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ATTEMPTS TO AVOID TAXES ON CORPORATE DISTRIBUTIONS

By W. Lewis Roberts*

The Internal Revenue Code provides that distributions made by corporations out of "earnings or profits" to shareholders shall be taxable as income to shareholders. It is not surprising to find that various attempts have been made to pass corporate accumulations and earnings to stockholders in such ways as to avoid making such dispensations taxable as dividends.

INTEREST vs. DIVIDENDS

The Code defines a dividend and it is but natural that the question should arise as to whether the particular payment made by the corporation comes within this definition. In two fairly recent cases this question was taken to the United States Supreme Court. In one it was found that the payment was interest and in the other that it was a dividend within Section 115(a). In the first case a reorganization was effected in which the proportionate holdings of the shareholders were not changed. All the common and preferred stock was held by a family group, to whom debentures were issued. These debentures were assignable and gave no right to participate in the management of the corporation. The greater part was given in exchange for preferred stock and the balance sold to stockholders at par which was paid for with sums obtained by the purchasers out of dividends from the common stock. In the second case a family-held corporation was recapitalized just prior to the fiscal year in which the tax question arose. The shareholders surrendered four-fifths of their stock and received in place thereof registered notes to the value of $400,000. These notes bore interest at a rate not to exceed 10%

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1 Sections 115(a), 115(b)

2 Section 115(a).


per cent nor less than 2 per cent. The interest was cumulative and payment might be deferred until maturity when the condition of the corporation required it. Stock dividends were not payable until interest on the notes was paid. Both corporations deducted interest payments from their gross incomes in the tax years in question and the commissioner assessed deficiencies on the ground that the payments were dividends and not interest. The Tax Court found in the first case that the payments on the debentures, if earned, had priority over the common stock, that the debentures were assignable regardless of transfer of stock and that a definite maturity date was fixed, consequently, these payments were interest and deductible. In the second case the Tax Court found the annual payments were fluctuating with a minimum of two per cent, and the issue of notes was limited to stockholders in exchange for stock. It concluded that the annual payments were really dividends and not interest. The Supreme Court refused to upset the findings of the Tax Court. In affirming the Tax Court it said

"The documents under consideration embody elements of stock. There is no characteristic, not even exclusion from management, which can be said to be decisive in the determination of whether the obligations are risk investments in the corporations or debts. So-called stock certificates may be authorized by corporations which are really debts, and promises to pay may be executed which have incidents of stock. Such situations seem to us to fall within the Dobson rule."

Mr. Justice Rutledge was of the opinion that the holding of the Circuit Court that in both cases the payments were dividends was correct. This was based on the ground that

"The taxing statute draws the line broadly between 'interest' and 'dividend. This requires one who would claim the interest deduction to bring himself clearly within the class for which it was intended."

Section 23, I. R. C. provides:

"(b) Interest paid or accrued within the taxable year on indebtedness" may be deducted from gross income.

Section 115 reads: "Distributions by Corporations.

(a) Definition of Dividends. The term 'dividend' when used in this chapter (except in Section 203(a)(3) and Section 207(c)(1), relating to insurance companies) means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year."

* 326 U.S. 521, at p. 530. Dobson v. Commissioner, 320 U.S. 489, 495 established the rule that a finding of the Tax Court can be reversed only if the reviewing court can find a mistake of law.

Id. at 534.
In *Broadway Corporation v. Commissioner* the Circuit Court sustained the Tax Court's ruling that the alleged debentures were in effect preferred stock and disallowed the deduction claimed as interest.

In *John Wanamaker Philadelphia v Commissioner,* the taxpayer was indebted to a director and principal owner of its stock. It issued preferred stock in payment thereof. This stock was to bear "interest" after six months from the death of John Wanamaker, to whom it was issued, and a certain part of it was to be redeemed each year. No right to participate in the assets of the company on liquidation was given the holder. It was held that the payments were dividends and not deductible as interest.

The question whether payments to holders of building and loan association certificates are payments of interest or dividends has been passed upon several times and the answer has been that they are dividends where payable out of earnings or profits.

