on which must be superimposed the even more involved provisions which are necessary to prevent undue hardship on the one hand and undesired tax avoidance on the other.

In considering the problem from this angle, the year 1916 is important. In that year the door was opened, perhaps quite by accident, for the beginning of a wide departure from the theory behind the treatment of corporate distributions in the 1913 Act. This was accomplished by defining the word "dividends," the original objective in doing this being to provide statutory certainty that stock dividends were taxed. But in the course of enacting

26 The Act of 1913 did not mention stock dividends and later was held not to include them. Towne v. Eisner, 245 U.S. 418 (1918). In ordinary language, a stock dividend perhaps is not a dividend. But it may be an advantage or gain which may be taxed. Swan Brewery Co. v. The King, [1914] A.C. 231, so holding with respect to a special Dividends Duties Act of Western Australia. For cases in which a different view is taken in respect of a general income tax, see Comm'r of Inland Revenue v. Blott, [1921] 2 A.C. 171; and two Indian cases: Steele Brothers & Co. v. Government, 1 REP. INCOME TAX CASES 326 (High Ct. of Judicature at Rangoon, India 1924); Comm'r of Income Tax v. Binney & Co., 1 REP. INCOME TAX CASES 358 (High Ct. of Judicature at Madras, India 1921). And under a federal income taxing act, there is the further question—whether the stock dividend is income within the Sixteenth Amendment so that a tax thereon need not be apportioned among the states even if it is held to be a direct tax.
the legislation, Congress also granted tax-exemption to dividends paid out of surplus accumulated prior to March 1, 1913, the date on which the 1913 Act went into effect. To achieve this latter objective, and apparently as sheer technique in draftsmanship, the phrase "earnings or profits" was used in the definition. Thus, in the bill as enacted, the term "dividends" was defined to mean "any distribution made or ordered to be made by a corporation, ... out of its earnings or profits accrued since" (emphasis added) March 1, 1913, whether paid "in cash or in stock of the corporation."^{27}

In other words, instead of this provision being limited in a simple way to its proposed scope, it in substance and effect set up a distinct income tax standard for determining the extent to which any distribution made was to be regarded as dividend income under the taxing act. It did this by introducing an earnings or profits test for tracing the source of all corporate distributions. As demonstrated by subsequent history, this step smoothed the way for taxpayers as well as tax officials and the courts to develop the art of defining solely for tax purposes what is meant by the elusive term "earnings or profits." And, what is even more significant, it did not preclude them from employing the term in a manner which need not conform to the business concept as derived from corporation law.^{28}

The distinct tax opinion and concepts brought forth by this approach appear to be geared to a view that the accumulated earnings and profits of a corporation at any

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^{27} See the Revenue Act of 1916, § 2(a), 39 Stat. 757, relating to individual stockholders, and § 10 of that Act, 39 Stat. 765, relating to corporate stockholders. One difficulty with the provision, which need not be discussed here in detail, was that it gave to the distributing corporation the power to designate the distribution as one made out of pre-March 1, 1913 surplus merely by stating in the corporate resolution that the dividend was so made.

^{28} I doubt that this aspect was anticipated when the 1916 Act was enacted. More likely, as I shall show, the legislative draftsmen presumed that earnings and profits would be determined in accordance with the legal and business accounting principles applied in corporation law.
given time are susceptible of precise ascertainment. On the other hand, in business and in corporation law, it is generally recognized, and, if we are to be realistic in the matter, it must be recognized, that the allocation of earnings and profits to fixed accounting periods is a process of estimation. There are many instances where the amount to be allocated to a given period depends entirely upon the application of what appears to be the most reasonable method of making the allocation. For this reason, the tax computation as well as the application of law for the protection of corporate creditors may be more than a skillful mechanical operation in computing earnings and profits with slide-rule accuracy.

For tax purposes, it therefore may be simpler, if not wiser, to consider the facts as we find them. Thus, in cases where the rights of creditors are properly respected —indeed where the creditors do not question the legality of a distribution—it may be simpler to proceed on the basis that there is no particular reason in income taxation

29 While determining the status of corporate dividends the court in Van Dyke v. Milwaukee, 159 Wis. 460, 146 N.W. 812 (1917), at 814 said that:

"Ordinary dividends declared by going corporations, including mining corporations, are and always have, in the common acceptance of the term, been regarded as income, spoken of and understood to be such by people generally. . . . The task of tracing dividends declared by all sorts of corporations to their source to determine how much came from capital, and how much from income, strictly speaking, or how much from an enhancement of capital value, would be colossal in the amount of labor required, perplexing in character, and productive of almost endless litigation."

To the same effect, State ex rel. Pfister v. Widule, 166 Wis. 48, 163 N.W. 641 (1917), under the Wisconsin income tax law of 1911. As to the English and Canadian rules, see note 19 supra. As late as 1925 similar simplicity was being urged in respect of our federal income tax:

"As a general rule, a corporation and its shareholders are different persons . . . In that view of the relationship of corporation and shareholder, it should make no difference from what source any particular corporate dividend is derived. It is a return of capital or it is not, and so far as the limitations of the constitution are concerned, every distribution by a corporation not a return of capital contributed may be taxed as a dividend. . . . Its incidence as a yield to the corporation, and the circumstances which produced it make no difference." (Emphasis added). G. E. HOLMES, FEDERAL INCOME TAX 789 (6th ed. 1925).
to trace the source of each distribution in order to determine whether it represents dividend income within the meaning of a concept devised only for tax purposes.\textsuperscript{29}

Notwithstanding all of this, the 1916 Act initiated a different course of tax considerations. In short, it then became imperative that we abandon utmost simplicity in classifying corporate distributions for tax purposes.

Even the simplest classification feasible for tax purposes divides these distributions into two categories—(1) those which are unchallengedly paid as dividends and (2) those which are made out of capital receipts upon liquidation of all or part of the corporate business or, if otherwise made, are returned to the corporation because they were illegally paid. The Act of 1916 rejected this scheme of classification, and created further categories. In doing so, it added a complexity of the sort which may be expected to be inherent in the administration of any practice which does not conform to the common concept of dividends.

The philosophy behind such action hence is fundamental to most of the ramifications in our current scheme of classifying corporate distributions for general income tax purposes. Because of it, we today determine whether some dividends though not out of capital receipts shall be applied against the shareholder's cost or basis of his stock and either not taxed or, if any part is to be taxed, that it may be treated as capital gain taxable at a special lower rate. Conversely, there is the possibility that some distributions which are actually out of capital receipts may be treated as dividend income.\textsuperscript{30}

This much however may be said in justification of the

\textsuperscript{30} In mentioning the effect of this method of classification, I do not mean that a reasonable estimation of earnings or profits has no proper place in corporation law or in business. On the contrary, I agree that it is sound business practice to pay dividends only when they may be paid out of earnings and profits as estimated in accordance with generally accepted business accounting principles, noting, however, that a conservative practice in this respect is not required in mining industries where the chief corporate asset is a wasting one.
1916 Act. From one point of view, its inclusion of the earnings or profits test might have been construed as though it went no further than to recognize the concepts generally applied in corporation law and sound business practice. Perhaps, even under that statute, it was proper to presume that all corporate distributions were out of earnings or profits in the absence of satisfactory evidence of the extent to which they were from capital receipts. However, even if this explanation of the 1916 statute should have been accepted as the correct one, it did not prevail, which is all the more reason for saying that we did not then anticipate the extent of the tax complications incident to the distinct tax concept of earnings or profits which was triggered by that statute.31

One reason for our naiveness in that respect is that income tax accounting did not unfold according to the pattern then provided. In the 1916 Act, provision was first made by federal statute for synchronizing income tax accounting with sound business accounting;32 and it therefore was proper then to assume that earnings and profits as calculated in accordance with generally rec-

31 The development hence began before the Supreme Court held that corporate distributions out of pre-March 1, 1913 surplus were taxable under the 1913 Act, in Lynch v. Hornby, 247 U.S. 339 (1918). Cf. Lynch v. Turrish, 247 U.S. 221 (1918); and Gulf Oil Corp. v. Lewellyn, 248 U.S. 71 (1918). This fact appears to contradict the view that these and other decisions in 1918 led Congress to establish the test respecting the source in the corporation, i.e., the earnings or profits test of taxability. Cf. Paul, Ascertainment of "Earnings or Profits" for the Purpose of Determining Taxability of Corporate Distributions, 51 Harv. L. Rev. 40 (1937).

