

## SECTION 102 AND PERSONAL HOLDING COMPANY PROVISIONS OF THE INTERNAL REVENUE CODE

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### I. INTRODUCTION

IN any income tax system which imposes higher rates of tax on individuals than on corporations, a provision to prevent, or at least to discourage, the use of the corporate entity as a means of avoiding the higher individual rates is virtually indispensable. Unhampered by such a provision, the industrialist or investor in the high surtax brackets will obviously find it advantageous to incorporate his business or form a corporation to hold his investments. By interposing the corporate entity between his income and himself and accumulating in the corporation whatever part of its income is not required for his personal needs or desires, he will be able to escape the surtax on the amount accumulated.

The need for a deterrent becomes acute at a time like the present when the maximum rate of tax on individual incomes is 79% while the maximum rate of tax on corporate incomes is only 19%;<sup>1</sup> so that incorporation and the consequent insulation of the corporate income against surtax would effect a maximum saving of 60%.<sup>2</sup> Thus an important problem

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1. Beginning with 1940, the maximum rate of corporation income tax will be 18%. INT. REV. CODE §§ 13, 14.

2. The rates of individual tax pass the corporation rate at about \$20,000, depending on individual status. It is interesting to note that in 1928, when the spread between the maximum corporate and individual income tax rates was only 11½%, the staff of the Joint Committee on Internal Revenue Taxation in its report for that year recommended the abandonment of § 220 (corresponding to § 102 of the present law) and the substitution of a provision which would allow the corporation a deduction in computing net income equal to a percentage of the excess of dividends paid over dividends received; in other words, a form of undistributed profits tax. The Committee itself neither approved nor disapproved this recommendation. *Report of the Joint Committee on Internal Revenue Taxation*, 70th Cong., 1st Sess. (1928) 2, 48-56.

is created: how may the revenue be safeguarded without at the same time interfering with legitimate corporate expansion? The Government has probably lost more than one billion dollars in tax because of the barrier between corporate earnings and individual surtax.<sup>3</sup>

Congress recognized the problem at the very beginning, and consequently every income tax law since the Sixteenth Amendment has contained some provision<sup>4</sup> designed to prevent the utilization of corporations as a means of escaping the surtax. The present Internal Revenue Code contains multiple provisions for this purpose.<sup>5</sup> The first of these<sup>6</sup> has had its counterpart in all previous income tax laws. It now relates only to corporations other than personal holding companies and imposes a penalty tax on corporations formed or availed of to prevent the imposition of the surtax on their shareholders through the medium of accumulating instead of distributing their profits. A second set of provisions<sup>7</sup> relates to "foreign"<sup>8</sup> personal holding companies. These sections do not impose any tax on the corporation itself, but instead, speaking generally, require the shareholders to include in their individual income tax returns their pro rata shares of the undistributed net income of the company. The third group of provisions<sup>9</sup> relates to personal holding companies other than "foreign" personal holding companies. This last set of provisions imposes a prohibitively high surtax on, again speaking generally, the undistributed net income of the corporation regardless of the reason for non-distribution.

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3. GREEN, *THE THEORY AND PRACTICE OF MODERN TAXATION* (1933) 140. This figure is undoubtedly very conservative. Cf. estimate contained in minority report of Senate Finance Committee on the 1936 Act, SEN. REP. No. 2156, 74th Cong., 2d Sess. (1936) pt. 2, at 2, that more than 600 million dollars of revenue would be lost for 1937 alone.

4. 1913 ACT, § II, A, 2; 1916 ACT, § 3; 1917 ACT, § 1206 (2) (amending § 10 of 1916 ACT); 1918 ACT, § 220; 1921, 1924, and 1926 ACTS, § 220; 1928 and 1932 ACTS, § 104; 1933 ACT (NATIONAL INDUSTRIAL RECOVERY ACT) § 214 (amending § 104 of 1932 ACT); 1934 ACT, § 102 and Tit. 1-A (§ 351); 1935 ACT, § 109 (amending § 351 of 1934 ACT); 1936 ACT, §§ 14, 102, and Title 1-A (§ 351); 1937 ACT, Tit. I and II; 1938 ACT, §§ 13, 102, 331-340 (Supplement P), and Title 1-A (§ 401 *et seq.*) INT. REV. CODE, §§ 102, 331-340, 500-511; 1939 ACT, § 211 (f) (g) and (i) (amending certain of the above mentioned sections of the CODE).

5. INT. REV. CODE § 102. The personal holding company provisions are: §§ 331-340 (foreign personal holding companies); §§ 500-511 (other personal holding companies) References to section numbers in this study are to sections of the Internal Revenue Code unless otherwise indicated.

6. INT. REV. CODE § 102.

7. INT. REV. CODE §§ 331-340 inclusive, commonly known as Supplement P.

8. The word "foreign" as applied to personal holding companies has a technical meaning. See p. 207 *et seq. infra*. This technical meaning is intended herein except where otherwise indicated.

9. INT. REV. CODE §§ 500-511 (Subchapter A of Chapter 2).

## II. BACKGROUND

1. *History Prior to 1934.* Space limitations forbid a complete historical treatment of the progenitors of the provisions under discussion. Herein it is proposed to describe briefly the earlier provisions and to discuss more fully the amendments made since the beginning of 1934 when the accumulation penalty section applicable to ordinary corporations first acquired its present number, (and the personal holding company as a special concept of income tax law first emerged.)

From the beginning of the modern income tax era (1913) the income tax law has contained a penalty section<sup>10</sup> applicable to corporations formed or availed of<sup>11</sup> for the purpose of preventing the imposition of the surtax on their shareholders through the medium of accumulating the earnings instead of distributing them. However, the Acts passed from 1913 to 1918 did not impose any penalty on the corporation itself; instead the shareholders of a corporation guilty of harboring the condemned purpose were taxed on their pro rata shares of the company's earnings. In 1920, doubts about the constitutionality of this method of applying the penalty were roused by the Supreme Court's decision in *Eisner v. Macomber*.<sup>12</sup> The majority opinion intimated<sup>13</sup> that a tax on the shareholders' respective shares of the undistributed earnings of the corporation, prior to dividend declaration, was not an income tax but a property tax which would have to be apportioned according to population.<sup>14</sup> In 1921 Congress, apprehensive that the whole penalty section might be invalid,<sup>15</sup> abandoned the scheme of taxing the shareholders and began, with the law of that year, to impose the penalty tax against the corporation.<sup>16</sup> From 1921 to 1934, various amendments<sup>17</sup> were made to eliminate defects in the 1921 Act by strengthening the section and increasing the penalty.

10. See note 4 *supra*.

11. Under the 1913 and 1916 Acts, the phrase was "fraudulently formed or availed of;" but the word "fraudulently" was dropped in the 1918 Act. See *Report of Senate Committee on Finance*, SEN. REP. No. 617, 65th Cong., 3d Sess. (1918) 52.

12. 252 U. S. 189 (1920). It was held, in a five to four decision, that the income tax on a stock dividend of common on common was unconstitutional.

13. 252 U. S. 189, 217-8 (1920).

14. In *Collector v. Hubbard*, 79 U. S. 102 (1871), the Supreme Court had held valid a provision in one of the Civil War Income Tax Acts which required the shareholders of a corporation to include in taxable income their proportionate shares of the corporation's income, whether distributed or not. The majority in the *Macomber* case declared that the *Hubbard* case was overruled by *Pollock v. Farmers Loan & Trust Co.*, 153 U. S. 601 (1895), but it may still be good law. See discussion *infra* pp. 210-211.

15. See H. R. REP. No. 350, 67th Cong., 1st Sess. (1921) 13; SEN. REP. No. 275 (1921) 16-17.

16. But the tax on the corporation could be avoided if the stockholders agreed to be taxed on their distributive shares of the corporation's net income in the same manner as the members of a partnership. REVENUE ACT OF 1921, § 220.

17. See note 4 *supra*.

The validity of the original method of imposing the penalty tax on the shareholders rather than against the corporation was never directly tested in the courts.<sup>18</sup>

2. *Act of 1934.* In 1934, the accumulation penalty section was renumbered 102, its present number, and substantial changes were made. The tax became a graduated surtax:<sup>19</sup> 25% on the first \$100,000 of the adjusted net income, and 35% on the remainder.<sup>20</sup> A separate classification of "personal holding companies" — a purely statutory concept — was created. Corporations within this category were excluded from the application of the penalty section and were made subject to a special surtax of 30% on the first \$100,000 of their undistributed net income and 40% on the remainder.<sup>21</sup> As we shall see, the personal holding company provisions of the 1934 Act contained so many loopholes that they missed many of their objectives.

3. *Act of 1936.*<sup>22</sup> The 1936 Act ushered in the much maligned undistributed profits tax.<sup>23</sup> This tax proved to be such a stimulus to the declaration of dividends that it highlighted the comparative inefficiency of Section 102.<sup>24</sup> Under the undistributed profits tax provisions of the 1936 Act, a corporation which did not distribute all of its earnings was

18. The 1916 provision was indirectly involved in *Kales v. Woodworth*, 32 F. (2d) 37 (C. C. A. 6th, 1929). This case is unique in that it is the only one where the taxpayer was asking for rather than fighting the application of the statutory penalty. Cf. *Maurice L. Stern*, 11 B.T.A. 1309 (1928). The 1918 Act was involved in *United Business Corp. of America v. Comm'r*, 19 B.T.A. 809 (1930), *aff'd*, 62 F. (2d) 754 (C. C. A. 2d, 1933), *cert. denied*, 290 U. S. 635 (1933), but the constitutional question did not arise as it was held that the company was not guilty of the condemned purpose for the year controlled by the 1918 Act.

19. The reason for this change is explained in *Report of the Senate Committee on Finance*, SEN. REP. No. 558, 73d Cong., 2d Sess. (1934) 31.

20. The section was also amended to make it plain that the penalty tax is applicable where the corporation is used to prevent the imposition of surtax upon the shareholders of another corporation, *e.g.*, a parent corporation, as well as against its own shareholders. See *Report of the Ways and Means Committee*, H. R. REP. No. 704, 73d Cong., 2d Sess. (1934) 12. In *Mead Corp. v. Comm'r*, 38 B.T.A. 687 (1938), it was held in a somewhat labored opinion (from which six members dissented) that this change was merely declaratory of the intention of the prior law.

21. REVENUE ACT OF 1934, § 351.

22. The 1935 Act made no change in Section 102, but did provide new and higher rates of personal holding surtax which never became operative, being superseded by the 1936 Act.

23. REVENUE ACT OF 1936, § 14.

24. Up to Oct. 1, 1926, only 78 cases had been considered by the Bureau of Internal Revenue for application of the corresponding sections of prior laws. From Oct. 1, 1926, to June 25, 1927, 158 additional cases were considered. Up to that time, there were no Court or Board decisions on the section. *Report of Joint Committee on Internal Revenue Taxation*, 70th Cong., 1st Sess., (1928) 49. But by November 1932, the Bureau had considered more than 2,000 cases. *Grimes, Surtax Rate Increase and Corporate Surplus Accumulations* (1932) 10 TAX. MAG. 403.

subject to a surtax which was graduated according to the percentage of earnings distributed, the maximum rate of such surtax being 27%.<sup>25</sup> Accordingly, it was felt that in the case of corporations subject to this undistributed profits tax, the rates imposed by Section 102 would be too high, and the penalty rates in the case of such corporations were reduced from 25% and 35% to 15% and 25%.<sup>26</sup> The 25% and 35% penalty rates were retained as to corporations not subject to the undistributed profits tax, such as banks and insurance companies. The 1936 Act also made important changes in the computation of the income subject to the penalty tax. Most of these amendments are incorporated in the present Law.<sup>27</sup>

4. *Loophole Law of 1937.* In 1937 came the "Loophole Law,"<sup>28</sup> designed to plug the loopholes in the income tax law brought to light in the hearings during the summer of 1937 before the Congressional Joint Committee on Tax Evasion and Avoidance.<sup>29</sup> So far as we are concerned here, these hearings disclosed four major media for escaping tax, all of which were virtually rendered useless by the 1937 Act. These may be classified<sup>30</sup> as: (a) incorporated pocketbooks (ordinary personal holding companies), (b) incorporated talents, (c) incorporated yachts and country estates, (d) foreign personal holding corporations.

(a) *Incorporated pocketbooks.* The 1934 and 1936 Acts had set up personal holding companies in a separate classification, and had subjected them to surtax rates on their undistributed income.<sup>31</sup> However, the Congressional draftsmen had left some yawning crevices. In the first place, 20% of the income could be accumulated without penalty. Secondly, the rates of personal holding company surtax were lower than the individual rates of tax of shareholders in the high brackets. Hence, despite the personal holding company tax, it was still advantageous for such wealthy taxpayers to accumulate the income in the corporation instead of distributing it as a dividend; and since Section 102 was no longer

25. The effective rate was somewhat lower due to the fact that the normal tax was deductible in computing the net income which measured the surtax.

26. As personal holding companies under the 1936 Act were subject to the undistributed profits surtax as well as the personal holding company surtax, the rates of the latter, which had been increased in the 1935 Act (see note 22 *supra*), were lowered.

27. See p. 180 *infra*, and note 56.

28. REVENUE ACT OF 1937.

29. For a thorough understanding of the 1937 Act, a knowledge of its background is practically essential. See Paul, *The Background of the Revenue Act of 1937 (1937)* 5 U. OF CHI. L. REV. 41; *Report of the Joint Committee on Tax Evasion and Avoidance*, 75th Cong. 1st Sess. (1937).

30. *Report of the Joint Committee on Tax Evasion and Avoidance*, 75th Cong., 2d Sess. (1937) 7. The term "incorporated pocketbook" had been used in the preliminary report of a subcommittee, transmitted to the Ways and Means Committee, December 4, 1933.

31. REVENUE ACTS OF 1934, 1936, § 351.

applicable to such companies, no further penalty could be imposed on them. Moreover, it was not very difficult to take a company out of the personal holding company classification by having it invest in real estate so that just over 20% of its gross income would be derived from rents.<sup>32</sup> For instance, the principal shareholder could transfer his country estate to the corporation and pay the corporation sufficient rent so that more than 20% of its gross income would be non-personal holding company income, thus removing the corporation from the personal holding company category. It is true that by removing itself from the personal holding company class, the company opened itself to attack under Section 102, but the penalty under that section was generally lighter; besides there was always the chance of eluding it.