In *Anketell Lumber and Coal Co. v United States* a husband and wife owned 95 per cent of a corporation. They withdrew large amounts which were in proportion to their holdings in the company and charged the same on the books as loans. No notes or securities were given. No interest was ever paid or charged on the corporation books. Small amounts were credited on the accounts from time to time. The sole question presented was whether these were bona fide loans or liquidating dividends and returns of capital invested. The Commissioner held the amounts paid were dividends and that the invested capital had been reduced by the payments. The court found that it was never intended that the amounts should be repaid and the Commissioner's position was sustained. The court cited several cases of similar loans made in family-owned corporations.

In *Hercules Gasoline Co., Inc. v Commissioner,* a creditor

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8 160 F (2d) 885 (Second Circuit, 1947)
9 139 F (2d) 644 (1943).
10 Fidelity Savings & Loan Ass'n v. Burnet, 65 F (2d) 477, (1933), cert. demed 290 U.S. 676; Commissioner v. Aaron Ward & Sons, 65 F (2d) 756 (1933).
11 1 F Supp. 724 (1932).
13 147 F (2d) 972 (1945).
of the company accepted stock in payment of his claim and the company sought to deduct from its gross income the dividends paid on the same, unsuccessfully contending that they were in fact interest, Mr. Justice Holmes said

"Interest is a fixed percentage premium paid on a time basis for the use or detention of money. It becomes a debt merely upon the passing of time, either by the terms of the primary obligation or by operation of law. A dividend, on the contrary, does not become a debt until profits have been earned and a declaration of dividends is made. It is a distribution of profits to adventurers in a common enterprise."

It is not even necessary that a formal declaration of a dividend be made nor that the distribution be made in proportion to the share holdings, if the stockholders consent as was pointed out in Van Vort v Commissioner. The shareholder there had purchased property from the company at a very advantageous price and the Tax Board said the Government must wait until he disposed of the property at an increased price before it could collect its tax. A minority was of the view that the stockholders had received a taxable income from the sale.

In George E. Towle v Commissioner, the two owners of the corporation agreed that monthly credits in excess of losses should be credited to their personal accounts on the books of the corporation and subject to withdrawal by them. The amounts so credited were held to constitute income of the shareholders when credited to their accounts.

SALES OR GIFTS TO SHAREHOLDERS

Attempts to avoid payment of taxes on corporate distributions have been made through so-called gifts or sales to shareholders. In one of the first cases to come before the United States Board of Tax Appeals, a corporation engaged in the real estate business, financed its various deals with funds furnished by the shareholders or by other corporations, in consideration of half the profits received. The wife of the president was a shareholder. She supplied cash for handling most of these transactions and was paid half the profits made by the corporation during the year. No dividends were distributed by the corporation. The

22 BTA 632 (1931), affirmed in 59 F. (2d) 677.
19 BTA 208 (1930).
Commissioner's determination that the amount paid her could not be deducted from the gross income of the corporation was approved by the Board. This was a distribution of profits and taxable to the shareholder as a dividend.\textsuperscript{16}

Nor will it aid the taxpayer for the directors of a corporation to make a distribution of stock to a shareholder who is president, beyond his proportionate share by calling it a gift in return for the exceptional services rendered the company. The court has said

"It is true that the directors considered it in part as a gift and not as a dividend, but this is not determinative of the nature of the distribution, nor is the fact that the distribution was to some of the shareholders only and not to others, nor that it was divided among the stockholders in proportions other than their respective holdings of stock in the corporation. It was made from the earnings or profits of the distributing corporations, and was divided among the stockholders of the distributing company in such proportions as was satisfactory to its directors and stockholders.\textsuperscript{17}"

A cancellation of promissory notes given by stockholders of a corporation for advances made by a trust estate, which obligations the corporation took over, was held to amount to a taxable dividend where the amount of the notes so cancelled was charged against surplus.\textsuperscript{18} Also where a wholly owned subsidiary corporation purchased stock of the parent corporation and gave it to the parent corporation, the gift was held a taxable dividend.\textsuperscript{19}