32 The Revenue Act of 1916, 39 Stat. 756, § 8(g) at 763, and § 13(d) at 771, inaugurated a system of income tax accounting applicable to individuals and corporations, whereby a corporation keeping books upon any basis other than that of actual receipts and disbursements is permitted, subject to regulations, to "make its return upon the basis upon which its accounts are kept . . . ", unless such basis does not clearly reflect its income. Provision for this system has been included in all subsequent federal income taxing acts. Cf. Int. Rev. Code of 1939, §§ 41-44, 53 Stat. 24. But the Int. Rev. Code of 1954, §§ 446, 451-454, 461, 462 amplified these provisions considerably. However, sections 452 and 462 were repealed retroactively for taxable years beginning after December 31, 1953 and ending after August 16, 1954, by Pub. L. No. 74, 84th Cong., 1st Sess. (July 5, 1955), 11 U.S. Cons Cong. & Ad. News 2211 (1955).
ognized and accepted business accounting principles would be used for tax purposes in considering whether a given corporate distribution constituted dividend income to the stockholders. To date this idealistic objective has not been attained, because even now there are conflicting views as to what income tax accounting methods are permissible. In fact, our views on tax accounting methods may alone cause some theoretical, and an occasional actual, incongruity in taxing corporate distributions.

For one thing, there are instances where a corporation may not pay a valid dividend, yet, if its earnings and profits available for dividend distributions are determined by the corporation’s tax accounting method, the corporation may be treated as though it could properly make a lawful dividend distribution. For example, suppose a given corporation has a sizeable sum of cash receipts, commonly referred to as deferred income because the receipts have not been earned. Let us also suppose that without taking this deferred income into account, the corporation has no surplus out of which to pay dividends. This being the case, it is unlikely under ordinary circumstances that the corporation would declare a dividend. If it did, and if there are no other circumstances to show that the capital of the corporation was not impaired by such action, the dividend should be considered to be an illegal one, in case a creditor properly objected to pay-

33 As to the use of generally recognized and accepted business accounting methods for tax purposes, see my discussion of the problem before the University of Chicago Federal Tax Conferences in Reiling, Practical Legal Aspects of Tax Accounting, 30 Taxes 1028 (1952); Tax Accounting for Repricing and Other Reserves, 31 Taxes 390 (1953). Cf. Pacific Grape Products Co. v. Commissioner, 219 F.2d 862 (9th Cir. 1955). See also Reiling, Tax Accounting and Abnormal Income, 30 Taxes 409 (1952).

34 Of course, I realize that to secure uniformity in income taxation on a nationwide basis not every statutory prohibition against paying dividends has tax significance. The main one involves the question whether a distribution is out of capital receipts. Other restrictions are aimed at prohibiting dividends even though as a matter of law they otherwise are permissible. Distributions made in violation of such restrictions or contrary to contractual arrangements or provisions in the corporate by-laws may nevertheless constitute dividend income to the stockholders.
ment of the dividend on the ground that his rights were being violated.

Nevertheless, in the example given, if the deferred income is treated as taxable income to the corporation, which is possible under some views with respect to income tax accounting methods,\textsuperscript{35} the distribution may be regarded as having been paid out of earnings or profits within the meaning of that term as used in the taxing statute, though for corporate purposes it may be deemed to have been paid out of capital receipts. And it may be taxed as dividend income to the stockholders receiving it, though as a matter of corporation law it impairs the corporate capital.

If in such case the stockholders later are required to repay the amount of the distribution to the corporation, there is a further tax complication, for this action poses the question whether the repayment is to be related back to the year in which the distribution was received, thereby entitling the stockholder to an adjustment of the tax paid on it, providing the adjustment is not barred by a time limitation. On the other hand, the stockholder's remedy may be to take a tax deduction for the year in which the repayment is made.\textsuperscript{36} In either event, the ulti-

\textsuperscript{35} As to whether deferred income is taxable when received, see G.C.M. 20021, 1938-1 Cum. Bull. 157, and compare it with the citations in note 33 supra, and with I. T. 3369, 1940-1 Cum. Bull. 46, and the decision in Beacon Publishing Co. v. Commissioner, 218 F.2d 697 (10th Cir. 1955), wherein a taxpayer apparently was allowed to change its method of accounting without applying for or receiving the consent of the commissioner.

\textsuperscript{36} For decisions adopting this latter rule, see: United States v. Lesoine, 203 F.2d 123 (9th Cir. 1953); St. Regis Paper Co. v. Higgins, 157 F.2d 884 (2d Cir. 1946), cert. denied, 330 U.S. 843 (1947); Charles G. Duffy, 2 T.C. 568 (1943). Contra, T. B. R. 42, 1 Cum. Bull. 65 (1919). This administrative application was made prior to the Supreme Court decision in North American Oil Consol. v. Burnet, 286 U.S. 417 (1932), in which the so-called "claim of right" doctrine was laid down by the Court. But under this prior view, as set out in the appeal of Charles G. Duffy, supra, the stockholder must be under a legal obligation to repay in order for repayment to relieve him of tax liability. It, therefore, is consistently held that voluntary repayment does not relieve the stockholder of liability for tax on the dividend. J. A. Swanson, 2 B.T.A. 1112 (1925); Sol. Op. 110, 4 Cum. Bull. 73 (1921); T. B. R. 42, 1 Cum. Bull. 65 (1919). It is similar where the corporation rescinds a dividend because it discovers that it has been said not to be subject to a personal holding company tax. Crellin's Estate v. Commissioner, 203 F.2d 812 (9th Cir. 1953).
mately tax result is one which may be reached by the stockholder personally applying the ordinary concept of dividend income, there being no good reason for making him or the corporate directors believe that the result depends upon the corporation accounting for its earnings or profits pursuant to a distinct tax rule.

Then too, there are other instances where the situation is reversed in that there are no earnings or profits as computed for tax purposes, even though a distribution may be made without impairing the capital of the corporation. For example, suppose a corporation with a long-term contract files its returns and reports its income from the contract according to the completed contract method.\footnote{This method is described in the U.S. Treas. Reg. 118, § 39-42-4 (1953), and in the corresponding sections or articles of prior regulations beginning with the U. S. Treas. Reg. 45, Art. 36 (1918).}

Also, suppose that the corporation has completed 80 per cent of the contract and has actually received 72 per cent of the contract price. If its tax accounting method is used in computing its earnings or profits,\footnote{See the U. S. Treas. Reg. 118, § 39.115 (a)-2 (1953), which states that "the amount of the earnings or profits in any case will be dependent upon the method of accounting properly employed in computing net income . . . ", which of course is a sound application of the statute, since it contemplates the use of a tax concept in determining earnings or profits as distinguished from a corporation law test as to whether there has been an impairment of capital which jeopardizes the rights of creditors and renders the dividend illegal. Thus, a corporation computing income on the installment basis is required to compute earnings and profits on such basis. Commissioner v. South Texas Lumber Co., 333 U.S. 496 (1948). But, showing the difficulty in settling the law in this respect, it was previously held to the contrary. Commissioner v. Shenandoah Co., 138 F.2d 792 (5th Cir. 1943).} the corporation has no earnings or profits available for dividend distribution, since the contract has not been completed and the time for a tax accounting of the profits earned has not arrived. Yet, if a dividend not in excess of the profits earned is paid, I have difficulty believing that under corporate law the payment would be regarded as illegally made out of capital receipts, unless there is some strange remedy available to the creditors which I have over-
looked.\textsuperscript{39}

This suggests the possibility that a charge of impairment of capital may be sustained by the creditors, or, on the other hand, may be adequately answered on behalf of the corporation or its directors, by a showing of all of the pertinent facts, no matter what accounting method is followed by a corporation in keeping its books.\textsuperscript{40} Development of standards for going behind the books, even if it may be accomplished outside the law of income taxation, of course is no easy matter; and the presence of this difficulty most likely contributed its fair share in prompting the adoption of an artificial standard for tax purposes, which of course is one solution of the problem if the taxation of corporate distributions must be wedded to an earnings or profits test of some kind.