Another leak consisted of allowing personal holding companies — for the purpose of the personal holding company surtax only — a deduction for a net capital loss in excess of the \$2,000 limitation allowed for normal tax purposes. In other words, an individual owning a personal holding company could, in effect, obtain the benefit of a larger capital loss than if there were no company. There were other minor gaps, such as the allowance of a deduction for amounts used to retire certain indebtednesses.<sup>33</sup>

Despite all these "cushions," the personal holding company provisions of the 1934 and 1936 Acts were not quite so ineffective as one would be led to believe from the testimony of Treasury officials in the hearings before the Joint Committee. For instance, Commissioner Helvering's statement that upon personal holding company incomes of approximately \$115,000,000 reported for 1935, less than \$2,000,000 of surtax had been collected was misleading.<sup>34</sup> The personal holding company surtax, like the surtax imposed by Section 102, was not intended to produce revenue *per se*. Instead, its primary purpose was to induce, or rather force, the distribution of the income of personal holding companies to their stockholders so that the latter would become liable to surtax on such income.<sup>35</sup>

32. Under the 1934 and 1936 Acts (as under the current law), one of the tests of a personal holding company was the nature of its gross income. If more than 80% of such income consisted of "personal holding company income" as defined in the statute, the company met this test. Rents, however, were not within the definition of "personal holding company income;" hence a company which derived more than 20% of its gross income from rents was not a personal holding company. Currently, rents are embraced by the definition of personal holding company income unless they constitute more than 50% of the gross income. See pp. 209, 214 *infra*.

33. This particular deduction is still allowed.

34. *Hearings before the Joint Committee on Tax Evasion and Avoidance*, 75th Cong., 1st Sess. (1937) 149. The Commissioner's statement has since been repeated without indication of its misleading character; Paul, *The Background of the Revenue Act of 1937* (1937) U. OF CHI. L. REV. 41, 60; *Sanford Corp. v. Comm'r*, C. C. A. 3d, Sept. 21, 1939.

35. *Report of the Joint Committee on Tax Evasion and Avoidance*, 75th Cong., 1st Sess. (1937) 2.

Taking into account estimated individual income tax liability resulting from extra dividends paid by personal holding companies, there was an estimated tax revenue for 1935 of \$49,000,000,<sup>36</sup> of which \$3,000,000 represented corporate surtax and the remainder, individual tax liability.

(b) *Incorporated talents.* The 1934 and 1936 personal holding company definition was not broad enough to include "talent" corporations organized by high-salaried motion picture stars, musical virtuosos, writers, cartoonists, and other persons with unique talents. Such individuals could organize corporations and "sell themselves" to their corporations at salaries which were sufficient to take care of their personal requirements, but which were much less than the amounts for which such services could be resold by the corporations. The amount thus retained by the corporation would, of course, escape surtax completely unless the corporation was caught by Section 102.<sup>37</sup> While it was possible for these companies to be caught by Section 102, the Government, as will be seen, was not uniformly successful in applying that section.<sup>38</sup>

(c) *Incorporated yachts and country estates.* It was found that in many cases wealthy individuals had transferred their yachts or country estates to a wholly owned corporation, to which they also transferred income-producing securities. They would pay to the corporation a rental for the yacht or estate which might be a fair rental, *i.e.*, as much as could be obtained were the property to be offered to an outsider, but which would be considerably less than the running expenses of the yacht or estate; and the income from the securities would be used to make up the deficit, so that the owner would escape tax on income from the securities.<sup>39</sup>

(d) *Foreign personal holding companies.* Foreign corporations are only subject to tax on income from United States sources.<sup>40</sup> The United States is apparently without jurisdiction to tax such corporations on income from sources outside the country.<sup>41</sup> Thus, if an American citizen

36. *Id.* at 8.

37. In the hearings before the Joint Committee it was brought out that Fritz Kreisler, the violinist and composer, had organized two Maine corporations, to one of which he had assigned the right to command his services, and to the other of which he had assigned royalties. *Id.* at 248. Percy Crosby, the cartoonist, also formed a corporation to which he transferred all of the rights to his character "Skippy," and the right to command his services at a salary which was much less than the amount his company received. *Id.* at 247. At least two other cartoonists—"Bud" Fisher and Fontaine Fox—organized similar corporations, as did at least two motion picture directors, William C. and Cecil B. DeMille. See pp. 196-197 *infra*. Cf. Charles Laughton, 40 B.T.A. 101 (1939).

38. Of the four incorporated talent cases which reached the courts for decision as to the applicability of § 102, the Government won two and lost two. See p. 196 *et seq. infra*.

39. Instances of the use of this device are contained in *Hearings, supra* note 34, at 226-240.

40. INT. REV. CODE § 231(c).

41. *Report of Joint Committee, supra* note 35, at 16-17.

organized a foreign corporation, transferred his funds to it and invested those funds so that income from them would arise outside the United States, the tax on such income would be completely avoided — except to the extent that it might be distributed as a dividend. The reason is that the income reached by Section 102, or the personal holding company provisions of the 1934 and 1936 Acts, consists only of income from United States sources in the case of a foreign corporation.<sup>42</sup>

All four of these chinks in the tax gathering armor were effectively stopped up by the 1937 Act, which created a new classification of "foreign" personal holding companies and very materially tightened the provisions with respect to other personal holding companies, as will be seen when the discussion of such companies is reached. Section 102 was not changed except to exclude from its application foreign personal holding companies.

5. *Act of 1938*. In 1938 the Treasury Department was apparently still complaining,<sup>43</sup> as it was back in 1918,<sup>44</sup> that its failure to apply more energetically the provisions of Section 102 was due to the inherent weakness of the Statute. The law had provided from the beginning that a prima facie presumption of the existence of the interdicted intent should arise from the fact that a corporation was a mere holding company or that its accumulation of earnings was in excess of the reasonable needs of the business. But the Department complained that these presumptions afforded scant aid in effectively applying the penalty section. The Circuit Court of Appeals for the Third Circuit had just reversed the decision of the Board of Tax Appeals in the *National Grocery Company* case,<sup>45</sup> and the Circuit Court of Appeals for the Ninth Circuit had also affirmed the Board's decision in the *Cecil De Mille* case.<sup>46</sup> Stung by the reversal in the *National Grocery Company* case, and the loss of the *Cecil De Mille* case, which the Supreme Court had declined to review, the Treasury Department appealed to Congress to strengthen further the existing provisions of Section 102.<sup>47</sup> Accordingly, in the 1938 Act, an

42. According to Elmer Irey, Chief of the Intelligence Unit of the Internal Revenue Bureau, 585 personal holding companies had been formed by Americans in Bahama Islands, Nassau, Panama, Newfoundland, and Prince Edward Island. See *Hearings*, *supra* note 34, at 38.

43. See *Report of Subcommittee of the Ways and Means Committee*, 75th Cong., 3d Sess. (1938) 20-21.

44. *Report of the Senate Committee on Finance*, SEN. REP. No. 617, 65th Cong., 3d Sess. (1918) 5.

45. *National Grocery Co. v. Comm'r*, 35 B.T.A. 163 (1936), *rev'd*, 92 F. (2d) 931 (C. C. A. 3d, 1937), *ultimately aff'd*, 304 U. S. 282 (1938).

46. *Cecil B. DeMille v. Comm'r*, 31 B.T.A. 1161 (1935), *aff'd*, 90 F. (2d) 12 (C. C. A. 9th, 1937), *cert. denied*, 302 U. S. 713 (1937).

47. The Subcommittee of the Ways and Means Committee in its report, *supra* note 43, at 20-26, had recommended and a majority of the committee itself had approved a so-called "third basket" provision whereby closely held companies not falling within the

attempt was made to comply with the Department's request: Congress retained the provision that the fact that a company is a mere holding or investment company is prima facie evidence of the intention to escape the surtax;<sup>48</sup> but it substituted for the corresponding provision with respect to unreasonable accumulation of earnings a new subsection (c) reading as follows:

"Evidence Determinative of Purpose. The fact that the earnings or profits of a corporation are permitted to accumulate beyond the reasonable needs of the business, shall be determinative of the purpose to avoid surtax upon shareholders unless the corporation by the clear preponderance of the evidence shall prove to the contrary."

The meaning of the new language, taken by itself, is far from being crystal clear. It imposes on the accused corporation the burden of proving by the clear preponderance of evidence that the accumulation of profits, if unreasonable, was not for the purpose of avoiding surtax on the shareholders.<sup>49</sup> But was not the corporation already faced with this burden? Every finding of the Commissioner, except fraud and transferee liability,<sup>50</sup> is presumed to be correct, and the taxpayer is under the burden of overcoming this presumption. The Treasury Department's complaint that it found difficulty in proving the condemned purpose was not wholly justified. The burden of proof has always been on the taxpayer, not on the Government.<sup>51</sup> In this connection, it may be noted that in the *National Grocery Company* case, the Government had no witnesses; it merely offered in evidence the tax returns and accounts of the taxpayer corporation and its sole shareholder. The grocery company on the other hand, adduced extensive testimony not only by its sole stockholder and its officers, but also by accountants, bankers and others. Yet the Government won the case.

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personal holding company classification would have been subjected to a special surtax on their undistributed profits. This proposal never passed the House.

48. The words "or investment" [company] were added by the 1924 Act.

49. The necessity for the change is also somewhat problematical. After the 1938 Act was passed, the Supreme Court reversed the circuit court of appeals' decision in the *National Grocery Co.* case and restored the decision of the Board, so that the incident which was probably chiefly responsible for the amendment vanished.

It has been held that the corporation must prove a complete absence of the forbidden purpose. See note 74 *infra*.

50. Under the rules of the Board (Rule 32), the Commissioner is also charged with the burden of proof in respect of any new matter pleaded in his answer. This rule stood the taxpayer corporation in good stead in *Dill Mfg. Co. v. Comm'r*, 39 B.T.A. 1023 (1938), where the Commissioner asserted the application of § 102 in his answer rather than in the deficiency letter.

51. See Sherman, *Taxation of Corporations Used to Avoid Taxes Upon Stockholders* (1935) 13 TAX MAG. 19, 46.

Despite the inherent obscurity of the new provision, the legislative history of the 1938 Act<sup>52</sup> indicates that by it, Congress intended to strengthen the presumption of prohibited purpose where earnings have been allowed to accumulate beyond the reasonable needs of the business and to increase the burden of proof on the taxpayer where such a situation exists.<sup>53</sup> The Treasury Department so interprets the change in the Law,<sup>54</sup> and its construction is likely to receive judicial sanction. With the elimination of the undistributed profits surtax (except for a straggling remnant), the rates of Section 102 surtax (for all corporations subject to the section) were restored to 25% and 35%. The other changes in Section 102 made by the 1938 Act were not important, the principal one being the elimination of the provision permitting exemption from the penalty tax if all the shareholders included their pro rata shares of the retained net income in their individual returns. This provision was eliminated for the reason that the 1938 Act permits the deduction of "consent dividends" (as defined in Section 28) in computing the income subject to the penalty tax.

6. *Present provisions.* The present provisions represent the crystallization of twenty-five years of effort to prevent the utilization of corporations as a device to escape surtaxes.<sup>55</sup>

Now the tax under Section 102, 25% on the first \$100,000 and 35% on the remainder, is measured by the undistributed Section 102 net income. This is computed by deducting from the statutory net income, without the benefit of the net loss carryover allowed by Section 23(s), the following:

1. Federal income tax other than the tax imposed by Section 102 or a corresponding provision of the prior law;
2. Disallowed charitable contributions;
3. Capital losses disallowed because of the \$2,000 limitation contained in Section 117(d);<sup>56</sup>
4. Dividends paid;<sup>57</sup>
5. Consent dividends (as provided by Section 28);

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52. *Report of the Senate Committee on Finance*, SEN. REP. No. 1567, 75th Cong., 3d Sess. (1938) 4-5, 16.

53. *Cf.* comment of the Ways and Means Committee in its report on the 1939 Act to the effect that if the 1938 amendment "fails to accomplish the purposes intended, further effort will be made to correct the situation in the near future." *Report of the Committee on Ways and Means*, H. R. REP. No. 855, 76th Cong., 1st Sess. (1939) 6.

54. U. S. Treas. Reg. 101, Art. 102-2.

55. This section is applicable to foreign as well as domestic corporations; but a foreign corporation deriving income from United States sources, whether resident or nonresident, is not subject to Section 102 if *all* of its shareholders are nonresident aliens who would not be subject to surtax on distributions made by the corporation. U. S. Treas. Reg. 101, Art. 102-1.

56. Deductions 1, 2 and 3 were first allowed by the 1936 Act.

57. This deduction was first allowed by the 1934 Act.

6. Operating loss of the preceding year subject to certain limitations;<sup>58</sup>
7. A special credit in the case of bank affiliates.

The last four items are included in the basic surtax credit allowed by Section 27(b).

The computation of the tax on personal holding companies will be discussed under subsequent headings.

### III. APPLICATION OF SECTION 102

To date there have been thirty-three decisions directly involving the application of Section 102 or its ancestors.<sup>59</sup> Of these cases, the Government has won eighteen. But even this insubstantial superiority, so far as the *present* Section 102 is concerned, disappears when it is considered that in thirteen of the Government's victories as against nine of its defeats, the taxpayer corporation was one which would now be classed as a personal holding company, and so outside the pale of Section 102.

Analysis of these thirty-three cases produces the conclusion that there is no single factor, whether it be the size of the accumulation, the percentage of income paid out as dividends, the existence of loans to stockholders, or financial condition which can be set up as an infallible barometer of liability under Section 102. For every situation which has been seized upon as a reason for holding one company taxable, it will be found that there is another case where the same situation existed, but where the decision was in favor of the taxpayer. Indeed, some factors, such as loans by a shareholder to his corporation, seem to be revolving weather vanes, sometimes pointing to liability and sometimes away from it.

While the decisions have not delineated any absolutely safe channel to steer clear of the rocks of Section 102, short of distributing all the income, the Treasury Department has very recently taken upon itself to set up some aids to navigation,<sup>60</sup> classifying five corporate situations

58. In computing the "Section 102 net income," the two-year net operating loss deduction provided in Section 23 (s) and Section 122 (added by the 1939 Act) is not allowed. INT. REV. CODE § 102 (d) (1). But in determining the "undistributed Section 102 net income" which measures the penalty tax, the one-year net loss carryover provided in Section 26(c) — which is computed somewhat differently from the carryover allowed by Section 23 (s)—is an allowable deduction by virtue of being included in the basic surtax credit allowed by Section 27 (b).