In \textit{Commissioner v Greenspun},\textsuperscript{20} the sole owner of a corporation, engaged in manufacturing carbonic acid gas, rented steel cylinders to the corporation at a minimum of one cent a pound and a maximum of three cents a pound at the will of the corporation, if its profits warranted the higher rate. The court found the excess charges over one cent a pound were informal dividends, taxable to the sole stockholder. In an earlier case that came before the Board of Tax Appeals, the question was presented whether certain disbursements made by the corporate taxpayer were payments for royalties or whether they were distributions of dividends. The Board agreed with the Commis-

\textsuperscript{16} Reliance Leasing Company, 1 BTA 728 (1925).
\textsuperscript{17} Lincoln National Bank v. Burnet, 63 F. (2d) 131 (1933).
\textsuperscript{18} Waggaman v. Helvering, 73 F. (2d) 721 (1935).
\textsuperscript{19} Golden State Theatre & Realty Corporation v. Commissioner, 125 F. (2d) 641 (1942).
\textsuperscript{20} 156 F. (2d) 917 (1946).
sioner that the taxpayer had failed to show that the payments were for royalties.\textsuperscript{21} Still another method which has been tried to siphon off corporate earnings to stockholders without incurring tax liability has been to pay excessive salaries or wages to officers and employees who own stock. These attempts, however, usually fail as was the case in \textit{Kennington v Donald}.\textsuperscript{22}

In a leading case, \textit{Palmer v Commissioner},\textsuperscript{23} Mr. Justice Stone pointed out that while a sale of corporate property to a shareholder at less than its fair market value might have the effect of a distribution of earnings, the bare fact that the transaction resulted in some of the corporate assets passing to the shareholder does not raise the inference that the distribution is a dividend within the meaning of Section 115. When the shareholder sells the property at an increased price he will be taxed on the increase as a capital gain.

\textbf{Payment of Shareholder's Debts, Etc.}

Many cases have arisen where the corporation has paid the debt of a shareholder or assumed an obligation owed by him. In \textit{Allen v Commissioner}\textsuperscript{24} the corporate stock was owned by two persons who were the only directors and who devoted all their time to the business of the corporation. They drew out funds as they needed them for personal use and at the end of each year fixed their salaries according to the earnings of the corporation. The withdrawals for their personal use might be in excess of the amounts voted as salaries at the end of a year. It was not anticipated that these excesses would be paid by the two officers. They claimed these were withdrawals of funds invested. These debts on the books of the company were charged off when the corporation had a large surplus. The decision of the Board that this was a distribution of dividends taxable to the shareholders was affirmed on appeal.\textsuperscript{25}

Where a note was given by the principal stockholder to cover withdrawals made by him and he later gave shares of stock

\textsuperscript{21} W N Thornbough Manufacturing Co. v Commissioner, 17 BTA 29 (1929).
\textsuperscript{22} 50 F (2d) 894 (1931).
\textsuperscript{24} 117 F (2d) 364 (1941).
\textsuperscript{25} To the same effect is Regensburg v. Commissioner, 144 F (2d) 41, (1944), cert. denied, 323 U.S. 783 (1944).
to the corporation in consideration of its cancelling the note, the Tax Board held that this constituted a redemption equivalent to the distribution of a taxable dividend under Section 115(g) of the Act of 1932. In a recent case the taxpayer, who owned half the corporate stock, bought the other half and gave his personal note in payment. He then turned over the stock so purchased to the corporation in consideration of its assuming the payment of the notes he had given. The stock was held as treasury stock. The court said this was a redemption within the statute and the transaction amounted to the distribution of a dividend taxable to the shareholder. It was suggested that this was equivalent to the corporation's paying the money to the stockholder and his paying the notes. In another recent case the taxpayer deposited the amount received as dividends and immediately gave a check for the amount to the corporation which carried out a plan to buy all outstanding stock not owned by the taxpayer. They held this was a taxable dividend under Section 22(a) and Regulation 111 (Sec. 29. 115-1) It was contended that the transaction was immune from tax since the taxpayer was under contract to deliver back the amount received to the corporation.