Even so, whatever justification there may be in income taxation for tracing the source of each distribution, it seems considerably unrealistic to classify corporate distributions by reference to earnings and profits as computed in accordance with its tax accounting method. By such classification, distributions by one corporation may be regarded as dividend income while those by another corporation with a different tax accounting system may not constitute dividend income. Thus, for the purpose of fixing stockholder tax liability, decisive significance attaches to differences in the manner in which corporations keep their books and make their reports for tax purposes. This, as I view it, is a feature which has little or no bearing upon a stockholder's ability to pay or upon his right to the same tax treatment afforded stockholders of other


\textsuperscript{40} It is generally recognized that bookkeeping entries do not necessarily reflect a corporation's earnings and profits. U. S. Treas. Reg. 118, § 30.115 (a)–2 (1953); Charles G. Duffy, 2 T.C. 568 (1943).
corporations under analogous circumstances.

In applying a distinct tax concept of corporate earnings or profits, the process of complication extends to matters such as the date as of which the tax determination shall be made in considering whether there are earnings or profits available for dividend distribution. For some time the prevailing tax rule has been that the date of payment, not of declaration, is the controlling date.\textsuperscript{41} The rule, though dealing with a matter of only occasional importance, however was not developed without considerable conflict of opinion and controversy.\textsuperscript{42} And it does not appear to reflect too much reality, though it may be said to be a proper interpretation of the word "distribution" as used in the taxing act.\textsuperscript{43}

The effect however is that we do not accept the facts as determined by corporation law. According to corporation law, the declaration of a dividend creates the relationship of debtor and creditor between the corporation and its stockholders; and the holders of the stock, with

\textsuperscript{41} In the U. S. Treas. Reg. 45, Art. 1541 (1918), it was said: "The mere declaration of a dividend is not a distribution." In Mason v. Routzahn, 275 U.S. 175 (1927), though it did not directly involve the point here discussed, the Court said at 178 that: "We think it clear that . . . the date of payment, not the date of the declaration of the dividend, is the date of distribution . . . ." But the decision has been followed in a number of cases such as Beneficial Corp. v. Commissioner, 18 T.C. 396 (1952), \textit{aff'd per curiam}, 202 F.2d 150 (1953); Hind v. Clarke, 34 F.2d 583 (N.D.N.Y. 1929), \textit{aff'd per curiam}, 39 F.2d 1022 (2d Cir. 1930); Dodge v. United States, 64 Ct. Cl. 178 (1927); Moody v. Commissioner, 9 B.T.A. 631 (1927); and the rule has been applied, regardless of whether the taxpayer was on the cash or the accrual basis, Tar Products Corp. v. Commissioner, 130 F.2d 866 (3d Cir. 1942); Commissioner v. American Light & Traction Co., 156 F.2d 398 (7th Cir. 1946). But if the individual accounts of the stockholders are credited with their pro rata shares of the dividend declared such action may constitute a distribution. Roe v. Commissioner, 192 F.2d 398 (5th Cir. 1951); Commissioner v. Goldwyn, 175 F.2d 641 (8th Cir. 1949), \textit{affirming}, 9 T.C. 510 (1947).

\textsuperscript{42} Prior to the \textit{Mason} case, note 41 supra, the date of declaration was considered decisive in several cases.

\textsuperscript{43} See the language of the Supreme Court in note 41 supra. No matter what date is employed, the tax test of earnings or profits puts a burden upon the stockholder who, except in the case of a closely held corporation, may be in no position to review the financial history of the corporation to ascertain whether a given distribution is out of earnings or profits.
respect to which a dividend has been declared, are on a par with other creditors of the corporation. This is to say, it is the declaration of a dividend which in law separates the earnings from the balance of the corporate property and appropriates them to the stockholders; and the fact that the dividend is payable at a future date is immaterial in determining when the appropriation is made. \(^44\)

Thus, according to the present tax treatment, which, as I have shown, had its basic origin in the Act of 1916, a dividend which is illegal in that it was declared out of capital receipts may be regarded as dividend income, if subsequent to the declaration and at the time of the payment of the dividend the corporation has earnings or profits which, when taken into account pursuant to its method of tax accounting, are equal to the dividend. But, despite the mental gymnastics to reach this conclusion, the dividend, being illegal, should be repaid and chances are this will be done if any creditor is injured. If it is repaid, there will be a tax adjustment. If it is not, then the illegality is more theoretical than real, and the end result could have been accomplished in a simple fashion under the pattern of the 1913 Act, without a special tax test of earnings and profits. On the other hand, if we apply the tax test, a dividend which is legal under corporation law may not be considered to be dividend income for tax purposes, if prior to payment the corporation suffers losses which wipe out the corporate earnings and profits as computed for income tax purposes. \(^45\)

As a practical matter, this divergence between the tax concept and corporation law may in some instances be

\(^44\) United States v. Guinzburg, 278 Fed. 363 (2d Cir. 1921). Moreover, after a dividend has been declared, it may be that the fund thereby appropriated to the stockholders is not taxable as property of the corporation. Cf. Pollard v. First Nat'l Bank, 47 Kan. 406, 28 Pac. 202 (1891). However, it does not follow that a stockholder on an accrual basis may not be required, as a matter of administrative convenience, to account for the dividend on a cash basis. Tar Products Corp. v. Commissioner, 130 F.2d 866 (3d Cir. 1942).
somewhat minimized by a change in the tax definition of dividends which was made in the Act of 1936⁴⁶ to treat as dividend income distributions which are not in excess of the earnings or profits of the year in which the distribution is made. By reason of this change in the statute,⁴⁷ the tax treatment may conform to the common concept of dividends, but not necessarily to corporation law in all States, where, except for the change, the distribution could not be treated as ordinary dividend income for tax purposes.

The next principal step along the hard road to a tax concept of earnings or profits available for ordinary dividends is to determine what items enter into the computation. On this point, the position was taken at the outset

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⁴⁵ But, to cite an example which may cause further confusion, if the corporation's tax liability is involved, perhaps it should look to the date of the declaration of the dividend—as, for example, in determining the amount of its earned surplus or invested capital for excess profits tax purposes—unless there is a statutory provision which requires a determination as of a different date. Bulger Block Coal Co. v. United States, 45 F.2d 675 (Ct. Cl. 1931); Davidson & Case Lumber Co. v. Motter, 14 F.2d 137 (D. Kan. 1926); Belmont Iron Works, 9 B.T.A. 216 (1927); Wm. H. Davidow Sons Co., 1 B.T.A. 1215 (1925). But, if borrowed capital may be included in equity invested capital, the amount of a dividend duly declared and payable may be so included subject to whatever limitation is prescribed, unless of course, as in the Int. Rev. Code of 1939, § 458, added by 64 STAT. 1137 (1951), the statute is geared to the Mason decision, note 41 supra, in which event invested capital is not reduced by a dividend declared but not paid. U. S. Treas. Reg. 130, § 40.458-5 (1950).

⁴⁶ In addition to the prior definition, the Revenue Act of 1936, § 115(a). 49 STAT. 1687 provided that the term "dividends" should include distributions made "... out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made."

⁴⁷ The provision as it stands now in the Int. Rev. Code of 1954, § 316(a) (2), previously was in the Int. Rev. Code of 1939, § 115(a) (2), 53 STAT. 46, and in the Revenue Act of 1938, § 115(a) (2), 52 STAT. 496.