59. These cases are listed in Appendix *infra* pp. 221-223. Cases indirectly involving § 102 or its predecessors: *Kales v. Woodworth*, 32 F. (2d) 37 (C. C. A. 6th, 1929); *French Mtge. & Bond Co. v. Woodworth*, 38 F. (2d) 841 (E. D. Mich. 1930) (the latter held that an injunction will not lie to prevent collection of tax assessed under the penalty section); and *Stern v. Comm'r*, 11 B.T.A. 1309 (1928), holding that a shareholder may not deduct his proportionate share of the corporation loss in his individual return by virtue of the provisions of the section.

60. T. D. 4914, INT. REV. BULL. No. 31, at § (1939).

which will be given close attention to determine whether Section 102 is applicable.<sup>61</sup>

While the cases fail to produce absolutely dependable guideposts to culpability or innocence, they do establish certain rules of law. However, before passing to the discussion of these rules, it should be emphasized that the ultimate question is one of fact—was the taxpayer corporation formed or availed of for the purpose of preventing the imposition of surtax upon its shareholders through the medium of accumulating its earnings? When the problem is one of fact, there are hardly two cases which are exactly alike. This explains in part why the results have been different in cases where the factual situation was similar. It also explains why an appeal from the Board or court of original jurisdiction in a Section 102 case is virtually useless. In all of the cases which have been appealed thus far, every one of the original decisions was ultimately sustained.<sup>62</sup> The closest to a reversal was in the *National Grocery Company* case where the Circuit Court of Appeals for the Third Circuit reversed the Board by a divided court and was itself reversed by a divided Supreme Court.

#### A. RULES OF LAW ESTABLISHED BY DECISIONS

1. *Constitutionality.* The validity of the penalty provisions of Section 102 was first upheld in the *United Business Corporation*<sup>63</sup> and *Williams Investment Company*<sup>64</sup> cases, and was finally sustained by the Supreme

61. The five classes of corporations referred to are: (1) Corporations which have not distributed at least 70 per cent of their earnings as taxable dividends; (2) Corporations which have invested earnings in securities or other properties unrelated to their normal business activities; (3) Corporations which have advanced sums to officers or shareholders in the form of loans out of undistributed profits or surplus from which taxable dividends might have been declared; (4) Corporations, a majority of whose stock is held by a family group or other small group of individuals, or by a trust or trusts for the benefit of such groups; (5) Corporations the distributions of which, while exceeding 70 per cent of their earnings, appear to be inadequate when considered in connection with the nature of the business or the financial position of the corporation or corporations with accumulations of cash or other quick assets which appear to be beyond the reasonable needs of the business. T. D. 4914, INT. REV. BULL. No. 31, at 8 (1939).

62. Fifteen cases were appealed up to November 1, 1939. Of the eighteen cases won by the Government, fifteen were decided by the Board, two by district courts, and one by the Court of Claims. Of the fifteen cases in which the taxpayer was victorious, twelve were decided by the Board and three by district courts.

63. *United Business Corp. v. Comm'r*, 19 B.T.A. 809 (1930), *aff'd*, 62 F. (2d) 754 (C. C. A. 2d, 1933), *cert. denied*, 290 U. S. 635 (1933). The same company was again held taxable for a later year in *United Business Corp. of America v. Comm'r*, 33 B.T.A. 83 (1935). Wherever "the United Business Corporation case" is referred to herein, the first case is intended unless otherwise noted.

64. *Williams Investment Co. v. United States*, 3 F. Supp. 225 (Ct. Cl. 1933).

Court in the *National Grocery Company* case.<sup>65</sup> The argument against constitutionality before the Supreme Court was five pointed.

First, it was argued that the Statute violated the Tenth Amendment because it interfered with the power of a corporation to declare or withhold dividends, and thus impinged on a state function. The answer to this was fairly obvious: the Statute does not enforce the declaration of a dividend; it merely imposes a tax on corporations which use their power to withhold dividends for the purpose of preventing the imposition of federal surtaxes upon their shareholders.<sup>66</sup> Second, it was argued that the Statute was invalid because it imposed not an income tax but a penalty designed to force corporations to distribute their earnings so that their stockholders might be taxed. This argument was rejected, Justice Brandeis saying that Kohl, the sole owner of the business, could not by conducting it as a corporation prevent Congress, if it chose to do so, from taxing him individually on the year's profits.<sup>67</sup> The third argument that the section was invalid because liability was imposed through mere purpose to prevent surtaxes, rather than upon the accomplishment of that purpose, was also rejected. The Court held that while the existence of the purpose is a condition precedent to the imposition of the tax, the tax is nevertheless a true income tax, pointing out that there are many instances in which purpose or state of mind determines the incidence of income tax; for example, the imposition of the fraud penalty or whether a payment is received as compensation or as a gift.<sup>68</sup>

Fourth, it was contended that the Statute was depriving the corporation of its property without due process of law because it was unreasonable, arbitrary and capricious in that no standard or formula is specified as a guide for avoiding the tax. The Court, however, held that the standard was a rational one, quoting the language of Judge Learned Hand in the *United Business Corporation* case to the effect that it was no more capricious to require a reasonable accumulation of earnings than it would be

65. See note 45 *supra*.

66. Cf. statement by Judge Green quoted *infra* note 67.

67. This is in direct conflict with the language of the majority opinion in *Eisner v. Macomber*, *supra* note 13; and is hardly a convincing answer as the tax imposed upon the corporation by the section bears no relationship to what the tax against the shareholders would be. A more cogent reply would have been the statement in the concurring opinion of Judge Green in *Williams Investment Co.*, note 64: ". . . Assuming for the purposes of the argument only that it is a penalty, it would appear to be immaterial in the case now under consideration for the reason that Congress has power to impose a penalty for evading taxes or assisting or furthering the evasion thereof. Penalties are imposed for a violation of a statute or regulation." However, where a penalty for defeating taxes is involved, the burden of proof is on the Government.

68. This reasoning is again unconvincing and the examples are not apt as the imposition of the fraud penalty connotes accomplishment of purpose and the "compensation—gift" character of a payment involves only the imposition of the ordinary tax rather than a penalty tax.

to require reasonable standards of prudence in driving an automobile, or reasonable care in similar tort situations.<sup>69</sup> The court also brushed aside the argument that the section was unfair to non-assenting minority shareholders who have no control over corporate distributions,<sup>70</sup> stating that this objection need not be considered as there were no minority shareholders. Finally, the argument that the section was void because it delegated to the Commissioner legislative power was rejected, since the Statute does not confer upon the Commissioner any power save that of finding facts upon evidence.

2. *Purpose the Touchstone.* The cases clearly establish the principle that the touchstone of liability is the *purpose* behind the accumulation of the income and not the consequences of the accumulation.<sup>71</sup> The Board in the *Cecil De Mille* case stated this aptly, as follows:

"The tax under section 102 is not imposed because of effects: avoidance *per se* is not prohibited. It is the purpose, the intention, motivating the course of conduct which is made controlling by the statute. Unless the purpose was to prevent the imposition of surtax, the tax may not be imposed."<sup>72</sup>

Once it is found that the company was availed of for the purpose of preventing the imposition of surtax by accumulating its income, it does not matter whether any tax was saved, or whether the company was an investment or holding company or some other kind of company, or whether its accumulation was reasonable or unreasonable.<sup>73</sup> If those in control of the corporation are guilty of the condemned purpose, the corporation is enmeshed by Section 102; and this is true even where there are other motives for accumulation, and the avoidance of surtax is not the dominant motive. In other words, there must be "a complete absence of the disapproved purpose."<sup>74</sup>

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69. See also Judge Green's concurring opinion in *Williams Investment Co. v. United States*, 3 F. Supp. 225, 236 (Ct. Cl. 1933).

70. Cf. the *Kales* case *supra* note 18. See discussion *infra* pp. 210-211, as to constitutionality of taxing shareholders on their proportionate shares of the corporation's undistributed income.

71. But the consequences are considered in determining whether the purpose was present. See pp. 193-194 *infra*.

72. See note 46 *supra*.

73. Until 1921, the Treasury Department in its regulations and rulings had misconstrued the Statute by stating that the application of the section depended upon *two* elements: "(a) purpose to escape the surtax and (b) unreasonable accumulation of gains and profits." The regulations were changed to reflect the correct construction that purpose alone is the ultimate test of liability. The present regulation is contained in Art. 102-2. See Sherman, *Taxation of Corporations Used to Avoid Taxes Upon Stockholders* (1935) 13 TAX MAG. 19, 25-26.

74. Member Sternhagen in *R. L. Blaffer & Co. v. Comm'r*, 37 B.T.A. 851, 856 (1938), *aff'd*, 103 F. (2d) 487 (C. C. A. 5th, 1939), *cert. denied*, U. S. Sup. Ct. No. 169 (Oct. 1939).

3. *Effect of Statutory Presumptions.* In almost any income tax controversy — the notable exception being that of fraud — the Commissioner is aided by a presumption: his finding is prima facie correct, and the taxpayer is faced with the burden of overcoming that presumption.<sup>75</sup> A finding by the Commissioner that Section 102 is applicable necessarily includes a finding that the attained purpose is present. But purpose is a frame of mind<sup>76</sup> and since the Commissioner cannot peer into the minds<sup>77</sup> of those who control the corporation, Congress thought it desirable to strengthen the general presumption in favor of the Commissioner's finding by statutory provisions which impute guilt to a corporation if it is a mere holding company or investment company, or if it has permitted an unreasonable accumulation of earnings or profits. Congress in the 1938 Act went even further and strengthened, or at least attempted to strengthen, the presumption of proscribed purpose where there has been an unreasonable accumulation of earnings. The effect of these presumptions is that the taxpayer is required to show his hand,<sup>78</sup> and, of course, if the disclosure of that hand reveals the prohibited purpose, Section 102 applies. In other words, the corporation is faced with the burden of showing what actually motivated the accumulation.

4. *What is a mere holding or investment company?* Undoubtedly, a corporation which passively holds property, whether it be real estate or other tangible property, or securities, and which simply collects the income and pays expenses, is a "mere holding or investment company." But suppose the corporation does more than this; suppose it actively engages in speculative trading on a large scale. Can it then still be a *mere* holding or investment company? The Board had an opportunity to answer this question in *Rands, Incorporated v. Commissioner*,<sup>79</sup> but dodged it, holding that the prohibited purpose was so clearly present that the company was taxable regardless of whether it was a mere investment or holding company.<sup>80</sup> The Board did indicate that a company formed to engage in speculation and intended to derive its income mainly from profits on the sale of securities is an investment or holding company, but refrained from a discussion of the effect to be given to the word "mere."<sup>81</sup> On the

75. See p. 179 and note 50 *supra*. Cf. U. S. Treas. Reg. 101, Art. 102-2.

76. Sherman, *Taxation of Corporations Used to Avoid Taxes Upon Stockholders* (1935) 13 TAX MAG. 19, 26.

77. DeMille Productions, Inc. v. Comm'r, 30 B.T.A. 826, 829 (1934), *petition for review dismissed*, 80 F. (2d) 1010 (1936).

78. United Business Corp. v. Comm'r, 62 F. (2d) 754, 755 (1933).

79. 34 B.T.A. 1094 (1936), *appeal dismissed*, 101 F. (2d) 1018 (C. C. A. 6th, 1939).

80. 34 B.T.A. 1094, 1103 (1936); cf. *Almours Securities, Inc. v. Comm'r*, 35 B.T.A. 61, 74 (1936).

81. The Regulations likewise avoid any discussion of the meaning of "mere." U. S. Treas. Reg. 101, Art. 102-2. Perhaps this is intended to imply that the Department does not consider the term significant. However, such a position would hardly be warranted in view of the Statute.

other hand, in *Industrial Bankers Securities Corporation v. Higgins*,<sup>83</sup> the Circuit Court of Appeals for the Second Circuit approved an auditor's report which held that the word "merè" must be given effect and that a corporation which owned the stocks of subsidiary small loan companies and apparently controlled the activities of such subsidiaries in an active manner, while a holding company, was not a "mere" holding company.

5. *What is an unreasonable accumulation of earnings or profits?* No answer to this question can be given that would be applicable to corporations generally. The results in the decided cases show plainly that each case rests on its own footing with respect to the amount of earnings that may reasonably be accumulated, and that no hard and fast rule can be evolved.<sup>83</sup> Nevertheless, certain principles have been established. For instance, we know from the Supreme Court via the *National Grocery Company* decision, that unrealized depreciation in the value of assets, while taken into consideration in determining whether the accumulation has been reasonable, does not preclude a finding of unreasonable accumulation even if such decline is in excess of the accumulated earnings.<sup>84</sup>

We can also conclude from the *United Business Corporation* case,<sup>85</sup> that there may be taken into consideration, in testing the unreasonableness of the accumulation: the possibility of operating losses;<sup>86</sup> the amount

82. 104 F. (2d) 177 (C. C. A. 2d, 1939). This case is unique in that it is the only Section 102 case that has been referred to an auditor. See also, *Seaboard Security Co. v. Comm'r*, 38 B.T.A. 560 (1938), where the court held that small loan companies were not mere investment or holding companies.

83. The Treasury regulations on the subject of reasonableness consist necessarily of generalizations and do not afford much help in establishing a line of demarcation between a reasonable and an unreasonable accumulation. U. S. Treas. Reg. 101, Art. 102-3. For a discussion of previous regulations and rulings on what constitutes a reasonable accumulation, see Sherman, *supra* note 76, at 78-80, and Graubard, *Accumulation of Surplus to Evade Surtaxes* (1932) 10 TAX MAG. 415. The regulations discussed in Sherman's article are substantially the same as the present regulations.

84. It can hardly be said that this conclusion has any logic back of it. The average stockholder would not consider that a corporation had unreasonably withheld a dividend where the assets of the company had dropped in value to a degree sufficient to wipe out the realized earnings. In fact, a director voting a dividend under such circumstances might incur severe criticism. The condemned purpose may have been present in the *National Grocery Company* case so that the imposition of the penalty tax was justifiable regardless of the existence of an unreasonable accumulation of the year's profits, but the finding that there was such an accumulation is difficult to swallow. Cf. the *Rands* case in which the Board had specifically found that there was an unreasonable accumulation in 1927 and 1928, but omitted a corresponding finding for 1929 and 1930 because in the two later years, the diminution in value of the assets had wiped out the realized gains.

85. 19 B.T.A. 809, 827, 828, 830, 838 (1930). Even though the corporation was held taxable for one of the years involved, there was no finding that the accumulation was unreasonable.