In one case the sole shareholder had the earnings of the corporation transferred to a trust he had created for the benefit of his children. The amount so transferred was taxable to him as income as under the law of the particular jurisdiction he was under the duty to support his children. In fact, numerous cases have arisen where amounts shown on the corporate books to be due from shareholders have been released by agreement of all the stockholders. The courts have not hesitated to find that there had been distributions of taxable dividends in such cases.

**Stock Dividends**

The Revenue Act of 1916 provided that the term "dividend" should include any distribution made by a corporation to

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27 Wall v. United States, 164 F (2d) 462 (1947).
28 Soreng v. Commissioner, 158 F (2d) 340 (1946).
29 Jackson v. Commissioner, 51 F. (2d) 650 (1931).
30 Clark v. Commissioner, 84 F (2d) 725 (1938).

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its shareholders out of earnings or profits accrued since March 1, 1913.

In 1920 the Supreme Court ruled that a dividend of common stock to holders of common stock which did not work a severance of corporate assets and did not change the pre-existing proportionate interest of shareholders was not income and therefore not subject to the tax. The Revenue Act of 1921 and later acts expressly stated that "a stock dividend shall not be subject to tax." That decision raised the question as to just what is a stock dividend. It was pointed out by the Board of Tax Appeals, "Not every dividend in stock is a stock dividend, Peabody v Eisner, 247 U. S. 347, United States v Phellis, 257 U. S. 156; nor is every stock dividend a dividend in stock, Harry A. Brown, 26 B.T.A. 901, cf. W. I. Wright, 10 B.T.A. 806." That being so, it is not surprising that the question whether a distribution of stock is taxable as a dividend has been in litigation ever since.

As a Circuit Court judge has pointed out, it is a question of fact depending upon the circumstances of the particular case. In the Board of Tax Appeals case just referred to, a dividend upon cumulative non-voting preferred shares payable in common voting stock was held, as to the preferred shareholders, a taxable dividend. In considering the statute passed after the Supreme Court decision in Eisner v Macomber, the Board said it was clear that the statutory exemption was only as broad as the decision and it was not the intention to exempt dividends by any general or loose concept but only when they were not income.

In 1937, the Supreme Court held that where common stock was issued to holders of preferred, the stockholders received a different interest from what they had before and the dividend was taxable as income. A year later, it ruled that a dividend

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26 Section 115 (f) (1) reads as follows: "General Rule.—A distribution made by a corporation to its shareholders in its stock or in rights to acquire its stock shall not be treated as a dividend to the extent that it does not constitute income to the shareholder within the meaning of the Sixteenth Amendment of the Constitution."
27 Tillotson Manufacturing Co., 27 BTA 913, 917 (1933).
29 Supra, note 34.
30 Supra, note 32.
31 Koshland v Helvering, 298 U.S. 441, (1936).
in preferred stock to holders of common stock was taxable income since the holders acquired an interest in the corporation different from that represented by their common stock. 30

In Helvering v Sprouse, 40 a dividend of non-voting common was issued to holders of both the voting and the non-voting common in proportion to their respective holdings so that their interests in the corporation were not changed. It was held that the dividend was not subject to income tax. The same result was reached in the companion case of Strassburger v Commissioner, 41 where the sole owner of the common stock received a dividend of non-voting preferred stock, since his interest in the corporation was not thereby changed.

Debenture bonds issued on surplus to stockholders were regarded as the equivalent of preferred stock and as such subject to a tax as a dividend. 42 An issue of non-voting common stock given to holders of voting common was held subject to a tax by the Board of Tax Appeals, since the dividend stock was not of "precisely the same character as" the voting common previously held. 43

It sometimes happens that a corporation has an agreement with its stockholders that they will take stock instead of cash. Such distributions are held stock dividends rather than cash; 44 or it may be that the stockholders have an option to take cash or stock. In such case they are regarded as cash dividends even though a majority elect to take stock. 45 However, where a stockholder gave his notes in payment for stock and they were paid out of dividends, the Board said it was not a stock dividend since it was equivalent to his receiving the cash and then paying the corporation. 46