⁴⁸ This was first stated by regulation in the U.S. Treas. Reg. 94, Art. 115-3 (1936), and has been continued in effect. See U.S. Treas. Reg. 118, § 39.115(a)-2 (1939); and I.T. 3764, 1945 Cum. Bull. 188, relating to amortizable bond premium on wholly tax exempt bonds. But the principle was applied much earlier. U.S. Treas. Reg. 45, Art. 1541 (1918), pointed out that, although interest on state bonds and certain other obligations is not taxable, dividends paid out of such interest are taxable. See also, I.T. 2131, IV-1 Cum. Bull. 90 (1925); I.T. 2222, III-2 Cum. Bull. 12 (1924). The theory is succinctly explained in Charles F. Ayer, 12 B.T.A. 284 (1928).
that the term "earnings or profits" as used in classifying corporation distributions is not synonymous with "net income" as used in the taxing acts. One difference is that "earnings and profits" includes tax-exempt income\(^4\) as well as taxable income.\(^4\) Indeed, beginning with the Act of 1934,\(^5\) Treasury Regulations have stated that the term includes "income not taxable by the Federal Government under the Constitution,"\(^5\) which statement embraces interest on state bonds. Apparently, it also includes items such as insurance proceeds\(^5\) even if they do not constitute income taxable to the corporation. Thus, there may be occasions when the ultimate determination of federal tax liability may depend upon our ability to agree upon

\(^4\) But by statutory exception, distributions out of pre-March 1, 1913 earnings or profits are not regarded as dividend income for federal tax purposes. This originated in the Revenue Act of 1916, § 2(a) and 10, 39 Stat. 751 and 765, and now is in the Int. Rev. Code of 1954, § 316. Beginning with the Revenue Act of 1921, § 201(b), 42 Stat. 228, it was made clear that this also is true as to distributions out of an increase in the value of property accrued before March 1, 1913.


\(^5\) In view of this attitude, it may seem somewhat strange even under the tax concept that income which has been earned is not included in earnings and profits prior to the time the corporation makes an accounting of it for tax purposes; and it is equally interesting that, by virtue of a corporation's tax accounting method, income received but not earned is included in earnings or profits before the income is earned or the profit on the transaction is determined.

\(^5\) It was so stated in I.T. 2222, III-2 Cum. Bull. 12 (1924). This was posed as a serious question in Isaac May, 20 B.T.A. 282 (1930), by reason of the decision in United States v. Supplee-Biddle Hardware Co., 265 U.S. 189 (1924). But I.T. 2222, supra, appears to be sound, for the rule in it has been applied even where it was claimed that the corporation acted as agent and that the insurance was payable to the stockholders as beneficiaries. Cummings v. Commissioner, 73 F.2d 477 (1st Cir. 1934). Similarly, where a trust company was an intermediary trustee. Golden v. Commissioner, 113 F.2d 550 (3d Cir. 1940). Query: Does the tax concept of earnings or profits include items such as accrued but unrealized appreciation, and ripened grain or mined ore? See Reiling, Tax Accounting and Abnormal Income, cited in note 33 supra. Also, does it include gifts? Gifts of personal property were classified as income in the Revenue Act of 1894, § 28, 28 Stat. 553, which act for other reasons was held unconstitutional in Pollock v. Farmers' Loan & Trust Co., 158 U.S. 601, 637 (1895). And gifts in excess of $1,000 were taxed as income under the Virginia Tax Law, § 10 (2) (1924). Also see Winsor, The Taxation of Gifts as Income, 9 A.B.A.J. 301 (1923), which was later reprinted in 6 Taxes 10 (1923).
a broad concept of income—income in the ordinary sense, if not in the economic sense, which is essential to the tax concept of earnings or profits—in addition to a concept of income within the purview of the Sixteenth Amendment, which is involved in defining taxable income. The reason for this of course is the valid one that tax exempt income received by a corporation loses its identity upon subsequent distribution by the corporation, a corporation and its stockholders being regarded in law as separate entities.\(^5^3\)

Likewise, charges or expenses, though not deductible in computing taxable net income, ordinarily are taken into account in computing earnings and profits, according to universal views in the business world they are deductible for this purpose.\(^5^4\) But all deductions allowable in arriving at taxable net income are not allowable in computing earnings or profits.\(^5^5\)

One major item of this character is the excess of percentage depletion over cost depletion.\(^5^6\) Depletion based upon discovery value is another item in the same category, subject to the same limitation, though it is not as synthetic as percentage depletion. For example, discovery value, less of course the cost of making the discovery, may constitute income in the economic sense at the time of the discovery and, when it is realized in taxable form, may be attributed to the year of discovery in administering relief provisions such as those in section 721 of the World War II excess profits tax.

Then too, even the allowance of cost depletion as it is applied may not be fully genuine where it is computed by reference to a "substituted basis" rather than upon true cost, as, for example, is the case where the property

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\(^5^3\) Miller v. Milwaukee, 272 U.S. 713 (1927). Also see notes 31 and 48 supra.

\(^5^4\) Charles F. Ayer, 12 B.T.A. 284 (1928).

\(^5^5\) Loren D. Sales, 35 B.T.A. 938 (1937).
is received upon a transfer in which gain or loss is not recognized to the transferor and where by statute the transferor’s cost or other basis of the property continues to be the basis for computing such cost depletion as is allowable to the transferee for tax purposes.

Strictly speaking, the excess of depletion upon a substituted basis over true cost depletion may not be allowable in computing earnings or profits except for practical rules of convenience in income taxation. But this is no cause for special concern, for the entire matter of deducting depletion in computing earnings or profits available for dividends would be in the nature of much ado about nothing if we looked to the facts and geared our tax concepts to corporation law which applies the wasting asset doctrine and permits the distribution of dividends out of depletion reserves of any kind—in which event, we could proceed more frankly to classify the distributions

56 A rule treating distributions out of a depletion reserve as liquidating distributions was first adopted in the U. S. Treas. Reg. 33 (Rev.), Art. 4, § 25 (1916), as amended by the act of 1917. The U. S. Treas. Reg. 94, Art. 115–3 (1936), however, was the first regulation to state the theory that cost depletion is deductible in computing earnings and profits, but it stated that “discovery and percentage depletion under all Revenue Acts for mines and oil and gas should not be taken into consideration.” To the same effect, U. S. Treas. Reg. 118, § 39.115(a)–2 (1953). The only statutory provision, which may be construed as authority for this rule, originated in the Revenue Act of 1921, § 201(c), 42 STAT. 228, which provided that distributions not out of earnings or profits and not out of an increase in value accrued prior to March 1, 1913, should be applied against the basis of the stock. In the House Ways and Means Committee report on the Revenue Act of 1924, § 201(d), 43 STAT. 255, this provision was said to include distributions such as those “out of depreciation or depletion reserves.” (Emphasis added). This statement presumes that depletion is deductible in arriving at earnings or profits for dividend purposes, which is not so in corporation law and business accounting. See citations in note 63 infra. But the Revenue Act of 1924, § 201(d), 43 STAT. 255, and the Revenue Act of 1926, § 201(d), 44 STAT. 11, and also the Revenue Act of 1928, § 115(d), 45 STAT. 822, specifically provided for applying distributions from depletion reserves based on discovery value against the basis of the stock, apparently presuming, as the 1924 committee report shows, that distributions out of a cost depletion reserve were to be so applied because of the provision as first included in the 1921 Act. Indeed, the committee report stated that the 1921 Act had been so construed by the Treasury Department. The problem remains the same today. Cf. INT. REV. CODE OF 1954, §§ 301 (c) (2) and 316.

57 See regulations cited in note 56 supra.
so as to tax or exempt them in any desired manner, without having to encounter all of the difficulties incident to the term "earnings or profits."

When the tax attitude respecting depletion is separated out of all the controversy respecting earnings and profits available for dividends, the result is that distributions out of a cost depletion reserve are not regarded as dividend income taxed at ordinary tax rates, but are applied against the basis of the stockholder's stock and any excess may be taxed at the capital gain tax rate. On the other hand, distributions out of percentage or discovery depletion reserves are taxed at ordinary tax rates to the extent that they exceed a reserve computed on cost or other tax basis of the assets. Thus, though a corporation deducts percentage or discovery depletion in computing taxable net income, it also must keep account of cost depletion, if it is to keep its stockholders advised of the tax attitude respecting distributions made to them.