86. In the *United Business Corporation* case it was shown that the operation of the real estate owned by the corporation had, in some of the past years, resulted in losses. But the possibility of speculative losses is apparently of no great consequence. Cf. *Rands*,

of money needed for operating expenses;<sup>87</sup> and the existence of bona fide<sup>88</sup> mortgage indebtedness requiring annual amortization.

The amount required for expansion purposes based on past experience is apparently another factor in measuring reasonableness. Thus, in the *National Grocery Company* case, where the number of stores in the chain had grown from 358 to 815 during a period of ten years, and Kohl, the sole stockholder, had testified that each store required a capital of about \$5,000, the Supreme Court reckoned that this rate of expansion could have accounted for an accumulation of only \$2,285,000 as contrasted with the actual accumulation during that period of about \$5,742,000.

The statutory provision with respect to the effect of an unreasonable accumulation contains the phrase "needs of the business."<sup>89</sup> It therefore becomes necessary to inquire into the meaning of the corporation's "business." In *R. C. Tway Sales Company v. United States*<sup>90</sup> the Government argued that the reasonable needs of the corporate business should be determined only by reference to the necessities of the business authorized by the company's charter, to wit, the coal business; and that the accumulation of profits from transactions in securities, not authorized by the charter, was unreasonable because not needed for the authorized business. But the Court rejected this argument, pointing out that the Government, by seeking to impose the penalty tax on the income from the ultra vires securities business, had virtually conceded that the securities transactions were part of the company's business; and it followed that the reasonableness of the accumulation was measureable by the needs of that business as well as by the requirements of the coal business.<sup>91</sup>

Mere ownership by one corporation of the stock and securities of another corporation does not make the business of the second corpora-

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Inc. v. Comm'r, 34 B.T.A. 1094 (1936); *R. L. Blaffer & Co. v. Comm'r*, 37 B.T.A. 851 (1938), *aff'd*, 103 F. (2d) 487 (C. C. A. 5th, 1939), *cert. denied*, U. S. Sup. Ct. No. 169 (Oct. 1939); *Nipoch Corp. v. Comm'r*, 36 B.T.A. 662 (1937).

87. In the *United Business Corporation* case, the income accumulated was not in excess of a single year's operating expenses. Cf. the *National Grocery Company* case where the rent and payroll for a year amounted to about \$4,000,000 contrasted with an accumulation of \$8,000,000.

88. Indebtedness incurred with the idea of legitimizing accumulations would probably react to the disadvantage of the taxpayer. See p. 198 *et seq. infra* for discussion of this point. In the *United Business Corporation* case there was a mortgage on the corporation's real estate requiring serial payments of \$50,000 per year on account of principal.

89. Section 102 (c).

90. 3 F. Supp. 668 (W. D. Ky. 1933), *aff'd*, 75 F. (2d) 336 (C. C. A. 6th, 1935).

91. Cf. U. S. Treas. Reg. 101, Art. 102-3, which provides: "The business of a corporation is not merely that which it has previously carried on, but includes in general any line of business which it may undertake. However, a radical change of business when a considerable surplus has been accumulated may afford evidence of a purpose to avoid the surtax."

tion the business of the first.<sup>92</sup> But the result is different where the other corporation is a wholly or substantially wholly owned subsidiary of the first corporation.<sup>93</sup>

6. *The meaning of "earnings or profits."* According to the Board in *W. S. Farish & Co. v. Commissioner*,<sup>94</sup> "earnings or profits" mean the same thing in Section 102 that they do in Section 115 relating to dividends.<sup>95</sup> Consequently, *realized* losses on sales of property, even though not allowed for ordinary income tax purposes, are deductible in computing "earnings or profits." In the *Farish* case, Farish organized the corporation and transferred to it in exchange for its stock — the exchange being tax-free<sup>96</sup> — securities which had cost him about \$800,000, but which had a value at the time of transfer of about \$1,200,000. For ordinary income tax purposes, the basis for computing gain or loss on the sale of securities would be their cost to Farish and not their cost to the corporation. But the Board held that Section 102 refers not to an accumulation of taxable net income, but to an accumulation of earnings or profits, and that earnings or profits are measured by the cost of assets to the corporation rather than to the transferor. The Board had reached a similar conclusion with respect to the dividend status of corporate distributions.<sup>97</sup>

7. *Section not applicable to avoidance of tax by some other method than accumulation of earnings.* The *Farish* case establishes another important principle: it holds that a corporation formed to prevent the imposition of taxes in some other way than by accumulation of earnings does not come within Section 102. Shortly after the organization of Farish's company, he sold securities to it and established large losses on such sales. Under the law as it then stood, such losses were deductible.<sup>98</sup> The Government argued that Farish organized the company for the purpose of realizing these losses and thus avoiding tax, and that it was, there-

92. *Keck Investment Co. v. Comm'r*, 29 B.T.A. 143 (1933), *aff'd*, 77 F. (2d) 244 (C. C. A. 9th, 1935), *cert. denied*, 296 U. S. 633 (1935). The taxpayer corporation had argued that the accumulation was needed to finance another company. The report of the case does not show what percentage of the second company's stock was owned by the taxpayer corporation.

93. U. S. Treas. Reg. 101, Art. 102-3; *Industrial Bankers Securities Corp. v. Higgins*, 104 F. (2d) 177 (C. C. A. 2d, 1939).

94. 38 B.T.A. 150 (1938), *aff'd*, 104 F. (2d) 833 (C. C. A. 2d, 1939).

95. This conclusion is fortified by the comment of the Senate Finance Committee in its report on the 1936 Act, which changed the word "gains" to "earnings." *Report of the Senate Committee on Finance*, SEN. REP. No. 2156, 74th Cong., 2d Sess. (1936) 17.

96. Under § 112(b) (5).

97. *McKinney v. Comm'r*, 32 B.T.A. 450 (1935), *aff'd*, 87 F. (2d) 811 (C. C. A. 10th, 1937); *Freshman v. Comm'r*, 33 B.T.A. 394 (1935); and *F. J. Young Corp. v. Comm'r*, 35 B.T.A. 860 (1937), *aff'd*, 103 F. (2d) 137 (C. C. A. 3d, 1939).

98. Under current law, such losses would not be allowable. INT. REV. CODE § 24 (b).

fore, within the ambit of Section 102; but the Board held that, assuming the existence of this purpose, Section 102 was nevertheless inapplicable.

8. *Illegality of dividend declaration.* The fact that the declaration of a dividend would be illegal under state law is not, according to existing decisions, sufficient of itself to save the corporation from Section 102.<sup>99</sup>

9. *Res judicata.* It has been held<sup>100</sup> that a decision holding a company subject to the section for one year is not *res judicata* as to another year.<sup>101</sup> There are dicta in the Board cases to the effect that if a corporation is formed for the disapproved purpose, the section is applicable regardless of whether or not it was availed of during the taxable year for that purpose.<sup>102</sup> However, this is dicta and in the cases which have been won by the Government, it has been uniformly held that the corporation was formed *and* availed of for the proscribed purpose or else availed of for that purpose.

#### B. ANALYSIS OF CASES BY REFERENCE TO CIRCUMSTANTIAL FACTORS

The attempt, by an analysis of the cases, to arrive at factors which can be used as definitive guides in determining whether Section 102 is applicable to a particular situation has not proved altogether fruitless, for it is at least possible to indicate certain tendencies or trends.

1. *Nature of company.* A manufacturing or mercantile company is certainly less likely to be ensnared by Section 102 than other types of corporations. But even aside from the type of corporation, the fact that it is in the process of liquidation does not relieve it from the application of Section 102.<sup>103</sup> Of the decided cases, six involved mercantile or manufacturing corporations, and of these the Government won only one—the *National Grocery* case—and even in that one the victory was by the barest possible margin.<sup>104</sup> On the other hand, of five decided

99. See p. 195 *infra*.

100. *United Business Corp. v. Comm'r*, 33 B.T.A. 83 (1935). See note 63 *supra*.

101. In *Charleston Lumber Co. v. United States*, 20 F. Supp. 83, 90 (S. D. W. Va. 1937), *petition for review dismissed*, 93 F. (2d) 1018 (C. C. A. 4th, 1937), the court inferred that the guilt of a company in prior years—presumably outlawed by the statute of limitations—is no ground for liability in a year for which the taint was not present. But the failure of the company to distribute its earnings in prior years will undoubtedly have an effect on the determination of liability for a later year. *Cf.* *National Grocery Co. v. Comm'r*, 35 B.T.A. 163 (1936), and *Almours Securities, Inc. v. Comm'r*, 35 B.T.A. 61 (1936), *aff'd*, 91 F. (2d) 427 (C. C. A. 5th, 1937), *cert. denied*, 302 U. S. 765 (1938).

102. *E.g.*, *Nipoch Corp. v. Comm'r*, 36 B.T.A. 662 (1937), and cases cited on p. 663 of opinion.

103. O. D. 838, 5 CUM. BULL. 226 (1921).

104. *Cf.* *Dill Mfg. Co. v. Comm'r*, 39 B.T.A. 1023, 1031 (1938). “. . . where . . . the petitioner is not a holding company but is engaged in a manufacturing business, which is so obviously hazardous from a business viewpoint, we will hesitate before substituting

cases involving companies which were neither mercantile companies nor companies which would now be classed as personal holding companies, the Government lost only one.

2. *Percentage of income distributed during the taxable year.* This factor is, of course, evidentiary, but it is apparently not of primary importance. Thus, in the cases decided in the Government's favor, the average amount of income distributed during the taxable year was slightly more than 7%, the highest being 55% in the *Almours*<sup>105</sup> case; whereas in the cases decided against the Government, the average amount of income distributed was about the same, to wit, 7%, the highest being 36%. However, the Treasury Department now takes the view that a company which distributes less than 70% of its earnings invites scrutiny.<sup>106</sup>

Dividends paid in years other than the taxable year are also taken into consideration. Thus, in the *Almours* case, while 55% was paid out during one of the taxable years, the aggregate amount paid out over a period of six years was only about 20%. The *Almours* company had declared huge stock dividends, but these were non-taxable to its shareholders under the law in force at the time of declaration, and had little effect on the company's liability for the penalty tax.<sup>107</sup>

The earlier Regulations had provided that a distribution of a large portion of the year's earnings might overcome the statutory presumption that a mere holding or investment company is subject to the penalty section,<sup>108</sup> but this was changed in 1934 and the Regulations now provide that the distribution of a large portion of the year's earnings is not of itself sufficient to override the presumption.<sup>109</sup>

3. *Existence of loans to shareholders.* Substantial loans to shareholders were present in eight of the Government's eighteen victories; on the other hand, there were substantial advances to stockholders in five of the cases lost by the Government. As to loans to stockholders, however, it may safely be said that in every case decided against the taxpayer in which such loans were present, they were an important factor in the ultimate result.<sup>110</sup> Thus, in the *National Grocery Company* case, the fact that Kohl, the sole shareholder, borrowed substantial sums from the corporation, and during the taxable year had borrowed \$140,000 for his

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our judgment upon the reasonableness of the corporate accumulations, for that of the directors."

105. *Almours Securities, Inc. v. Comm'r*, 35 B.T.A. 61 (1936).

106. See notes 60 and 61 *supra*.

107. Cf. Sol. Op. 144, I-2 CUM. BULL. 4 (1922), holding that the distribution of a non-taxable stock dividend does not deplete earnings or profits.

108. E.g., U. S. Treas. Reg. 77, Art. 542.

109. U. S. Treas. Reg. 101, Art. 102-2.

110. Cf. notes 60 and 61 (3) *supra*.

personal purposes,<sup>111</sup> was in all probability the turning point of the case against him, so far as the Board was concerned. Similarly, in the *United Business Corporation* case, the loans to Smith, the sole stockholder, emasculated his argument that the accumulated earnings were needed for the purposes of the business. Again in the *William De Mille* case<sup>112</sup> the loans to him were undoubtedly the deciding factor, in fact the only one which distinguished it from his brother Cecil's case.<sup>113</sup> Loans were also an important factor in *A. D. Sacnger, Inc. v. Commissioner*,<sup>114</sup> and in the *Dill Manufacturing Company* case<sup>115</sup> the Board pointed to the absence of loans in deciding the case in the taxpayer's favor. In some of the cases, notably *National Grocery Company*, some emphasis was placed on the fact that the loans to the shareholders were made without interest. It is difficult to see, however, why this should operate against the taxpayer, since the payment of such interest will generally effect a greater reduction in the stockholder's individual tax — such interest being an allowable deduction — than the increase in the corporation's tax burden.

4. *Non-interest bearing loans by shareholders.* In *Rands, Incorporated v. Commissioner*<sup>116</sup> and *Reynard Corporation v. Commissioner*,<sup>117</sup> the sole stockholder in each case urged that his case was distinguishable from other cases decided against the taxpayer, because in such other cases there were loans to stockholders, whereas in the *Rands* and *Reynard* cases the corporations were indebted to Rands and Fox respectively. Instead of bolstering the taxpayer's case, this argument proved to be a boomerang and was turned against him. The Board pointed out that the loans, being without interest and the funds being used by the corporation to purchase income-producing securities, would effect a further escape of surtax, since if the individual had invested in the securities himself, he would have had to pay individual tax on the income from such securities at higher rates than the corporation paid. On the other hand, in *Mellbank Corporation v. Commissioner*,<sup>118</sup> the fact that the corporation's owner lent it large sums to enable it to tide over the banks it owned during a period of banking difficulties was accepted in support of the taxpayer's position that the accumulation of earnings was not unreasonable. And in *Sauk*

111. Of this sum, Kohl used \$40,000 to purchase a residence in Florida and made a \$100,000 charitable contribution.

112. See note 77 *supra*.

113. See note 46 *supra*.

114. 33 B.T.A. 135 (1935), *aff'd*, 84 F. (2d) 23 (C. C. A. 5th, 1936), *cert. denied*, 299 U. S. 578 (1936).

115. See note 50 *supra*.

116. See note 79 *supra*.

117. 37 B.T.A. 552 (1938), *petition for review dismissed*, (C. C. A. 2d, 1938) (unreported).

118. 38 B.T.A. 1108 (1938).

*Investment Company v. Commissioner*,<sup>119</sup> advances by the stockholders to the corporation to enable it to meet interest and principal payments on account of the purchase price of its chief asset, were helpful in sustaining the taxpayer's argument that it was not in a position to declare dividends.