Rights to subscribe for stock are treated as dividends in practically the same way stock dividends are treated. It has

31 318 U.S. 604 (1943), affirrnmg 125 F. 2d 973 (1941).
33 Deterschuck v. United States, 274 F. 2d 739 (1921)
34 Keister v. Commissioner, 42 BTA 484 (1940).
37 Hull v. Commissioner, 13 BTA 299 (1928).
been suggested that the line between taxable and non-taxable stock rights is to be determined by considering whether the stock or property offered to the holders of the rights would be taxable as a dividend if distributed instead of the rights. The Circuit Court has held that rights to purchase preferred stock issued to holders of common stock, are taxable. The issue of "rights" to purchase in another corporation, however, is not a taxable dividend even though the "rights" have a market value. The corporation there is seeking to sell its holdings in the other corporation. It was regarded by the Court as a "sale" and not a "dividend." However, the Supreme Court has held that where a corporation gave rights to its employees to buy shares it held in another corporation, there was taxable income to the employees to the extent of the difference between the cost of the shares and their value at the time the rights were exercised.

REDEMPTION OF STOCK

Prior to the enactment of Section 201(g) of the Revenue Act of 1926, which in the Act of 1928 and later acts became Section 115(g), it was possible for a corporation to redeem out of earnings stocks that had been issued tax free and in that way make a distribution of earnings free from tax. Congress sought to prevent this under the new section. This section makes taxable any distribution out of earnings or profits through any "cancellation or redemption in whole or in part essentially equivalent to the distribution of a taxable dividend."

Whether a redemption of stock comes within this section is not to be settled by the test of whether the issue and redemption are part of a plan to distribute surplus, which would ordinarily be paid to stockholders as dividends. Neither "moral obliquity"

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47 Lowndes, The Taxation of Stock Dividends and Stock Rights, 96 Univ. of Pa. L. Rev. 147, 158 (1947).
48 Choate v. Commissioner, 129 F. (2d) 684 (1942)
49 Commissioner v Smith, 324 U.S. 177 (1945).
50 "(g) Redemption of Stock.—If a corporation cancels or redeems its stock (whether or not such stock was issued as a stock dividend) at such time and in such manner as to make the distribution and cancellation or redemption in whole or in part essentially equivalent to the distribution of a taxable dividend the amount so distributed in redemption or cancellation of the stock, to the extent that it represents a distribution of earnings or profits accumulated after February 28, 1913, shall be treated as a taxable dividend."
51 Hill v Commissioner, 66 F. (2d) 45 (1933)
nor an intent to evade taxes is necessary to call into operation Section 115(g) 53. The ultimate test under the section as pointed out in Commissioner v. Brown,54 is whether the circumstances of time and manner make the redemption in fact the essential equivalent of a dividend. In Stein v. United States,55 no dividends were paid until 1936, but beginning with 1932, the company redeemed twice a year one-tenth of the outstanding preferred stock so that by the end of 1936, most of the preferred holders had been paid for four-fifths of their stock. The Court of Claims held the redemption was essentially equivalent to a distribution of a taxable dividend.

Where a corporation declared a stock dividend in 1940 and in December, 1941, bought back the shares so issued and stipulated in its minutes that it should be held as treasury stock subject to resale, the court held this was a redemption although there was no cancellation, and consequently the transaction resulted in a taxable dividend under Section 115(g) 56. Judge Hand, in writing the opinion of the court, pointed out that the confusion that had existed on the point among the Circuit Courts was settled by the Supreme Court in the case of Commissioner v Estate of Bedford.57 In Commissioner v Babson58 stock was issued to take care of an expansion of business which proved unprofitable. The capital was then reduced by the redemption of the stock so issued. The court held this was a capital transaction which did not come within Section 115(g). Also where the stock was not redeemed until nine years after its issue, the rule did not apply 59.