In a way it is worthy of particular notice that we have accepted this result. In the first place, as I have explained, it may be said that in substance and effect depletion is not considered to be an allowable deduction in computing earnings or profits available for dividend distribution. Logically, the same rule is permitted in computing the cost of goods sold. By T.D. 6028, 1953-2 Cum. Bull. 100, the U. S. Treas. Reg. 111, § 29.22(a)-5 (1942), was amended to permit, but not necessarily require, cost depletion to be included in the cost of goods sold. For an explanation of this change, see the Rev. Rul. 141, 1953-2 Cum. Bull. 101. A similar provision is contained in the U. S. Treas. Reg. 118, § 29.22(a)-5 (1953). This regulation however in substance affects only the time as of which the depletion is taken into account for income tax purposes. Where the meaning of cost of goods sold is a decisive factor other than in fixing the time for accounting for the deduction, it may be urged that depletion is not includible in the cost of goods sold. Rev. Rul. 54-88, 1954-1 Cum. Bull. 177; and see my discussion of cost of goods sold in Practical Legal Aspects of Tax Accounting, note 33 supra.

This is because the wasting asset doctrine is applied to permit distributions to stockholders out of depletion reserves. See note 63 infra.

Coltness Iron Co. v. Black, 6 App. Cas. 315 (1881), 1 Tax Cas. 287.
did not enumerate deductions as our statute does and which treated income as being the net amount after deducting the expenses of earning the income, the courts took the position that depletion is not allowable in computing taxable income. And in construing the Corporation Excise Tax Act of 1909 our courts held that no depletion could be deducted in computing gross or net income. Thus, except in the case of timber, and in the absence of a statutory provision to the contrary, no depletion is considered deductible under any theory in arriving at gross or net income. Indeed, business accounting, which recognizes that depletion must be provided for before the net profits are known, also gives effect to the legal theory that no depletion need be deducted in computing the amount of dividends which legally may be paid. This however is not to say that all distributions out of depletion reserves should be taxed as ordinary dividend in-

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61 Firstly, it was held under the 1909 Act that depletion was not to be subtracted from gross sales in computing gross income, Stratton's Independence, Ltd. v. Howbert, 231 U.S. 399 (1913); also that moneys received for ore were not the proceeds of an outright sale of mining property from which an allocable part of the cost of the property could be subtracted in arriving at the amount of profit, Von Baumbach v. Sargent Land Co., 242 U.S. 503 (1917), and United States v. Biwabik Mining Co., 247 U.S. 116 (1918). A deduction allowed by the 1909 Act for depreciation did not include depletion. Goldfield Consol. Mines Co. v. Scott, 247 U.S. 126 (1918). Similarly, under the 1913 Act, Stanton v. Baltic Mining Co., 240 U.S. 103 (1916), and under the 1916 Act, Weiss v. Mohawk Mining Co., 264 Fed. 502 (6th Cir. 1920), cert. denied, 254 U.S. 637 (1920).

62 Under the 1909 Act, Doyle v. Mitchell Bros. Co., 247 U.S. 179 (1918), and T. D. 1675, (1911), held that the cutting of timber merely changes in the form of an asset. Similarly, under the Acts of 1913 and 1916, in U. S. Treas. Reg. 33, Art. 139 (1913), and U. S. Treas. Reg. 33 (Rev.), Art. 173 (1917). Some confusion was introduced by the Revenue Act of 1918, § 214(a)(10), 40 Stat. 1067 (1918), which allowed depletion of timber as a deduction from gross income (see U.S. Treas. Reg. 45, Art 227 (1918)); but this does not preclude a subtraction in arriving at gross income. Though regulations under the Act of 1918 and later acts, recognize that the depletion of timber takes place at the time the timber is cut, they permit a delay of the depletion—the effect of which is to treat it as a part of the cost of the timber sold. See, e.g., U. S. Treas. Reg. 118, § 39.23 (m)–21 (1953).

63 2 Finney, Principles of Accounting 10 (1928); 2 Kester, Accounting Theory and Practice 311 (1921). But it appears that this is not so in the case of timber.
come, for stockholders of corporations with depletion reserves are entitled to be taxed upon the same basis as stockholders of other corporations, and the wasting asset doctrine need not be applied for tax purposes to defeat tax uniformity on a nation-wide basis.64

Be that as it may, in permitting a deduction for depletion in computing net income, the present scheme conforms to business accounting.65 In allowing stockholders to apply dividends which are out of a cost depletion reserve against the cost or other basis of their stock and then to be taxed at capital gain rates on any excess distributions,66 there is a synchronization with the treatment given stockholders of other corporations.67 Thus, the end result may be a sound one, my only point being that it is reached in a roundabout way.

The problem, however, is not confined to depletion. It also concerns depreciation.68 For example, the present American rule in corporation law is supposed to be that provision must be made for depreciation in determining the amount of net profits available for dividends. But there is no outstanding list of authorities to this effect.69 However, without questioning this result, it is conceivable that dividends paid out of earnings as computed without

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64 Such rule however may be employed without the tax concept of earnings and profits, instead of being an added ramification to a structure which is crowded with complexities.

65 See note 63 supra.

66 As to the statutory basis for this, see note 56 supra.

67 There are other instances where the amounts received by a stockholder are applied against the cost or basis of his stock rather than against the amount of capital paid in for the stock, and for this reason the amount so applied is not necessarily a distribution out of capital receipts.

68 And it also may concern losses sustained on the sale or other disposition of capital assets. See articles cited in note 69 infra. Shrinkage in the market value of securities does not reduce earnings or profits, though an unreasonable accumulation thereof may subject the corporation to a special tax on its accumulated taxable income. Helvering v. Nat'l Grocery Co., 304 U.S. 282 (1938); R. L. Blaffer & Co. v. Commissioner, 103 F.2d 487 (5th Cir. 1939); Nipoch Corp., 36 B.T.A. 662 (1937); Reynard Corp., 37 B.T.A. 552 (1938). Contra, C. H. Spitzner & Sons, Inc., 37 B.T.A. 511 (1938).
deducting depreciation may be lawful, if, for example, it is clearly shown that the property has appreciated in value and that the appreciation more than offsets the depreciation.

The validity of this argument does not depend upon treating unrealized appreciation as taxable income. It may be sufficient to say that the value added by the appreciation constitutes income at the time it accrues, though it is not returnable as taxable income until it is realized by sale or exchange. Or, it may be that the appreciation assures assets sufficient to prevent an impairment of the capital. But whatever the problem as to appreciation may be, any search for the solution only serves to emphasize the simplicity of the pattern employed in the 1913 Act.

The Act of 1913 also did not pose any special problem respecting the treatment of gains and losses of the type which for some time have not been recognized for income tax purposes. One reason for this is that the 1913 Act did not contain such non-recognition provisions. But even if it had, most likely such gains or losses would not have been ignored in computing earnings and profits available for dividends. A gain, which is not recognized for tax purposes, nonetheless is a gain; otherwise it would not be a

69 But what recent precedent there is is rather positive. "Directors would be derelict in their duty if they did not . . . provide for depreciation," Nat'l Newark & Essex Banking Co. v. Durant Motor Co., 124 N.J. Eq. 213, 1 A.2d 216, 219 (1938). See the Note, The Effect of Depreciation, Depletion and Appreciation of Assets on the Payment of Dividends, 28 Colum. L. Rev. 231 (1928); and Weiner, Theory of Anglo-American Dividend Law: The English Cases, 28 Colum. L. Rev. 1046 (1928), and his next article of the series dealing with the Theory of Anglo-American Dividend Law: American Statutes and Cases, 29 Colum. L. Rev. 461 (1929). As to the statutory basis for tax purposes see note 56 supra.

70 In administering the World War II excess profits tax relief provisions in respect of abnormal income, appreciation was recognized as a possible basis for attributing income to the years in which appreciation occurred. See Reiling, Tax Accounting and Abnormal Income, cited in note 33 supra. And, as I have shown above, even under the tax concept, earnings or profits are said to include income not taxable by the federal government under the Constitution.
"non-recognized gain." By the same token, a loss not recognized for tax purposes is a loss. And the gain increases the earnings and profits available for dividends, while the loss decreases them.