5. *Nature of income.* The fact that the greater part of the income received by the corporation is such as would be subject to tax when received by an individual, but would be wholly or largely tax-exempt when received by a corporation, to wit, intercorporate dividends and federal bond interest,<sup>120</sup> has weighed heavily against the taxpayer in some cases, notably *United Business Corporation*,<sup>121</sup> *Williams Investment Company*,<sup>122</sup> *Saenger*,<sup>123</sup> and *Almours*.<sup>124</sup> In fact, in fifteen of the eighteen cases won by the Government, dividends constituted the major item of income. On the other hand, in about one-half of the fifteen cases won by the taxpayer, dividend income was also substantial.

6. *Unrealized declines in the value of assets.* This has already been discussed to some extent in connection with the meaning of "unreasonable accumulation." Such declines were not sufficient to save the corporation in the *Rands*, *Nipoch*,<sup>125</sup> *R. & L.*,<sup>126</sup> *Almours*, *Saenger*, *National Grocery Company* and *Blaffer*<sup>127</sup> cases. On the other hand, they were responsible for the taxpayer winning in *C. H. Spitzner & Son, Inc. v. Commissioner*.<sup>128</sup> The Board distinguished the *Spitzner* case from the *Rands* and *Nipoch* cases on the ground that the *Spitzner* corporation was a mercantile company, and that the decline in the value of assets of such a company should be given more weight than in the case of an investment or holding company. This distinction loses most of its significance in the light of the *National Grocery Company* case, which also involved a mercantile company with unrealized declines in asset values. The *Spitzner* case was decided after the circuit court of appeals had reversed the Board decision in the *National Grocery Company* case and before the Supreme Court reversed the circuit court.<sup>129</sup>

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119. 34 B.T.A. 732 (1936).

120. Income excluded from gross income, such as state or municipal bond interest, or the exempt proceeds of a life insurance policy, does not measure the penalty tax, but being part of "earnings or profits," it presumably has a bearing on the determination of whether the accumulation of other income is reasonable.

121. See note 63 *supra*.

122. See note 64 *supra*.

123. See note 114 *supra*.

124. See note 101 *supra*.

125. See note 86 *supra*.

126. *R. & L., Inc. v. Comm'r*, 33 B.T.A. 857 (1935), *aff'd*, 84 F. (2d) 721 (C. C. A. 5th, 1936), *cert. denied*, 299 U. S. 588 (1936).

127. *R. L. Blaffer & Co. v. Comm'r*, 37 B.T.A. 851 (1938), *aff'd*, 103 F. (2d) 487 (C. C. A. 5th, 1939), *cert. denied*, U. S. Sup. Ct. No. 169 (Oct. 1939).

128. 37 B.T.A. 511 (1938).

129. See the last sentence of the majority opinion in the *Spitzner* case, 37 B.T.A. 511, 523 (1938). However, the *Spitzner Company's* case might be distinguished from the

7. *Change in policy.* A sudden shift in corporate or individual policy may be indicative of an attempt to achieve the condemned purpose.<sup>130</sup> Thus, in the *United Business Corporation* case, the company started out as a pure real estate operating company,<sup>131</sup> but later Smith, the sole stockholder, transferred to it large blocks of dividend-paying stocks. Had Smith received the dividends from these stocks, he would have incurred substantial individual surtax liability. Smith's corporation, on the other hand, received the dividends tax-free.<sup>132</sup> In the *National Grocery Company* case, the company had started to pay dividends in 1917 and 1918, but stopped after the high rates of surtax were enacted in 1919.<sup>133</sup> In the *Williams Investment Company* case, Neiman, the controlling stockholder, who theretofore had received relatively modest dividends from a newspaper company, organized the investment company and transferred to it the stock of the newspaper company shortly before the declaration by the latter of an extraordinarily large dividend.<sup>134</sup> On the other hand, in the *Tway Sales Company* case,<sup>135</sup> the fact that the company, which had originally confined its activities to the coal business, went outside the limits of its charter and engaged in securities speculation to such an extent that its income from the latter during the taxable year far exceeded the income from the coal business, did not bring down upon it the visitation of the accumulation penalty.

8. *Effect of accumulation on taxes of shareholders.* The amount of tax saved by the individual stockholders as a result of non-distribution is undoubtedly a vital factor. While avoidance *per se* is not prohibited,<sup>136</sup> such avoidance is taken into consideration in determining whether the interdicted purpose is present. The fact that the stockholders of the cor-

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*National Grocery Company* case on the ground that a substantial portion of its investments were in securities of tobacco companies with which it did business, *i.e.*, the investments were germane to the business of the company, whereas in the *National Grocery Company* case the investments were in the securities of banks, railroads, utilities and other companies whose business was not related to that of the grocery company. See p. 200 *infra*.

130. Cf. note 91 *supra*.

131. The majority opinion in the *United Business Corporation* case indicated that if the company had confined its business to its buildings, that it would not have fallen within the provisions of Section 220 of the Revenue Act of 1921, 19 B.T.A. 809, 823 (1930).

132. Such intercorporate dividends under the 1921 Act were even free from the penalty tax, due to a loophole which was eliminated by the 1924 Act. Cf. *Keck Investment Co. v. Comm'r*, 29 B.T.A. 143 (1933), *aff'd*, 77 F. (2d) 224 (C. C. A. 9th, 1935), *cert. denied*, 296 U. S. 633 (1935).

133. Cf. *United Business Corp. v. Comm'r*, 62 F. (2d) 754, 755 (C. C. A. 2d, 1933). "A sudden change of policy, coincident with large increases in the surtax rates, might . . . betray a purpose to accumulate against a season more propitious for distributions."

134. This dividend would have been taxable had Neiman received it directly, but it was not taxable when received by his corporation.

135. See note 90 *supra*.

136. See p. 184 *supra*.

poration have saved large amounts of tax has undoubtedly weighed against it. For example, in the *National Grocery Company* case, Kohl saved more than \$1,300,000 in surtax over a ten-year period. Few of the reports in cases won by the Government indicate just how much tax the stockholders escaped as a result of non-distribution. However, it may be taken for granted that in each such case the saving was substantial. But where, as in the *Charleston Lumber Company* case<sup>137</sup> and in two other cases, namely, *Irvington Investment Company v. Commissioner*,<sup>138</sup> and *Rofam, Inc. v. Commissioner*,<sup>139</sup> it was shown that the amount of tax on the shareholders would have been trivial even if the corporation had distributed its entire earnings, the decision was in favor of the taxpayer.<sup>140</sup>

Directors of companies generally know when they are skirting the fringes of liability under Section 102, and in determining dividend policies, weigh the possible penalty against the individual tax saved by non-distribution. If the controlling stockholder of a company within the scope of Section 102 is already in tax brackets beyond 25%<sup>141</sup> and is content to forego receipt of the corporate income until distribution can be effected without burdensome individual tax liability, the corporation can accumulate \$100,000 without effective financial penalty. And once the controlling stockholder's income passes the 35% bracket, unlimited accumulation is possible without penalty other than the opprobrium<sup>142</sup> of being charged with tax avoidance. Where this situation exists, the evidence to overcome the charge of liability should have to be particularly convincing. On the other hand, as the cases indicate, the less the individual saving resulting from accumulation, the milder will be the threat of chastisement under the section.

9. *Financial condition of the company.* This has been an important factor in some cases. Thus, in the *National Grocery Company* case, the fact that the company had more than \$1,000,000 in cash in excess of its liabilities was pointed to as negating the argument that it needed the

137. See note 101 *supra*.

138. 32 B.T.A. 1165 (1935).

139. Memo. B.T.A. Docket No. 81,597, April 17, 1937.

140. *Seaboard Security Company v. Comm'r*, 38 B.T.A. 560 (1938) (involving small loan companies).

141. The 25% bracket is reached when net income after deducting exemptions equals \$32,000; the 35% bracket is reached at \$50,000. Neither is a particularly forbidding figure.

142. Cf. GILBERT AND SULLIVAN, RUDDIGORE (1887) Act II: "Sir Ruthven: On Tuesday I made a false income tax return.

All: Ha! Ha!

1st Ghost: That's nothing.

2d Ghost: Nothing at all.

3d Ghost: Everybody does that.

4th Ghost: It's expected of you."

accumulation in its business.<sup>143</sup> But, in *Sauk Investment Company v. Commissioner*,<sup>144</sup> and in *Mellbank Corporation*,<sup>145</sup> the fact that the company was always short of cash and had no cash with which to pay a dividend, (there being no loans to shareholders) was cited as a point in its favor. In the *Sauk* case, the reason the company never had any substantial amount of cash was that the dividends received by it were largely in the form of bonds.<sup>146</sup> In the *Mellbank* case, the income was used to tide over banks owned by the Mellbank Corporation during a period of banking difficulties. In the *Saenger* case<sup>147</sup> the company's argument that it had no cash with which to pay a dividend lost all of its force in view of loans to its shareholder. And in *R. & L., Incorporated*,<sup>148</sup> the Board pointed out that the alleged shortage of cash resulted from reinvestment of the current income rather than from any exigency of the business.

In the *Tway Sales Company* case,<sup>149</sup> decided in the taxpayer's favor, some importance was apparently attached to the fact that the company's current asset and liability ratio was less than two to one, the requirement of the Federal Reserve Board for rediscounting commercial paper.

10. *Illegality of dividend declaration.*<sup>150</sup> In the *Spitzner* case,<sup>151</sup> the company's assets (largely securities) had depreciated in value to an extent sufficient to wipe out its surplus. The company followed the consistent practice of writing its securities up or down to end-of-year market values and by so doing for the taxable year, reduced its book surplus to practically zero. The company's attorney advised it that the declaration of a dividend in such circumstances would be illegal under local (New York) law. The illegality of a dividend declaration probably decided the *Spitzner* case in the taxpayer's favor. Yet, very shortly thereafter, the majority of the Board, in the *R. L. Blaffer & Company*<sup>152</sup> case, held the corporation subject to the penalty tax even though the declaration of a dividend would have been clearly illegal under local law (Texas) because of a decline in the value of the corporation's assets (almost entirely securities) which not only wiped out its surplus but its capital as well. In other words, the company was insolvent, its liabilities far exceeding the value of its assets.<sup>153</sup> The liabilities, however, consisted entirely of stock brokerage

143. See notes 60 and 61 (5) *supra*.

144. See note 119 *supra*.

145. See note 118 *supra*.

146. The point that the *Sauk* company might have distributed the bonds as a dividend in kind does not appear to have been suggested, so far as the case report indicates.

147. See note 114 *supra*.

148. See note 126 *supra*.

149. See note 90 *supra*.

150. This factor is mentioned briefly at p. 189 *supra*.

151. See note 128 *supra*.

152. See note 127 *supra*.

153. In *Rands* case (for one of the later years) and in the *Nipoch* case (both of which were decided against the taxpayer) the decline in asset values was sufficient to

accounts guaranteed by Blaffer individually. The Board rejected the plea of insolvency as an excuse for non-distribution of the realized income, and rationalized its conclusion as follows:

"Insolvency was a mathematical abstraction, for the creditors were fully secured by Blaffer's individual guaranty and Blaffer had ample assets to assure it. Even article 1347 of the Texas Civil Statutes, which petitioner cites, would go no farther than to make the directors jointly and severally liable for the corporation's debts, to the extent of the dividend; and such liability Blaffer had already assumed by his guaranty."<sup>154</sup>

Conceding the peculiar factual situation in the *Blaffer* case, the Board's reasoning is, nevertheless, specious. To say the insolvency was "mathematical abstraction" because Blaffer, who was wealthy, was a guarantor of the corporation's debts, completely overlooks the fact that Blaffer was not the sole stockholder,<sup>155</sup> and that the declaration of a dividend would have depleted the assets which the creditors could look to for satisfaction of their claims.<sup>156</sup> Moreover, no mention seems to be made of the possible criminal liability which might result from the declaration of a dividend in the face of known insolvency. Nevertheless, the circuit court of appeals affirmed the Board's decision and the Supreme Court has just denied certiorari.

11. *Incorporated talents cases.* These are *sui generis*. The imponderable factor of credibility of witnesses was probably largely responsible for the result in each case. Of the four cases, two involved motion picture directors, the brothers De Mille;<sup>157</sup> the other two involved cartoonists, "Bud" Fisher<sup>158</sup> and Fontaine Fox.<sup>159</sup> The De Mille brothers advanced as the reason for the accumulation by their corporations that they were

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wipe out the surplus but not the capital. However, no point seems to have been made in these cases of the illegality of a dividend declaration. On the other hand, the question was raised in the *R. & L.* case and *Saenger* case, but the Board pointed out that the companies involved had surpluses, even allowing for the depreciated values of their assets, and hence were not prevented by the local law (La.) from making distributions.

154. The Board's opinion included a dictum to the effect that a rise in the market value of the company's securities would not have been significant in discovering the applicability of Section 104. This does not appear to be sound. Suppose a corporation has a modest accumulation of current income and tremendous unrealized gains. Why should not the latter be considered in measuring reasonableness or ascertaining purpose?

155. Blaffer's wife owned almost half the stock.

156. The assets would have been depleted to the extent the dividend was payable to others than Blaffer and to the extent that Blaffer individually might have become insolvent.

157. See notes 77 and 46 *supra*.

158. *Fisher & Fisher, Inc. v. Comm'r*, 32 B.T.A. 211 (1935), *aff'd per curiam*, 84 F. (2d) 996 (C. C. A. 2d, 1936).

159. *Reynard Corp. v. Comm'r*, 37 B.T.A. 552 (1938), *petition for review dismissed*, (C. C. A. 2d, 1938) (unreported).

building up surplus to a point where they could achieve independent picture production instead of relying on the major companies to finance their productions.<sup>160</sup> The Board upheld Cecil, but William lost his case. Although William started out on the straight and narrow path—the Board held that his company was not liable for 1924 and 1925—he strayed from it in 1926, when, in connection with a divorce from his then wife, he borrowed large amounts from the corporation in order to settle with her. The corporation's advances to William De Mille proved to be the turning point against him. It was held that when he borrowed a large amount from the corporation for personal purposes, he abandoned his original purpose and his company was held liable for the years 1926, 1927 and 1928.