Corporate Reorganization

Prior to the Revenue Act of 1924 provision for tax-free reorganization of corporations was not fully provided for and during the three or four years preceding the enactment of that act

53 Hyman v. Commissioner, 28 BTA 1231, aff'd 71 F (2d) 342 (1934).
56 Kirschenbaum v Commissioner, 155 F (2d) 23 (1946).
57 325 U.S. 283 (1945).
58 70 F (2d) 304 (1934). Accord: Staub v. Commissioner, 29 BTA 216 (1933), aff'd 76 F (2d) 368 (1935).
59 Allen v. Commissioner, 41 BTA 206 (1940).
there were several decisions in which the shareholders were taxed on what they received because their interests in the new companies were different from what they had had in the old companies. In one, the new company was incorporated in a different state than the old company. In a second it was held that the stockholder's interest was changed because the old company's business was split into separate businesses. In a third the new company was a holding company instead of an operating company. Section 112(b) (3) of the 1924 Act was designed to give relief in such cases and to encourage reorganization where business needs demanded it. That section reads

"No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization."

Ten years later the Supreme Court was confronted with an attempt to apply the reorganization provisions literally in order to pass accumulations from earnings to stockholders tax-free. In *Gregory v Helvering* the taxpayer owned all the stock of the A Corporation which held one thousand shares of the B Corporation. It was desired to give these shares to the taxpayer so that she could sell them and her attorneys sought to do this in such a way that she would not have to pay a tax on the distribution. They organized the C Corporation and transferred the thousand shares in the B Corporation to the new organization, for which all the shares in the new company were issued to the taxpayer. A few days later the new corporation was dissolved, and liquidated by distributing all the assets, to wit, the one thousand shares of the B Corporation, to the taxpayer. The court found that "no other business was ever transacted, or intended to be transacted, by that company." All the steps taken were literally within the terms of Section 112 (9) of the 1928 Act. Mr. Justice Sutherland, in speaking for the court, characterized the transaction as "a mere device which put on the form of a corporate reorganization as a disguise for concealing its real character." The taxpayer was held liable for a tax on the amount so distributed to her as this was not in fact a reorganization of a business.

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60 United States v. Phellis, 257 U.S. 156 (1921).
63 293 U.S. 465 (1934)
The next, outstanding, decision on the subject is that of Commissoiners v. Estate of Bedford. It concerned a question of recapitalization and came under Section 112(g) (B), which provides that the term "reorganization" means "a recapitalization." In that case the corporation had incurred a book deficit by charging stock dividends against its surplus, and under the state law it could not pay dividends although it had large earnings. It sought to work out a distribution through a recapitalization plan. The taxpayer exchanged stock for cash and new stock of less value than the old and thus realized a gain as a result of the increased market value. The taxpayer contended the transaction amounted to a partial liquidation under Section 115(i) and therefore the cash received was taxable as a capital gain only. The Commissioner maintained it was taxable as income since it had the "effect of the distribution of a taxable dividend" under Section 112(c) (2). The Court reversed the Circuit Court and supported the position of the Tax Court, which held with the Commissioner that the cash received was taxable as a dividend. Mr. Justice Frankfurter said, "Treating the matter as a problem of statutory construction for our independent judgment, we hold that a distribution, pursuant to a reorganization, of earnings and profits 'has the effect of a distribution of a taxable dividend' within Section 112(c) (2)."

325 U.S. 283 (1945)

Section 115 (i) reads: "As used in this section the term 'amounts distributed in partial liquidation' means a distribution by a corporation in complete cancellation or redemption of a part by its stock, or one of a series of distributions in complete cancellation or redemption of all or a portion of its stock."

"(2) If a distribution made in pursuance of a plan of reorganization is within the provisions of paragraph (1) of this section but has the effect of a distribution of a taxable dividend, then there shall be taxed as a dividend to each distributee such an amount of the gain recognized under paragraph (1) as is not in excess of his ratable share of the undistributed earnings and profits of the corporation accumulated after February 28, 1913. The remainder, if any, of the gain recognized under paragraph (1) shall be taxed as a gain from the exchange of property."