The reason for the present tax rule of not taking a non-recognized gain or loss into account in computing earnings and profits available for dividend distribution appears to be largely a matter of convenience to save determining the amount of the non-recognized gain or loss; or perhaps there may be some fear that, if a non-recognized gain or loss is taken into account, an adjustment also might be necessary for the recognized gain or loss upon a subsequent sale or exchange of the property, thus causing a duplicate adjustment.\(^7^1\) The problem therefore is to choose the gain (or the loss) transaction which should affect earnings or profits, i.e., the one which results in no recognized gain or loss for tax purposes, or the one which does. By statute, the latter is taken into account. The fact that a statutory provision is deemed necessary to secure this result therefore dramatizes the observation that, once we initiate a distinct tax rule to ignore a universally accepted reality, such action may require a further rule.

\(^7^1\) It was not until the promulgation of the U. S. Treas. Reg. 86, Art. 115-1 (1934), that the regulations provided for no adjustment to earnings and profits respecting those gains and losses, although this had been the practice, which however was disapproved in Commissioner v. F. J. Young Corp., 103 F.2d 137 (3d Cir. 1939), (thus again emphasizing the difficulties encountered when distinct tax rules stray too far away from common concepts). But the rule in the regulations was made statutory by the Int. Rev. Code of 1939, § 115(1), as added by the Second Int. Rev. Code of 1940, § 501(a), 54 Stat. 1004 (1940). Similarly in the Int. Rev. Code of 1954, § 312 (f) (1).

\(^7^2\) As an illustration of the difficulty which we have in this respect, some have said that the statutory rule in the Int. Rev. Code of 1939, § 115(1), added by 54 Stat. 1004 (1940), (similar to the Int. Rev. Code of 1954, § 312 (f) (1) ) for not reducing earnings and profits by a loss disallowed on a wash sale of securities is to prevent an improper duplicate reduction of earnings and profits on account of the loss, thus showing how easy it is for us to believe that the law of income taxation has so lost its bearings that it would sanction a duplicate reduction in the absence of a legislative mandate to the contrary. Cf. 1 Montgomery, Federal Taxes—Corporations and Partnerships 158 (1951).
extending the abstraction to other circumstances in order to prevent us from reaching improper tax results.

So much for the tax concept of the general elements of earnings or profits available for dividend distribution. The next step is to ascertain the manner in which earnings and profits as computed pursuant to this concept are affected by corporate distributions, and first of all by distributions of stock dividends.

The Act of 1913 did not pose the questions which arise in this connection, because stock dividends were at that time believed to constitute taxable income. Indeed, in the 1916 and 1918 acts, Congress expressly made it clear that the legislative intent was to tax stock dividends. In 1918 the Supreme Court however held that where a corporation declares a dividend on its common stock, in the form of common stock, the stock dividend was not taxable under the 1913 Act. And in 1920 it held that the 1916 Act was unconstitutional in so far as it purported to tax a common stockholder because of his having received a dividend in common stock. Following this decision, Congress provided in the Act of 1921 that no stock dividend should be subject to tax, and a similar provision was included in all subsequent revenue acts prior to the Act of 1936.

By the time the 1936 Act was passed, the Supreme Court had made it clear that all stock dividends are not constitutionally tax-free. The statute therefore was changed to tax stock dividends and stock rights in cases where they constitute income within the meaning of the Sixteenth

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76 Revenue Act of 1921, § 201(d), 42 Stat. 228.
77 The case before it involved the basis of common stock issued to holders of non-voting preferred stock, and the common stock was said to constitute income to its recipient, which could have been taxed had the taxing act not provided otherwise. Koshland v. Helvering, 298 U.S. 441 (1936).
Amendment,\textsuperscript{78} thus further reopening the controversy respecting the taxability of stock dividends.\textsuperscript{79}

Shortly after the enactment of the 1936 Act, but not because of it, the Supreme Court pointed out that for a stock dividend to constitute income it must work a change so that the proportional interest of the stockholder after the stock dividend is essentially different from his prior interest,\textsuperscript{80} to the end that the stockholder may be said to have received property on the distribution. And this holding in turn posed questions as to what constitutes a change of this character.\textsuperscript{81} In the 1954 Code\textsuperscript{82} the application of this distinction however is precluded because it exempts all stock dividends except where they are made in discharge of preference dividends or where the stock-

\textsuperscript{78} Revenue Act of 1936, § 115 (f) (1), 49 Stat. 1688.

\textsuperscript{79} But this change did not suffice to permit a reopening of the question whether common on common may be taxed. Helvering v. Griffiths, 318 U.S. 371 (1943). For an idea of the scope of this controversy, see Dean, The Stock Dividend, 32 Taxes 586 (1954).

\textsuperscript{80} Helvering v. Sprouse, 318 U.S. 604 (1943).

\textsuperscript{81} The difficulties are illustrated by these examples: Preferred stock dividend on common was held not taxable where only common stock was outstanding. Chamberlin v. Commissioner, 207 F.2d 462 (6th Cir. 1953), cert. denied, 347 U.S. 918 (1954); Bass v. Commissioner, 129 F.2d 300 (1st Cir. 1943). Contrary views had been taken previously. Francis Elliott Clark, 26 B.T.A. 1225 (1933); Pearl B. Brown, 26 B.T.A. 901 (1932). It was held that there was a change of the stockholders proportionate interest in the corporation where preferred stock was outstanding at a time a preferred stock dividend was paid on the common. Helvering v. Pfeiffer, 302 U.S. 247 (1937); Helvering v. Gowran, 302 U.S. 238 (1937). The lower courts had taken a contrary view. Commissioner v. Tillotson Mfg. Co., 76 F.2d 189 (6th Cir. 1935); James H. Torrens, 31 B.T.A. 787 (1934). No income was held to have been received where a stock dividend of non-voting common was issued to the holders of voting and non-voting common. Helvering v. Sprouse, 318 U.S. 604 (1943). Similarly, in the case of a common stock dividend issued to holders of cumulative non-voting preferred, Koshland v. Helvering, 298 U.S. 441 (1936), and where common stockholders received class B preferred which was junior to other preferred outstanding, Albert E. Smith, 39 B.T.A. 80 (1939). But where class A stockholders received a stock dividend in the same stock and class B stock was issued to class B stockholders, the stock dividends were held tax-free to all stockholders. Wiegand v. Commissioner, 194 F.2d 479 (3d Cir. 1952); Tourtelot v. Commissioner, 189 F.2d 167 (7th Cir. 1951).

\textsuperscript{82} Int. Rev. Code of 1954, § 305. But, if the dividend stock is not common on common, the profit on its disposition or redemption may be treated as ordinary income. Int. Rev. Code of 1954, § 306.
holder may elect to take cash or other property\(^{83}\) in lieu of the stock dividend.

These changes and their ramifications alone are sufficient to add considerable complexity to the task of adjusting earnings or profits on account of stock dividends. In addition, there are two further complications. In the first place, we began as early as the regulations\(^{84}\) under the 1916 Act to enunciate the idea that stock dividends clearly exempt from tax under that Act (i.e., those declared from pre-March 1, 1913 earnings or from surplus created by a revaluation of capital assets) do not represent a "distribution" of earnings or profits subject to tax in the hands of the corporation. This is so. The implication however is that taxable stock dividends constitute distributions of earnings or profits, which of course is not a fact.

No distribution of earnings or profits is made to stockholders by the issuance of a stock dividend. A stock dividend may capitalize earnings and profits and prevent them from being available for distribution to stockholders.\(^{85}\) To assume for tax purposes that the earnings and profits so capitalized will be distributed as dividends even though such action violates corporation law, is not too realistic except perhaps in the case of a closely held corporation with stockholders who for reasons\(^{86}\) peculiar to the case may not observe corporation law too rigidly.

On the other hand, a stock dividend, which is taxable, represents income to the stockholder because it constitutes property received by the stockholder in that he re-

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\(^{83}\) This first exception, which covers the case where stock is issued in payment of a money liability, appears to accord with previously existing law, and the second exception incorporates the rule previously stated in the Int. Rev. Code of 1939, § 115(f) (2), 53 Stat. 47; in United States v. Davison, 9 F.2d 1022 (3d Cir. 1926) (memorandum decision), cert. denied, 271 U.S. 670 (1926); and in United States v. Mellon, 281 Fed. 645 (3d Cir. 1922).

\(^{84}\) U. S. Treas. Reg. 33 (Rev.), Art. 4, para. 28 (1916-17).