The *Fisher* and the *Fox* cases are more difficult to reconcile than the *De Mille* cases. The principal reason advanced for accumulation in each case was that the corporation was building up surplus so that it would have capital with which to effect distribution of its own comic strips in case the syndicates through which distribution was normally effected should fail, or refuse to renew the distribution contracts. Each also advanced the argument that it would be necessary to accumulate money with which to finance the production of animated cartoon movies. The Board evidently believed the story told on Fisher's behalf, but found Fox's story less persuasive.<sup>161</sup>

12. *Income used to pay off obligations.* Another interesting series of cases in which the personal element has apparently played an important part consists of *Sauk*,<sup>162</sup> *Mead*,<sup>163</sup> *Rofam*<sup>164</sup> and *Beim*.<sup>165</sup> In each of these cases, the corporation acquired assets (stock of another company) and assumed obligations in connection with the acquisition of these assets. The income was used to pay off the obligations. In the *Sauk* and *Rofam* cases, the Board believed the testimony that the corporations were organ-

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160. In the *National Grocery Company* case, Kohl had argued that he was obsessed with the idea of expansion—of adding more stores to his chain—and that the accumulation was to finance such expansion and fulfill his ambition. The Supreme Court answered that since Kohl was the sole owner of the company, his purpose could have been achieved through distribution and individual reinvestment of the corporate earnings (depleted, of course, by individual tax) as well as through accumulation of the corporate earnings. As a general proposition, this reasoning is decidedly tenuous—it overlooks the fact that the stockholder and his corporation are separate entities and that the legitimate purposes of each may not coincide—but it could equally be applied to the *DeMille* cases. It is conceivable that if Cecil's case had been decided after the Supreme Court decision in *National Grocery Company* his corporation would have met the same fate as his brother's.

161. It is interesting to note that the same attorney counseled both Fox and Fisher.

162. See note 119 *supra*.

163. *Mead Corp. v. Comm'r*, 38 B.T.A. 687. See note 20 *supra*.

164. See note 139 *supra*.

165. *Beim Co. v. Landy*, D. Minn., Sept. 19, 1939.

ized for legitimate purposes and that the accumulation of income was incidental.<sup>166</sup> On the other hand, in the *Mead* case, Mead's contention that he had not formed his corporation for the prohibited purpose was weakened by the fact that he also formed another corporation, which held the stock of the first, at a time when it was thought by many that the provisions of Section 102 could be successfully dodged by the interposition of a second corporation between the stockholder and the first corporation.<sup>167</sup> Aside from the element of credibility, there is little to distinguish the *Beim* case from the *Sauk* decision. A case related to these four cases is *Dill Manufacturing Company*<sup>168</sup> where preferred stock had been issued to minority common stockholders in part payment for their common, and the accumulated earnings were thereafter used in part to buy in such preferred stock.<sup>169</sup> The company was held not taxable, the Board stating that the preferred stock, which had to be retired within five years, was in the nature of a debt.

Presumably, the indebtedness which is paid off with the accumulated income must be bona fide, *i.e.*, it must not be incurred with the idea of using it as a shield against the application of Section 102. Any other interpretation would make evasion of the section easy. For example, if an individual owning unencumbered real estate worth \$1,000,000 transfers it to a wholly owned corporation which issues to him \$100,000 of stock and a purchase money mortgage of \$900,000, the use of the income to make principal payments on the mortgage should rather conclusively indicate the presence of the condemned purpose.

One writer<sup>170</sup> advocates the proposition that "the accumulation of corporate profits to discharge a mortgage debt, incurred prior<sup>171</sup> to the acquisition of the mortgaged assets by the corporation, is not such a reasonable accumulation as to excuse the payment of taxes thereon by the stockholders, or by the corporation for them . . ." He argues that a "contrary holding would open the door to a simple method of tax evasion," and suggests an example in which an individual organizes a

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166. The *Rofam* case was probably strengthened by the fact that distribution of its income would not have resulted in any appreciable tax to the shareholders. But the Board did not comment on this point.

167. See note 20 *supra*.

168. See note 50 *supra*.

169. *Cf. Williams Investment Co.* case, 3 F. Supp. 225 (Ct. Cl. 1933), in which the reason advanced for accumulation was a desire on the part of the controlling stockholder to acquire the minority stock in another corporation—a newspaper company. (The taxpayer corporation already held a majority interest in the newspaper company). The court stated that this was a private purpose of the controlling shareholder rather than a corporate purpose.

170. Graubard, *loc. cit. supra* note 83.

171. The significance of the time of incurring the debt is not clear. Logically, there is little distinction between investing accumulated income in new property and using it to pay off incumbrances on old property.

corporation to which he transfers \$100,000 with which the corporation buys apartment houses of a value of \$1,000,000 with mortgage encumbrances, presumably held by outsiders, to the extent of \$900,000 due in twenty years. The corporation does not declare any dividends but accumulates its income against the day when the mortgage matures.<sup>172</sup> "All objective tests of determining intent in such a case," it is said, "fall down, once it is conceded that an accumulation need only be made for a reasonable business [purpose?] to be outside the scope of the statute." This argument, however, overlooks the fact that the ultimate test of liability under Section 102 is not the reasonableness of the accumulation but the presence of the condemned purpose; and if, in the case suggested, the surrounding circumstances indicated the existence of the proscribed motive, the mortgage liability would not save the corporation from the penalty tax. The courts have not experienced insuperable difficulty in finding the interdicted purpose even where the accumulation of income was not unreasonable.<sup>173</sup>

Another writer,<sup>174</sup> commenting on the provision in the Regulations<sup>175</sup> that "undistributed income is properly accumulated if . . . in accordance with contract obligations placed to the credit of a sinking fund for the purpose of retiring bonds issued by the corporation" suggests that it affords "a facile mode of escape from the application of the statute." He goes on to point out that:

"In England, after five years of experience with a statute similar in many ways to ours, the law was amended so as to exclude from the scope of 'reasonable needs of the business' the withholding of corporate profits for the purpose of (1) payment for the business, undertaking or property which the company was formed to acquire or which was the first business undertaking or property of a substantial character in fact acquired by the company; or (2) repayment of any share, loan or debt incurred on account of such purchase; or (3) meeting any obligations, incidental to such purchase, otherwise than in pursuance of an obligation entered into before August 4, 1914; and (4) payments made on account of any fictitious or artificial transaction."<sup>176</sup>

Aside from the fact that under the English law, liability turns solely on the reasonableness of the accumulation rather than on purpose,<sup>177</sup> the provision mentioned in the above quotation is perhaps justified because capital gains under British law are not taxable and the increase in the

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172. Sherman, *supra* note 51, n. 69.

173. *E.g.*, United Business Corp., Rands, Inc., Nipoch, Blaffer cases, etc.

174. Sherman, *loc. cit.* *supra* note 51.

175. U. S. Treas. Reg. 101, Art. 102-3.

176. See also CARROLL, TAXATION OF BUSINESS IN GREAT BRITAIN (published by the Dep't of Commerce in 1928 as Trade Promotion Series, No. 60) 72-74.

177. See note 297 and pp. 218-219 *infra*.

stockholders' equity resulting from application of the accumulated earnings to the payment of corporate indebtedness of the kind mentioned would otherwise completely escape tax even when realized on a disposition of the stock. At any rate the existence of an analogous provision in our law would undoubtedly hamper borrowing for legitimate corporate expansion, and it is doubtful whether such a provision would be necessary or even justifiable.

13. *The closeness of the corporation.* While this has never been mentioned in any of the cases, it is undoubtedly a factor. In almost all the cases involving Section 102 or its forebears, the corporation was owned either by a single stockholder or by a controlling stockholder and the members of his immediate family. Normally, the greater the number of stockholders, and the wider the distribution of the stock, the less will be the incentive to withhold dividends in order to achieve the condemned purpose.

Up to 1934, the Regulations stated that the statutory presumption applicable to a mere holding or investment company could be overcome by showing that the "stock was held not by members of a family or of a small group but by a large number of persons and in comparatively small blocks."<sup>178</sup> Presumably this provision was designed to allay the fears of legitimate publicly owned investment trusts. However, the Regulations were changed in 1934<sup>179</sup> and the provision was eliminated.

14. *Form in which accumulated earnings are invested.* The Regulations contain the statement: "The nature of the investment of earnings or profits is immaterial if they are not in fact needed in the business."<sup>180</sup> Nevertheless, in at least three cases the form in which the accumulated earnings were invested was a factor. Thus, in the *National Grocery Company* case, the fact that they were largely invested in the stocks and bonds of banks, public utilities, railroads, etc., having no direct or indirect relationship to the grocery business, was apparently given weight.<sup>181</sup> However, in the *Spitzner* case,<sup>182</sup> the fact that they were invested to a substantial degree in securities of tobacco companies, with which the Spitzner company did business, and in *Charleston Lumber Company*,<sup>183</sup> that they were invested in local real estate and securities of local companies, the Charleston company being engaged in the building materials business,

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178. U. S. Treas. Reg. 77, Art. 542.

179. T. D. 4470, XIII-2 CUM. BULL. 151 (1934).

180. U. S. Treas. Reg. 101, Art. 102-3. This is, of course, correct in so far as it affects the question of reasonableness. If the accumulation is in fact unreasonable, the form it takes can have no bearing on the applicability of the statutory presumption.

181. Cf. *Industrial Bankers Securities Corp. v. Higgins*, 104 F. (2d) 177 (C. C. A. 2d, 1939), involving a financing company, where temporary investments in stocks of unrelated companies did not prevent a finding in the company's favor.

182. See note 128 *supra*.

183. See note 101 *supra*.

was apparently given weight in deciding the case favorably to the taxpayer.

Reinvestment of the earnings in additional productive plant and equipment should, of course, be a conclusive answer to any charge of unreasonable accumulation.<sup>184</sup>

15. *Effect (under prior Acts) of shareholders reporting corporate income.* One other problem remains to be considered before leaving Section 102. It involves a situation that would not arise under current law, but might arise under Acts prior to the 1938 Act. *Mellon, et al, Executors v. Commissioner*<sup>185</sup> posed the question. There Richard Mellon had included in his 1930 individual return, pursuant to subdivision (d) of the penalty section as it stood prior to the 1938 Act,<sup>186</sup> what he thought was the entire undistributed income of the Mellbank corporation, the same corporation which was held not taxable for 1932 in the *Mellbank* case.<sup>187</sup> The Government adjusted the income of the Mellbank corporation for 1930 and took the position that since Mellon who owned all of the company's stock had elected to report the undistributed income, he would be required, upon adjustment of that income, to include the increased amount. Mellon's executors, on the other hand, claimed a refund on the amount which had already been reported, claiming that the company was not guilty of the condemned purpose in 1930. The Board upheld the executors, and allowed the refund, stating that since the interdicted purpose was not present, Mellon had no right to elect under subdivision (d) to report any part of the undistributed income. The result in the *Mellon* case may be correct, but the Board's reasoning is specious. The Board said: "To hold otherwise would be to permit the shareholders of any corporation to choose the year in which they desired to be taxed on their distributive shares of the corporate earnings, whether distributed or not." But did not the shareholders already have this option, since the declaration of a dividend and its reinvestment is ordinarily within their choice? However, a more appealing argument would have been that since Mellon had not included *all* of the corporation's income in his individual return, he had not relieved his company from liability under the penalty section, and hence should not be bound by his election.<sup>188</sup>

184. Cf. *Dill Mfg. Co. v. Comm'r*, 39 B.T.A. 1023 (1939) and *J. E. Baker Co. v. Comm'r*, Memo. B.T.A. Docket No. 87,758, June 6, 1939.

185. 38 B.T.A. 1259 (1938).

186. The provision referred to is no longer in the law. See p. 180 *supra*.

187. See note 118 *supra*.

188. But cf. *Clay v. Comm'r*, 40 B.T.A. No. 88 (1939); *Gardiner v. Welch*, 17 A. F.T.R. 1047, 1937-1 CUM. BULL. 256 (S. D. Cal. 1936), in which the shareholders included their proportionate distributive shares of the corporation's income in their individual returns and then sued to recover the resulting tax on the grounds that the guilty purpose was not present. The court denied recovery and held further that the proscribed purpose was present.

## IV. PERSONAL HOLDING COMPANIES GENERALLY

The personal holding company, as a creature of income tax law, was first born in 1934 when Congress tardily recognized that Section 102 was not a particularly effective contraceptive. In casting about for methods of reaching accumulated corporate income, the legislators accepted the suggestion that personal holding companies be placed in a separate category and be subjected to a special surtax on their undistributed income — such surtax to be in addition to the normal corporation tax and to be imposed regardless of the reason for non-distribution. It was soon discovered that the original rates<sup>189</sup> were too low to be fully effective and in 1935 they were raised;<sup>190</sup> but these increased rates never became operative as they were only applicable to years beginning after December 31, 1935, and were superseded by the 1936 Act. The 1936 Act lowered the 1935 rates because of the co-existence of the undistributed profits tax,<sup>191</sup> but did not otherwise make any changes of vital importance to the personal holding company provisions. However in 1937, Congress discovered that the burdens of existence as a personal holding company, even with the combined increased rates of surtax — undistributed profits and personal holding company — provided for by the 1936 Act were not quite so disagreeable as it had thought.<sup>192</sup> Furthermore, many of the reprobate corporations at which the 1934–1936 provisions were aimed found it not too difficult to wash off the scarlet letters by which they were labeled and to assume the guise of respectable corporations.<sup>193</sup> Still further it was found that incorporated talent corporations and foreign corporations owned by Americans were successfully eluding not only the personal holding company provisions, but Section 102 as well. The disclosure in 1937 of these infirmities of the law during the Hearings before the Joint Committee on Tax Evasion and Avoidance<sup>194</sup> resulted in the corrective legislation discussed hereinafter, including the separate classification of “foreign” personal holding companies and the imposition of

189. The rates under the 1934 Act were: 30% on the first \$100,000, and 40% on the remainder of the undistributed net income.

190. Except that the lowest bracket was lowered; the rates under the 1935 amendment to the 1934 Act—the amendment, as stated in the text, never became operative—were: 20% on the first \$2,000 of undistributed adjusted net income; 30% on the next \$98,000; 40% on the next \$400,000; 50% on the next \$500,000; and 60% on the balance.

191. The rates of personal holding company surtax under the 1936 Act were exactly 12% less in each bracket than the rates given in the preceding footnote.

192. Even under the combined surtaxes of the 1936 Act, it was possible by the use of multiple personal holding companies with sufficiently small incomes to put them into lower brackets to avoid tax. *Report of the Ways and Means Committee*, H. R. REP. No. 1546 (1937) 3. However, the provisions of the 1934 and 1936 Acts were not nearly so ineffective as some of their critics intimated. See p. 176 *supra*.

193. See pp. 175–176 *supra*.

194. See pp. 177–178 *supra*.

a 75% surtax on undistributed adjusted net income (65% on the first \$2,000) against other personal holding companies.