The section (1) referred to above reads: "(1) If an exchange would be within the provisions of subsection (b) (1), (2), (3) or (5), or within the provisions of subsection (l) of this section if it were not for the fact that the property received in exchange consists not only of property permitted by such paragraph or by subsection (l) to be received without the recognition of gain, but also of other property or money, then the gain, if any to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property."
is not the form but the effect, then, that the Court is going to consider in determining whether a distribution made to a shareholder on a reorganization or recapitalization of a company, shall be taxed as income or as capital gain.

Finally, the Supreme Court has said in the *Bazley*\(^{67}\) and *Adams*\(^{68}\) cases, decided in 1947, that the reorganization must have a business purpose to come within the tax-free provisions of Section 112. In the *Bazley* case there were outstanding one thousand shares of stock of $100 par value, owned by husband and wife. There was an earned surplus of over $855,000. They surrendered their one thousand shares and received in exchange five thousand shares of a new common stock of no par value and new debenture bonds, having a face value of $400,000, callable at any time. The *Adams* case was similar in its facts. The taxpayer owning all but a few shares of the stock, exchanged his shares for new no par shares and 6 per cent 20-year debenture bonds of the amount of $295,700. This was an exchange of one old share for one new share and a $50 bond. The accumulated earnings at the time, which were available for distribution, amounted to nearly $165,000. When the exchange was made the debentures had a value of that amount. The Court said that “a ‘reorganization’ which is merely a vehicle, however elaborate or elegant, for conveying earnings from accumulations to the stockholders is not a reorganization under Section 112.” The judgments of the lower courts confirming the assessments on the distributions were affirmed. As the “reorganization” did not benefit the corporation, it did not serve a business purpose.

Two Circuit Courts have recently had occasion to apply this “business purpose” doctrine. In the first case, the only purpose was to supply the individual stockholders with funds to pay their individual debts.\(^9\) Judge Thomas, in referring to the Supreme Court decision in the *Bazley* case, quoted with approval the following passage from the opinion:

“In the case of a corporation which has undistributed earnings, the creation of new corporate obligations which are transferred to stockholders, so as to produce, for all practical purposes, the same result as a dis-

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\(^{67}\) *Bazley v Commissioner*, 331 U.S. 737 (1947).

\(^{68}\) *Adams v. Commissioner*, 331 U.S. 737 (1947).

\(^{69}\) *Survaunt v Commissioner*, National Typesetting Corporation v. same, 162 F. (2d) 753 (1947).
distribution of cash earnings of equivalent value, cannot obtain tax immunity, because cast in the form of a recapitalization-reorganization."

In the second case, it was held that "recapitalization" included the exchange of debentures solely for bonds of the same corporation in a bona fide court reorganization of the corporation and was taxable. Having in mind the Bazley case the Court said

"At the outset, it is not inapposite to note that the case at bar is not one in which the corporation involved is the alter ego of the taxpayer, or where the plan of reorganization was a vehicle for conveying earnings from accumulations to the stockholders."

The problem is summarized by a Circuit Court judge in the following manner:

"In the usual case the taxpayer in seeking the tax advantages of the tax free exchange provisions of Section 112 (b) urges that a transaction within the literal terms of the statute is a 'reorganization' while the Commissioner asserts that a deficiency exists because the 'reorganization' lacks 'business purpose. In such cases a definite finding of lack of 'business purpose' may usually be found."

In two recent Circuit Court decisions, it has been held that the Code provisions whereby no taxable gain or loss is recognized as to securities received in a reorganization plan are confined to private corporations. In the particular cases municipal bonds were exchanged by the taxpayer for a new issue put out in a municipal refinancing plan. The taxpayer was held for the difference between the price paid for the old bonds and the fair market value of the new bonds. 72

THE SANSOME RULE

Attempts have been made to frustrate the congressional purpose to tax all corporate distributions from earnings and profits by a reorganization which leaves earnings undistributed. These attempts have been defeated by the so-called Sansome rule. In the case that gave rise to the rule, a corporation, having an accumulation of earnings, transferred all its assets to a newly