\(^{85}\) See Gibbons v. Mahon, note 17 supra.

\(^{86}\) See note 16 supra.
ceives an interest different from that which his former stock holdings represent.\textsuperscript{87} In such case, whether the corporation has earnings or profits is immaterial, for the stock dividend may be income, even though it does not “distribute” earnings or profits.\textsuperscript{88} In other words, the earnings or profits test has no bearing on the question whether a stock dividend constitutes income.

Nevertheless, the capitalization of earnings and profits by the issuance of a stock dividend does, as a matter of corporation law, reduce the earnings and profits available for distribution to stockholders. This is so, whether the dividend does or does not constitute income to the stockholder. But, because we apply the earnings or profits test for tax purposes, we are forced to ignore this important fact and unrealistically say that the earnings or profits available for dividends are not reduced by a non-taxable stock dividend.\textsuperscript{89}

Now what I have said suffices to show that the tax concept of earnings or profits—and in turn the tax concept of dividend income—has long been an artificial one. Two further observations however are implicit, which may be considerably significant if perchance there is some thought that this concept is bottomed upon reality. In the first place, it is evident that, where a distinct tax concept of any kind runs counter to fact, there always is a possibility that it may be pierced by an abrupt reversion to actuality, unless the concept is clearly buttressed by statute to preclude any such possibility.

\textsuperscript{87} See cases cited in notes 80 and 81 supra.

\textsuperscript{88} But by corporation law it may be that the stock dividend must capitalize earnings or profits in order to be a valid stock dividend unless surplus created by a revaluation of capital assets may be capitalized by a stock dividend. See Note, The Effect of Depreciation, Depletion and Appreciation of Assets on the Payment of Dividends, 28 Colum. L. Rev. 231 (1928).

\textsuperscript{89} This rule was stated in the Revenue Act of 1936, § 115(h), 49 Stat. 1688, and was continued in the Int. Rev. Code of 1939, § 115(h), 53 Stat. 48, and in the Int. Rev. Code of 1954, § 312(d). As so stated, it includes other stock or securities which are received tax-free.
To cite a recent experience, a reversion of this sort occurred in the Hirshon and Godley cases. In each case, the corporation made a distribution in kind of property which had appreciated in value, the distribution being made at a time when the corporate earnings or profits were not sufficient to cover the appreciation in property. Because of statutory provisions purporting to limit dividend income to distributions out of earnings or profits, the court, in order to classify the appreciated value as dividend income, treated the excess of fair market value over the corporation's basis of the asset as a distribution of earnings or profits. This was done on the ground that the cost (or other basis) of the property was out of earnings or profits and hence the entire property was out of earnings or profits.

This, so it has been argued, goes against the tax rule that unrealized appreciation is not income to the corporation, and allegedly it is contrary to a long established tax practice of not including appreciation in corporate earnings or profits. But to make my point, the distribution was not in any respect out of capital receipts. And, despite an artificially devised statute which may be construed to give a different treatment, the common concept of dividends prevailed by force of conviction, though it had to do so by reason of skillful statutory construction.

The next general observation respecting the artificiality is in the nature of a reminder that, as long as the tax concept of earnings and profits is employed, further arti-
ficiality may be validly devised to revert in a circuitous and perhaps complicated manner to the ordinary concept of dividend income. A statutory change of this character occurred when a definition of dividends was expanded in 1936 to include a distribution "out of" earnings or profits of the taxable year of the distribution. This definition does not prevent a tax adjustment where any such distribution was returned to the corporation because of its illegality. On the other hand, it does not extend to amounts which are not out of capital receipts and are distributed in liquidation of a corporation, or to similar amounts distributed in cancellation or redemption of stock in cases where the cancellation or redemption is not essentially equivalent to the distribution of a taxable dividend. In other words, in this respect, it leaned far toward the common concept of dividends but did not go as far as that concept would require.

Another illustration of the artifice which may be used in reverting to the common meaning of dividends is to be found in the Revenue Code of 1954, which, oddly enough, pertains to appreciation. This is the method adopted. When certain described assets which have appreciated in value are distributed in kind to the corporation or other property of a kind which would properly be included in inventory; and property held by the corporation primarily for sale to its customers.

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95 Stock in trade of the corporation or other property of a kind which would properly be included in inventory; and property held by the corporation primarily for sale to its customers.
porate stockholders, earnings and profits are at that time increased by the amount of the excess of the fair market value of the assets over the adjusted basis of the assets to the corporation, subject however to an adjustment for certain liabilities; and earnings or profits are of course then correspondingly reduced because of the distribution. Thus, at the single instant the distribution occurs, appreciation is in and out of earnings and profits in a wink of the eye.

In such case, if we avail ourselves of blinders and look only to what a pure concept of earnings or profits should be, it may be, as the critics of this provision say, that it poses the question whether unrealized appreciation is truly an element of corporate earnings or profits. On the other hand, even if appreciation is not a proper part of earnings or profits, the proper rationale of the provision clearly seems to be that it in substance and effect partially abandons the earnings or profits test, and to that extent it reverts to the ordinary concept of dividend income.996

This, I may add, is no new development. In the treatment of liquidating distributions by collapsible corporations as first prescribed by the Act of 1950, the same result may be achieved, the only difference being in the form of device used to secure the result. In such case, the statute frankly prohibits the gain, attributable inter alia to appreciation, from being considered to be capital gain taxable at the special capital gain tax rates.997

This is the rational foundation for other in-and-out adjustments required by the 1954 Code, which however also may be explained on other interesting grounds. One such adjustment998 relates to rights to payment for goods

996 In the Summary, note 92 supra, on referring to this adjustment of earnings and profits, it is stated at page 36: “The adjustment serves to insure that appreciated inventory assets have dividend consequences when distributed to stockholders.”


delivered or to be delivered and for services rendered or to be rendered, where the rights are distributed in kind to the stockholders, the amount of such rights not having been included in corporate taxable income by reason of the method of tax accounting employed by the corporation. Similar in-and-out adjustments to the earnings and profits account are required where a LIFO inventory is distributed in kind.\textsuperscript{99} In such case, the adjustment is in the amount by which the inventory when valued other than on a LIFO basis exceeds the value on that basis.

Clearly, these adjustments may be supported on the theory that the statute in reality abandons the earnings and profits test of dividend income with respect to the distributions reflected in the adjustments. But an additional theory may be that the adjustments are but delayed corrections of the earnings and profits account to include earnings which, except for the method of tax accounting employed by the corporation and even if not income in the constitutional sense, would have been included in the account at an earlier date. As a matter of fact, in the adjustments respecting LIFO inventories, the theory goes further, in that the amount of the adjustment is included in the corporation's taxable income by reason of the distribution.\textsuperscript{100}

The strength of this theory is illustrated by the fact that gain also is taxed, and in-and-out adjustments to earnings and profits are provided for, where a corporation distributes property subject to a liability in excess of the adjusted basis of the property in the hands of the distributing corporation or where the distributee of the property

\textsuperscript{99} \textsc{Int. Rev. Code of 1954}, § 311(b).
\textsuperscript{100} The principle is much the same as that where a corporation reporting for tax purposes on a completed contract basis was liquidated before the contract was completed and the corporation was held to be taxable upon the income earned prior to the liquidation, Standard Paving Co. v. Commissioner, 190 F.2d 330 (10th Cir. 1951); Jud Plumbing & Heating, Inc. v. Commissioner, 153 F.2d 681 (5th Cir. 1946).
assumes a liability in excess of such basis. But, if the theory were not sound, the fact remains that the stockholder's tax liability does not depend upon an earnings or profits test where as in these cases, and also in the distribution of proceeds of a loan insured by the Government, the distribution is not out of capital paid in for the stock and the stockholder receives an increment or gain from his stock interest in the corporation.

For the same reason — if I may refer to a problem of much wider significance — except for the statutory tax rule making dividend income dependent upon earnings and profits, there may have been no occasion for the alarm and litigation which led to the adoption of the fiction that, where a corporate reorganization results in no recognizable gain or loss, the earnings and profits of the original corporation become the earnings or profits of the continuing corporation. In such case, it also may be said that the capital paid in for stock does not increase by reason of the reorganization, and the continuing corporation is in a position to make distributions which are not out of capital receipts, which distributions, when received by the stockholder, constitute dividend income in the ordinary sense.