The 1938 Act made no significant changes with regard to personal holding companies. The 1939 Act denies them the benefit of the capital loss provisions which will be available to other corporations beginning with 1940.<sup>195</sup> It also<sup>196</sup> denies them the benefit of the two-year net loss carryover, but apparently it still permits them to deduct, in computing the income subject to surtax, or taxable to the shareholders, the one-year loss carryover allowed by Section 26(c).<sup>197</sup>

Of course, all personal holding companies were not conceived in sin — many were organized for legitimate personal or business reasons; but Congress has made little distinction between the goats and the sheep. Moreover, some of the victims are being spanked much more vigorously than they, and perhaps Congress, anticipated — and without regard to the heinousness of past tax obliquities. For instance, consider the case of a domestic personal holding company which has taxable income but has neither accumulated earnings or profits<sup>198</sup> of past years<sup>199</sup> (after February 28, 1913), nor earnings or profits of the taxable year. This situation will arise where the corporation has non-deductible capital losses or other non-allowable expenses or losses which more than offset the current income. Under existing law such a corporation will perforce be subject to a 75% surtax on its net income (65% on the first \$2,000). It cannot escape this tax, because even if it makes a distribution to its shareholders equal to its taxable net income, that distribution, not being out of earnings or profits of either the taxable or past years, is not a "dividend" within the meaning of Section 115(a) and hence cannot constitute any part of the dividends paid credit allowed by Section 27.<sup>200</sup> The tax cannot be avoided even if all the stockholders, under the consent dividend provisions of Section 28(f), elect to include their proportionate shares of the corporation's taxable net income in their individual returns, because under subdivision (c) of Section 28 the corporation may include

195. REVENUE ACT OF 1939, § 212 (a), amending § 117 of the Code.

196. REVENUE ACT OF 1939, § 211 (b), adding § 122 to the Code.

197. This carryover which is allowed by virtue of being included in the basic surtax credit, § 27 (b), is computed somewhat differently from that allowed by § 23 (s). See note 58 *supra*.

198. Taxable income is not, of course, synonymous with "earnings or profits." See U. S. Treas. Reg. 101, Art. 115-3; PAUL AND MERTENS, LAW OF FEDERAL INCOME TAXATION (1934) ¶ 8.40 *et seq.*

199. The accumulated earnings of a predecessor corporation, acquired by the successor corporation in a tax-free reorganization will be considered earnings of the successor in determining the dividend status of distributions by the latter. *Acce Corp. v. Comm'r*, Memo. B.T.A. Docket No. 93,368, Sept. 30, 1939.

200. Section 27 (i) provides that a distribution which is not a taxable dividend is not to be included in the basic surtax credit. A distribution is not a taxable dividend unless made out of earnings or profits of either the current or past years. § 115 (a).

in its basic surtax credit only so much of the consent dividend as it would have been entitled to include had it made actual distribution in cash.<sup>201</sup> As a consequence, a corporation unfortunate enough to find itself in this position is enclosed in a straight jacket from which no one but Congress or the courts can extricate it.

That scant help is to be expected from the courts is foreshadowed by the decision in *Foley Securities Company v. Commissioner*.<sup>202</sup> In that case, which involved Section 351 of the 1934 Act, a personal holding company distributed approximately \$42,000 to its stockholders in 1934. Its net earnings during the taxable year amounted to about \$49,000; but due to the fact that the company had an operating deficit of about \$23,000 at the beginning of the year, its accumulated earnings amounted to only about \$26,000, and hence only that amount was treated as a taxable dividend.<sup>203</sup> The Commissioner ruled that in computing the undistributed income which measured the tax imposed by Section 351, the credit allowed by subdivision (b) (2) (C) of that section for dividends paid during the year, referred only to a dividend within the definition of that term contained in Section 115; and that accordingly there could be deducted only that part of the dividend which was out of accumulated earnings and hence taxable to the stockholders. The Board, in sustaining the Commissioner, interpreted the intention of Congress as follows:<sup>204</sup> "The purpose of Section 351 [now Section 500 of the Code] was apparently to subject all the income of personal holding companies to surtax either in the hands of the stockholders or in the hands of the corporations themselves."<sup>205</sup>

As a general proposition, this seems to be sound enough, especially where, as under the 1934 Act, the stockholders can save the corporation

201. *Report of the Ways and Means Committee*, H. R. REP. No. 1860, 75th Cong., 3d Sess. (1938) 24-25. Note also § 504(a) which specifically excludes from the dividends paid credit for personal holding company surtax purposes, the deficit credit allowed in § 27 (a) (3).

202. 38 B.T.A. 1036 (1938), *aff'd*, C. C. A. 8th, Oct. 11, 1939.

203. Under the 1936 and subsequent Acts—§ 115 (a)—"dividend" is defined to mean a distribution out of (1) earnings or profits accumulated after February 28, 1913, or (2) earnings or profits of the taxable year without regard to the amount of accumulated earnings or profits. But clause (2) was not contained in the 1934 Act (or earlier Acts), and consequently even though the Foley company had earnings of the taxable year (\$49,000), its distribution was only a taxable dividend to the extent of the accumulated earnings (\$26,000).

204. 38 B.T.A. 1036, at 1037 (1938).

205. The Board virtually repeated this in *Gaston & Co. v. Comm'r*, 39 B.T.A. 640 (1939) (also involving § 351 of the 1934 Act), and held that a distribution in liquidation, not being taxable to the shareholders (unless in excess of basis), was not an allowable dividend credit in computing the personal holding company surtax. But under current law, a credit would apparently be allowed with respect to liquidating distributions under certain circumstances. See U. S. Treas. Reg. 101, Art. 27 (g)-1; also I. T. 3067, 1937-1 CUM. BULL. 91.

from the surtax by including their proportionate shares of the corporate net income in their individual returns.<sup>206</sup> But under existing law, as indicated above, this avenue of escape is not open to a corporation without accumulated earnings or earnings of the taxable year: the 75% surtax is automatically imposed.<sup>207</sup> An inescapable tax of this size imposed on only a limited class of taxpayers, whose existence is not vicious *per se*, is so arbitrary and unreasonable, and comes so close to confiscation, that serious question must exist as to its validity.<sup>208</sup>

The constitutional point in the *Foley* case was apparently not pressed strenuously before the Board, although it was in the appellate court. The Board contented itself with the observation that doubts as to the validity of Section 351 of the 1934 Act had been set at rest by the determination — in the *National Grocery Company* case — that Section 102 is valid. But this observation is not at all persuasive — the appellate court did not even refer to it — as the tax imposed by Section 102 is a penalty tax necessary to prevent evasion and applicable only when an oblique purpose is present. However, the personal holding company surtax, at least in the absence of an escape provision corresponding to Section 351(d) of the 1934 Act, is imposed even in the face of the most innocent motives. Strangely, neither the Board nor the appellate court in sustaining Section 351 of the 1934 Act mentioned the safety valve contained in subdivision (d). Yet its presence suggested the strongest reason for upholding the provision's validity. The court paid lip service to the

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206. Section 351 (d) of the 1934 Act. A similar option was available under the 1936 Act. [§ 351 (d)] subject to the qualification that 90% or more of the adjusted net income had to be reported in the returns of non-corporate taxpayers. In *Clay v. Comm'r*, 40 B.T.A. No. 88 (1939), it was held that where the sole stockholder of a personal holding company had elected to be taxed under this section, the Commissioner could increase to the correct amount, the amount she had reported. *Cf. Mellon et al. v. Comm'r*, 38 B.T.A. 1259 (1938).

207. Complete liquidation of such a company during the taxable year would probably *not* avoid the prohibitively high surtax. In I. T. 3067, note 205 *supra*, it was ruled that a corporation which liquidated completely in 1936 was entitled to a dividends paid credit (for undistributed profits surtax purposes) equal to its earnings or profits for that year notwithstanding the fact that it had no accumulated earnings. (The deficit at the beginning of the year exceeded the earnings for the year). This ruling appears to go beyond the literal meaning of § 27 (g) and (i). At any rate, it is doubtful whether the ruling would extend to a corporation with *neither* accumulated earnings *nor* earnings of the taxable year.

208. It has been said that by the 1937 (Loophole) Law, Congress imposed a death sentence against the use of personal holding companies as a tax-avoiding device. Paul, *The Background of the Revenue Act of 1937*, *op. cit. supra* note 29, at 62; *Sanford Corp. v. Comm'r*, C. C. A. 3d, Sept. 21, 1939. But this is not to say that Congress intended to sound the death knell of personal holding companies. Such companies very often do serve useful and legitimate purposes, and it is questionable whether the Federal Government could validly use its taxing powers to legislate them out of existence. *Cf. Bailey v. Drexel Furniture Co.*, 259 U. S. 20 (1922).

well-established rule that a too literal interpretation of a statute will be departed from where the intention of the law makers was clear and a strict construction would defeat that intention, lead to absurd consequences or entail great hardship,<sup>209</sup> but refused to apply it, concluding "that Section 351 must be taken to mean exactly what it says."<sup>210</sup>

On the constitutional question, the court held that Section 351 violated neither the Sixteenth nor the Fifth (due process) Amendments. Scarcely any quarrel can be made with the conclusion that the tax in the *Foley* case did not violate the Sixteenth Amendment: it was imposed on income, not capital. But the determination with respect to the applicability of the due process amendment does not appear to be on equally firm ground. The court itself indicated that the ground was thin by pointing out that a literal adherence to the Statute had the effect of placing personal holding companies with an impairment of capital in a far worse position than those without an impairment of capital, and this for no apparent reason. Hence, despite actual distribution of the current income, the companies "with the largest operating deficits were required to pay the largest surtaxes."<sup>211</sup> Notwithstanding the illogic and unreasonableness of this result, the court, relying in part on a dictum in the *Social Security Tax* case,<sup>212</sup> and the dissenting opinion of Mr. Justice Stone in *Heiner v. Donnan*,<sup>213</sup> concluded that Section 351 does not violate the Fifth Amendment.

The result in the *Foley* case would seem to be correct in the light of the escape provision contained in subdivision (d) of Section 351 of the 1934 Act, although the court's reasoning would appear to better support a contrary determination. However, as heretofore indicated, the elimination of the escape mechanism raises doubts as to the validity of the corresponding section of current law in so far as it affects companies with no accumulated earnings and no taxable year earnings.

While some personal holding companies, like those in the situation discussed above in connection with the *Foley* case, have turned out to be

209. An illustration much in point is the last sentence of U. S. Treas. Reg. 101, Art. 401-1, which excludes certain foreign corporations from the definition of "personal holding company." A literal construction of the Statute will not support this provision, which was undoubtedly inserted to avoid absurd and harsh consequences. See pp. 214-215 *infra*.

210. No consideration appears to have been given to the point that the personal holding company surtax, being an outgrowth of § 102, was only intended to reach companies which that section (prior to amendment) might encompass. The *Foley* company, having no accumulated earnings or profits, would not have been subject to § 102.

211. *Cf. Crane-Johnson Co. v. Comm'r*, 38 B.T.A. 1355 (1938), *aff'd*, 105 F. (2d) 740 (C. C. A. 8th, 1939), holding that the undistributed profits surtax as applied to a deficit corporation prohibited by local (North Dakota) law from declaring a dividend, was constitutional.

212. *Stewart Machine Co. v. Davis*, 301 U. S. 548 (1937). "There are, however, limits to the power of Congress to create a fictitious status under the guise of supposed necessity." *Helvering v. City Bank Co.*, 296 U. S. 85, 92 (1935).

213. 285 U. S. 312 (1932).

Frankensteins which are devouring their creators, personal holding companies may not be entirely without their tax uses. For instance, they may still be used to, in effect, convert a long term capital gain or loss into a short term capital gain or loss, or vice versa; so that one kind of loss could be offset against the other kind of gain, a procedure forbidden to individuals.<sup>214</sup> To take a concrete example: an individual desires to realize a \$100,000 short term loss and a \$100,000 long term gain. As an individual he cannot offset one against the other; but by transferring the respective assets to a wholly owned corporation which then proceeds to sell them, the offset is in effect accomplished. Or suppose an individual owning all the stock of a foreign personal holding company transfers it to an irrevocable trust of which he is the life beneficiary, the remainder over to other persons. For trust accounting purposes the beneficiary is entitled only to dividends actually paid by the corporation. Accordingly, by paying half the corporation's income out in dividends and accumulating the other half in the corporation so that the trustee of the trust will pay the tax on the undistributed half, the income is chopped down into two equal piles at a considerable saving in tax. However, there is a possible flaw in this latter plan, as it may be held that it comes within the provisions of Section 167, relating to trusts where the income is accumulated for the benefit of the grantor.

It may also be possible to convert a cash sale of property into an installment sale through the use of a personal holding company. The Supreme Court will soon pass on this question, since it recently granted certiorari in *Griffiths v. Commissioner*.<sup>215</sup>

#### A. Foreign Personal Holding Companies

Before a company may be classified as a foreign personal holding company, it must be a foreign corporation, *i.e.*, it must be organized under the laws of some foreign country and it must meet two tests, one known as the gross income requirement, and the other known as the stock ownership requirement.<sup>216</sup>

1. *Gross income test.* This requirement is met if 60% or more of the company's gross income<sup>217</sup> for its taxable year consists of foreign personal holding company income as that term is defined by the Statute. Moreover, in order to prevent circumvention of the Statute by manipulation of the corporation's affairs so that its foreign personal holding

214. Section 117.

215. 103 F. (2d) 110 (1939), *cert. granted*, U. S. Sup. Ct. No. 49, Oct. 9, 1939.