71 Judge Mahoney in Lewis v. Commissioner, 160 F. (2d) 339, 844 (1947). (The taxpayer was here claiming lack of business purpose.)
72 Girard Trust Co. v. United States, 166 F. (2d) 773 (1949)
Emery v Commissioner, 166 F. (2d) 27 (1948).
organized company, which issued its shares directly to the stockholders of the first corporation, which was then dissolved. The new corporation operated without profit for more than a year and then discontinued business. It made a partial distribution but the total distributions were less than the surplus and undivided profits received from the old company. The Commissioner treated the payments as dividends and the courts agreed that they were. Judge Hand said the reorganization did not toll the company's life and that what were "earnings or profits" of the original or subsidiary company remained such for the purposes of distribution by its successor. Whether the Sansome rule should apply where new interests for cash were involved in the reorganization was considered in Commissioner v. Munter and the Supreme Court remanded the case to the Tax Court to determine whether the new corporation acquired earnings from the old company in 1928 and retained the same so that they were available to pay the 1940 dividend. On the other hand, the question whether deficits of the old corporation should likewise be carried over in the reorganization was recently passed upon in Commissioner v. Phillips. There a parent corporation owned five subsidiaries. One of them had accumulated earnings of over $90,000, and the four had accumulated deficits of over $3,000,000. The five were liquidated in a tax-free proceeding by surrendering their assets to the parent which had assumed their liabilities. The parent had no deficit but did have over $2,000,000 accumulated earnings. The taxpayer received thereafter a distribution of over $18,000 of which only $8,990 was paid out of current earnings. It was held only that amount constituted taxable dividends. The deficits of the subsidiaries were allowed to be reflected in the accounts of the parent company.

SALES OF CORPORATE PROPERTY BY SHAREHOLDERS

Attempts to avoid or to reduce taxes have also been made in the sale of corporate property by the shareholders. In a leading case, the corporate officers made an oral contract to sell the real property of the corporation. They repudiated the contract and then distributed the corporate property to its shareholders.

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73 Commissioner v. Sansome, 60 F. (2d) 931 (1932) Cert. demed, 287 U.S. 667 (1932)
74 67 Sup. Ct. 1175 (1947)
75 167 F. (2d) 117 (1946)
in a liquidation proceeding. The shareholders then sold to the purchaser on the same terms. The corporation was held for the capital gain tax. In *Wichita Terminal Elevator Co. v Commissioner*, the corporate property was sold on dissolution and the deeds were signed by one Powell as agent. He had been designated as liquidating agent and had received a conveyance of the property from the corporation. The gain accruing from the sale was held taxable to the corporation. The corporation needed part of the proceeds to pay debts. However, where the corporation declared and paid in kind to its stockholders and they disposed of the corporate property so assigned to them, the gain realized from the sale was ruled to be income to the stockholders. Finally, in a recent case, the controlling stockholder made a contract to convey the corporate assets before the corporation had taken any steps to make a sale. He conveyed the property after securing the written assent of the other shareholders and dissolving the corporation. The court found the sale was by the shareholders and not the corporation and that they were liable for the tax.

**Conclusion**

A survey of court rulings involving cases where taxpayers have attempted to avoid paying taxes on corporate distributions from earnings and profits shows that those rulings have, on the whole, produced right results. They have for the most part carried out the congressional intent that all who share in corporate distributions from earnings shall include the same in their income tax returns. They have, at least, made easier the administration of the code provisions on the subject. The "business purpose" requirements as set out in the *Gregory, Bazley* and *Adams* cases and the Sansome rule both aid in preventing tax avoidance. The courts have made it clear that a literal compliance with the code provisions allowing immunity from taxes is not enough. They will look to the substance of the transaction in determining whether it is tax-free.

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*Commissioner v. Court Holding Co., 324 U.S. 331 (1944) reversing 143 F (2d) 823 (1944).*  
*162 F (2d) 513 (1947).*  
*United States v. Cummins Distilleries Corporation, 166 F (2d) 17 (1948).*  
*Baum v. Dallman, 76 F Supp. 410 (1948).*
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