By reason of the long sustained effort to bend the scheme of tracing the source of distributions to fit all situations, the issuance of stock dividends became a further source of difficulty where it was said that cancellation or redemption of stock might be used to defeat the purposes of the tax. Indeed, this difficulty was anticipated when the Act of 1921 was changed to make it clear that no stock

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103 Baker v. Commissioner, 80 F.2d 813 (2d Cir. 1936), followed in Cable v. Commissioner, 102 F.2d 977 (2d Cir. 1939), and Corrigan v. Commissioner, 103 F.2d 1010 (3d Cir. 1939) (memorandum decision); Murchison's Estate v. Commissioner, 76 F.2d 641 (6th Cir. 1935); United States v. Kauffman, 62 F.2d 1045 (9th Cir. 1933); Commissioner v. Sansome, 60 F.2d 931 (2d Cir. 1932).
dividends were to be taxed. It was then provided that, if after the distribution of a stock dividend the corporation proceeds to cancel or redeem its stock at such time and in such manner as to make the distribution and cancellation or redemption "essentially equivalent to the distribution of a taxable dividend," the amount received in redemption or cancellation was to be treated as a taxable dividend to the extent of the post-March 1, 1913 earnings or profits.104

This problem however was not settled by provisions such as those in the 1921 Act. The statute has been amended from time to time in an effort to prevent alleged abuses. There has been considerable litigation to determine what is "essentially equivalent to the distribution of a taxable dividend."105 And the problem, though elaborately treated in the Code of 1954,106 still is with us.

In these cases, it seems to me that the earnings or profits test adds a complication, especially where the redemption of stock is a disproportionate one107 in that the dividend stock in the hands of other holders is not redeemed. In

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104 See the Revenue Act of 1921, § 201(d), 42 STAT. 228. Similarly, in the Revenue Act of 1924, § 201(f), 43 STAT. 255. The Revenue Act of 1926, § 201(g), 44 STAT. 11, however, extended the rule to cover any stock cancelled or redeemed, "whether or not such stock was issued as a stock dividend." This provision was continued in the later acts until the enactment of the INT. REV. CODE OF 1954, § 302, which applies the rule but did not adopt the language previously employed.

105 For an elaboration of the difficulty on this point, see Treusch, Corporate Distributions and Adjustments: Recent Case Reminders Of Some Old Problems under the New Code, 32 TAXES 1023, 1035 (1954) (a paper delivered at the Seventh Annual Federal Tax Conference of the University of Chicago).

106 The INT. REV. CODE OF 1954, § 302, which is in many respects substantially the same as the prior statute but adds three other tests which had no statutory equivalent in the prior statute, namely: (1) whether the distribution in redemption is substantially disproportionate with respect to the stockholder; (2) whether it is in complete redemption of all of the corporate stock owned by him; or (3) whether the redemption is of stock issued by a railroad corporation pursuant to a plan of reorganization under section 77 of the Bankruptcy Act. See also INT. REV. CODE OF 1954, § 306, pursuant to which the profit on a redemption of dividend stock other than common on common may be taxed as ordinary income.

107 See the INT. REV. CODE OF 1954, § 302, which makes a distinction based on whether or not the distribution is a disproportionate one.
corporation law, and in income taxation, it is recognized that dividends may be distributed disproportionately if the stockholders agree, and, unless there is a dissenting stockholder who has taken action compelling a pro rata distribution, it would seem that the disproportionate distribution may for tax purposes be recognized as a valid distribution, and that the same rule may be applied to redemptions. Admittedly, however, the fact that a redemption is disproportionately made may increase the difficulty of showing that the redemption was equivalent to the distribution of a dividend, if a determination to this effect is in any way believed to turn on whether the redemption was part of a device to avoid tax.

Be that as it may, the compelling motive for juggling corporate distributions, redemptions and liquidations for tax avoidance purposes springs from the general pattern, first adopted in the 1918 Act, of treating distributions received by stockholders in cancellation, redemption or liquidation of stock as belonging in the same class with payments received upon a sale or exchange of stock. The effect of this is to pose the perplexing question whether all gain from liquidating distributions or from redemptions of stock should be treated as dividend income, as was possible under the 1913 Act and, to the extent of post-March 1, 1913 earnings and profits, also was possible under the 1921 Act; or whether the distribution in redemption of the dividend stock is to be applied against

108 See especially 58th Street Plaza Theatre, Inc., 16 T.C. 469 (1951), and the cases cited therein. As to corporation law, see Breslin v. Fres-Breslin Co., 70 N.J.L. 274, 58 Atl. 313 (1904); Pittsburgh & Steubenville R. R. v. Allegheny County, 79 Pa. 210 (1875). But there may be a factual question whether withdrawals by one stockholder or by the majority stockholders constitute dividends or loans. Cf. Rolien C. Reynolds, 44 B.T.A. 343 (1941). But whether the withdrawals are disproportionate is not determinative of whether they are loans or dividends. Ben R. Meyer, 45 B.T.A. 228 (1941).

109 Revenue Act of 1918, § 201 (c), 40 Stat. 1059.

110 A stockholder who receives any such distribution certainly is not a seller of stock. He does not have the duties and rights which depend upon a seller’s engagements.

the holder’s basis in the stock and if it exceeds such basis the excess may be taxed at capital gain rates; or whether the possibility of capital gain should be limited to the excess of capital receipts returned by the corporation to stockholders over the stockholders’ basis of their stock.

Lastly, if simplicity is an important objective, it is significant that by reason of the earnings and profits test, a stockholder can not compute his tax liability by reference solely to the amounts which he receives as distributions on his stock. In addition, he must know what the earnings and profits of the corporation are as determined for tax purposes. Thus, though there is no statutory mandate that a corporation shall furnish its stockholders all of the information essential to a correct tax report of distributions received, the corporation may have an obligation of some kind to furnish this information to its stockholders. This involves considerable labor, time and expense to the corporation, and there is the additional burden on the Internal Revenue Service in auditing the corporation’s earnings and profits. Where there is a change in views as to the proper meaning of the term “earnings or profits,” this change carries back to every similar item in the history of the corporation. Obviously, the work of keeping such statement up to date is not entirely a simple matter.

Now, in all I have said, I trust it is implicit that unsatisfactory complexities respecting the taxation of corporate distributions are not inherent in income taxation. They are not all bottomed upon universal concepts of reason and justice. They are man-contrived and man-operated. And they are not of recent origin.

I must say however that it may be hard for a tax technician to discard the tangled webs of complexity which we

112 Where the dividend stock does not constitute income which may be taxed, the holding period essential to such treatment for the dividend stock relates back to the date of acquisition of the stock on which the dividend stock was received.
have woven during the past forty years. And it may be equally difficult for him to understand that the law of income taxation has the power to develop a simpler system without the benefit of detailed legislation. For some time, we have had a growing psychosis that rules of reason in taxing income may be developed and brought into operation only by legislation; and we tend to lose sight of the source and power of a law of income taxation. We begin with a complicated pattern, which can not be brought into operation except by legislation, and, in instances where its results shock our tax conscience, we resort to a simpler philosophy as a corrective means, at a time when it may be put into effect only by complex devices which tend to obscure any intended simplicity.

Perhaps it would be better if the basic scheme of taxing corporate distributions were a simple one with variations wherever deemed necessary, instead of formally subjecting all distributions to a complex tax rule and then attempting to superimpose simplicity upon such structure in an effort to remove undue hardship or to prevent tax avoidance. Be that as it may, simplicity may be possible, even if according to the skeptic it is not probable.

The purpose of this discussion however is not to furnish a blueprint of the actions which may be taken. My main desire is that an effort of some kind may be made to destroy the illusion that complexity is inescapable — indeed, if we may believe our ears, that further complexity is inevitable. And I would like to pin-point our own thinking as the source of our difficulties, whether they are real or imaginary, to the end that, if we must have a high degree of complexity, we may at least agree upon the reason for its existence.

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