216. Section 331 (a). The definition does not include a corporation exempt from taxation under § 101, § 331 (b).

217. Gross income is not synonymous with gross receipts. U. S. Treas. Reg. 101, Art. 331-2.

company income will be just under the 60%, the Statute goes on to provide that if once a company has fallen within the foreign personal holding company category, it continues to be such even if its gross income from foreign personal holding company sources drops to 50%, until either three consecutive years have elapsed in each of which the foreign personal holding company income constitutes less than 50% of the gross income, or until a year occurs in which the stock ownership requirement is not met.<sup>218</sup>

2. *Stock ownership test.* The stock ownership requirement is met if at *some* time during the taxable year more than 50% in value<sup>219</sup> of the company's outstanding stock<sup>220</sup> is owned — in the sense that the word is used in the Statute — by not more than five individuals who are citizens or residents of the United States.<sup>221</sup> In order to prevent escape from the stock ownership requirements by the distribution of stock to members of one's family or by the interposition of some other entity between the stock and the real owner, the law provides that in applying the stock ownership requirement an individual is deemed to own not only stock which he actually or directly owns, but also stock which he indirectly or constructively owns.<sup>222</sup> For this purpose an individual owns indirectly a proportionate share of the stock owned directly or indirectly by a corporation of which he is a shareholder, or by a partnership of which he is a partner, or by an estate of which he is a beneficiary.<sup>223</sup> He constructively owns stock owned directly or indirectly by a member of his family or his partner; the term "family" being defined to embrace spouse, ancestors, descendants and brothers and sisters, including half-brothers and sisters.<sup>224</sup> He also constructively owns stock on which he has an option.<sup>225</sup> Securities such as bonds which are convertible into stock are counted as stock according to certain elaborate rules.<sup>226</sup>

218. Section 331 (a) (1). If a foreign operating company owned by Americans is abnormally inactive for a particular year, it may unwittingly find itself an unintended victim of the foreign personal holding company provisions.

219. The Regulations [U. S. Treas. Reg. 101, Art. 331-3] state that the value "may be determined upon the basis of the company's net worth, earning and dividend-paying capacity, appreciation of assets, together with such other factors as have a bearing upon the value of the stock." Where there is more than one class of stock outstanding, the value of each class must be determined.

220. In *Collateral Equities Trust v. Comm'r*, 39 B.T.A. 834 (1939), it was held that outstanding stock includes stock subscribed and paid for but not evidenced by certificates, and that local law controls the status of stock ownership. The petitioner was held *not* a personal holding company.

221. Section 331 (a) (2).

222. Section 333.

223. Section 333 (a) (1).

224. Section 333 (a) (2).

225. Section 333 (a) (3).

226. These rules are set out in § 333 and U. S. Treas. Reg. 101, Art. 333 (a)-1 to 7. The rules as to constructive ownership and convertible securities, all of which are designed

3. *Foreign personal holding company income.* Generally speaking, foreign personal holding company income<sup>227</sup> includes dividends,<sup>228</sup> interest,<sup>229</sup> royalties, the taxable portion of annuities,<sup>230</sup> gains from the sale or exchange of stock or securities (except in the case of dealers — as distinguished from traders — in stock or securities), gains from transactions in commodity futures (except bona fide hedging transactions), income from estates or trusts, income from personal service contracts of the type involved in the incorporated talent cases,<sup>231</sup> rent or other compensation for the use of the corporation's property by its shareholders (to close up the incorporated yacht or incorporated country estate loophole),<sup>232</sup> and rents, unless such rents, not counting amounts received from the shareholders, constitute 50% or more of the gross income. This last provision is intended to prevent bona fide real estate corporations from being caught by the foreign personal holding company provisions. In the case of personal service contracts and compensation for the use of the corporation's property by a shareholder, the income is not includible unless at some time during the taxable year the shareholder in question owns directly, indirectly or constructively 25% or more in value of the company's stock.<sup>233</sup> The Treasury Department apparently takes the position<sup>234</sup> that gains on sales of property required to be included refer to the total of all gains rather than to the gains less losses, *i.e.*, the net gain, and the statutory language<sup>235</sup> is broad enough to justify this construction. Thus a company which has \$100,000 of gains and \$90,000 of losses on sales of property will, in determining whether it meets the gross income test, include in foreign personal holding income not \$10,000 but \$100,000.

4. *Undistributed Supplement P net income taxed to shareholders.* Supplement P does not impose any tax on the corporation, although the corporation is still subject to the regular corporate taxes on income from

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to prevent evasion of the stock ownership requirement, are only applicable if they operate to make the company a foreign personal holding company. [§ 334 (a) (4)]. Otherwise they are not applicable, *i.e.*, if, as a result of these rules, but not otherwise, the company is taken out of the personal holding company classification, the rules do not apply.

227. Section 332.

228. This includes dividends as defined in § 115 (a) and amounts acquired to be included in income under Supplement P. U. S. Treas. Reg. 101, Art. 332-1 (1).

229. In *Elverson Corp. v. Comm'r*, 40 B.T.A. No. 97 (1939) it was held that although the excess of the value of collateral acquired on a note default over the cost of the notes represented income, it was not "interest" income. This determination saved the taxpayer more than half a million dollars in personal holding company surtax.

230. U. S. Treas. Reg. 101, Art. 332-1.

231. See p. 177 *supra*.

232. See p. 177 *supra*.

233. Section 332 (f).

234. U. S. Treas. Reg. 101, Art. 332-1.

235. Section 332 (b) and (c).

United States sources.<sup>236</sup> Instead, Section 337 requires each United States shareholder<sup>237</sup> in a foreign personal holding company on the last day during its taxable year on which it was a foreign personal holding company, to include in his (or its) return as a dividend the amount which would be received by him (or it) if the company on such last day distributed its entire undistributed Supplement P net income.<sup>238</sup> If the company was not a foreign personal holding company for the entire year, then only a proportionate part of the income is reported. For example, suppose the company's taxable year is the calendar year and that it ceases to be a foreign personal holding company on September 30, 1939; then the persons who are United States shareholders on September 30, 1939, must include in their 1939 returns nine-twelfths of the company's income for 1939, regardless of whether that correctly measures the income for the first nine months of the year or not. Section 334 contains provisions designed to prevent the use of a chain of foreign corporations to evade application of the foreign personal holding company provisions. The Statute does not contain any provision whereby shareholders of a foreign personal holding company may deduct their proportionate shares of any net losses sustained by the corporation.

5. *Constitutionality*. Is this method of taxation valid? In *Collector v. Hubbard*,<sup>239</sup> a similar method of taxation, applicable to corporations generally, was sustained, but in *Eisner v. Macomber*,<sup>240</sup> the majority opinion indicated that the *Hubbard* case was overruled by *Pollock v. Farmers Loan & Trust Company*,<sup>241</sup> which itself has probably been overruled, at least in part, by recent decisions.<sup>242</sup> On the other hand, *Eisner v. Macomber* has been whittled down until about all that remains of it is the rule that a dividend in common stock on common stock is constitutionally exempt.<sup>243</sup> And even if that question were presented anew,

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236. These would depend on whether or not the corporation was resident or non-resident. § 231.

237. This would include citizens or residents of the United States, domestic corporations, domestic partnerships, and estates or trusts (other than foreign estates or trusts). § 337 (a).

238. Each shareholder is entitled to a credit for normal tax purposes equal to his proportionate share of the interest received by the company on federal obligations which is exempt from normal tax. § 337 (c).

239. See note 14 *supra*.

240. See note 12 *supra*.

241. See note 14 *supra*.

242. The doctrine of intergovernmental immunity—state and federal—has certainly been weakened considerably. *Helvering v. Gerhardt*, 304 U. S. 405 (1938); *Graves v. New York ex rel. O'Keefe*, 306 U. S. 466 (1939). See Knollenberg, Book Review (1939) 49 YALE L. J. 158.

243. The Treasury Regulations still contain the Court's definition of income: "In general, income is the gain derived from capital, from labor, or from both combined,

it is conceivable that the bare minority in the *Macomber* case might be a majority today. At any rate, in the *National Grocery* case, Mr. Justice Brandeis, who wrote the minority opinion in the *Macomber* case, said in so many words that Congress could, if it chose, tax the shareholder of a corporation individually on the undivided profits of the corporation; so that perhaps *Collector v. Hubbard* is good law today. There seems to be small chance of the foreign personal holding company provisions being upset on constitutional grounds.

In the *National Grocery* case a question crept in as to the validity of taxing any minority shareholder on his proportion of the undistributed profits of the corporation, since he has no control over the corporation and cannot compel any distribution to himself. The court, however, refused to pass on the question, since there were no minority stockholders in the grocery company. As to minority stock in a corporation organized after the Statute was enacted, no great difficulty presents itself, for it could be justly held that the stockholder acquired his stock with its burdens.<sup>244</sup> But as to a bona fide minority stockholder in a corporation organized before the Statute was passed, the question is not quite so simple. Probably it will be held that since under *Collector v. Hubbard*, Congress always had the power to tax the shareholders on the income of the corporation,<sup>245</sup> the minority shareholder acquired his stock subject to the Congressional exercise of that privilege and therefore could not invoke either the due process clause or the argument that the tax would be on capital rather than income.

6. *Computation of income required to be included by shareholders.* The income which the shareholders must report in their individual returns is termed the "undistributed Supplement P net income."<sup>246</sup> In arriving at this figure, the starting point is the net income<sup>247</sup> computed as if the corporation were a domestic corporation. All of its income and deductions are included regardless of whether from or related to United States

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provided it be understood to include profit gained through a sale or conversion of capital assets."

244. See *United States v. Phellis*, 257 U. S. 156, 171 (1921).

245. Cf. *Helvering v. National Grocery Co.*, 304 U. S. 282 (1938), *rev'd*, 92 F. (2d) 931 (C. C. A. 3d, 1937).

246. U. S. Treas. Reg. 101, Art. 336-2, § 335 contains an illustration of the computation of "Supplement P net income" and "undistributed Supplement P net income."

247. U. S. Treas. Reg. 101, Art. 336-1 defines "Supplement P net income" to mean "the gross income as defined in § 334 less the deductions provided in § 23 . . ." Taken literally, this would permit the deductions, such as losses on intrafamily stock sales, forbidden by § 24, a result surely not intended by the Treasury Department. The Statute (§ 336) simply defines "Supplement P net income" as meaning "the net income" with certain adjustments. This definition plainly contemplates the non-deductibility of the items specified in § 24.

sources,<sup>248</sup> except that the two-year net operating loss carryover,<sup>249</sup> the net short term capital loss carryover, and the unlimited long term capital loss deduction, all of which will, beginning with 1940, be allowed to ordinary corporations, will not be available for Supplement P purposes.<sup>250</sup> This net income is then adjusted by adding back certain non-allowable items, principally<sup>251</sup> the excess of expenses<sup>252</sup> and depreciation over income from incorporated yachts and country estates (although this may be allowable under certain circumstances)<sup>253</sup> and deducting federal income taxes (other than the penalty or personal holding company surtaxes) and charitable contributions in excess of the 5% deduction allowed by Section 23(q) (subject to certain limitations).<sup>254</sup> The resulting figure is termed the "Supplement P net income;"<sup>255</sup> and from it there are deducted in determining the income taxable to the shareholders, dividends paid,<sup>256</sup>

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248. Sections 334 (a), 336. The corporation's share of the Supplement P net income of another foreign personal holding company in which it is a stockholder must be included in gross income under § 334 (b) and (c) both for determining its own Supplement P net income and for determining whether the company meets the gross income requirement.

249. The one-year net loss carryover provided for by § 26 (c) will apparently still be allowable. See p. 203 *supra*.

250. Nor will they be available for personal holding company surtax purposes. Personal holding companies for purposes of computing the surtax or the income taxable to the shareholders, will only be able to deduct capital losses, whether short or long term, to the extent of the capital gains plus \$2,000.

251. Minor non-allowable items are contributions to pension trusts otherwise allowable under § 23 (p) and taxes of a shareholder paid by the corporation otherwise allowable under § 23 (d). § 336 (b) (1).

252. This refers only to expenses allowable under § 23 (a). It does not include items otherwise deductible, such as interest and taxes.

253. Section 336 (b) (2). The loss on such yachts and estates (and similar property) will be allowed if it is established to the satisfaction of the Commissioner that (1) the rent or other compensation received for the use of the property was the highest obtainable, or if none was received, that none was obtainable, (2) the property was held in the course of a business carried on bona fide for profit, and (3) either that there was reasonable expectation that the operation of the property would result in a profit, or that the property was necessary to the conduct of the business. U. S. Treas. Reg. 101, Art. 336-1 states that the burden of proof to sustain the deduction rests on the taxpayer and sets out information required to be included in the shareholder's return where the loss is claimed. The analogous provisions with respect to other personal holding companies are contained in § 505 (b) and Art. 406-1.

254. The limitation is 15% of the company's net income before deducting contributions and the non-allowable items mentioned in the text and note 251 *supra* [§ 336 (b)], and without the inclusion of the company's share of Supplement P income of another foreign personal holding company required to be included under § 334 (b).

255. Section 336.

256. Presumably this would include only dividends within the meaning of § 115 (a). See p. 203 *supra*.

consent dividends,<sup>257</sup> and the net operating loss of the prior year subject to certain limitations.<sup>258</sup>

7. *Effect on basis and on accumulated earnings of the company.* In order to prevent double taxation of the same income, the amount which a shareholder is required to include in his return as his share of the undistributed Supplement P net income is added to the basis of his stock. It is treated as if he had received the dividend and had immediately reinvested it in the corporation,<sup>259</sup> and for the purpose of determining the status of subsequent distributions, such income is treated as a reduction of the accumulated earnings and profits of the corporation.<sup>260</sup>

8. *Special provision with respect to liquidation.* In order that individuals who were alert enough to escape taxes by the use of foreign personal holding companies in years before the present provisions were enacted might not profit too much by their ingenuity, the Statute provides that even in the event of a complete liquidation of such a company, 100% of the gain must be included in income, no matter how long the stock has been held.<sup>261</sup> Moreover, in the event of the death of a shareholder, the basis for his stock can never be increased by enhancement of the value thereof to the date of his death, and such basis must remain at the lower of the decedent's basis or the value at the date of his death.<sup>262</sup>

9. *Special statute of limitations.* There is a special statute of limitations provision with respect to shareholders of foreign personal holding companies.<sup>263</sup> If they omit from their returns any amount properly includible therein under Section 337, the statute of limitations with respect to their returns is extended to seven years after the return is filed, instead of the normal three-year period. Apparently, the Statute would be kept open for the extended period even with respect to items not connected with the foreign personal holding company.<sup>264</sup>

257. Query: Would consent dividends be deductible if there were no earnings or profits? See p. 203 *supra*. If not, a literal construction of the Statute might result in double taxation of the stockholders on the same income.

258. See note 197 *supra*.

259. Section 337 (f).

260. Section 337 (e).

261. Section 115 (c).

262. Section 113 (a) (5). Up to December 31, 1938, it was possible to liquidate a foreign personal holding company and obtain the advantage of the low capital gain tax rate, but in many cases advantage could not be taken of this provision either because the cost was still prohibitive, or else the individual involved did not have sufficient cash with which to pay the tax, even allowing for the fact that under certain circumstances an extension may be obtained for the payment of the resulting tax over a period of five years. Sections 115(c), 56(c) (2) (1938).

263. Section 275 (d).

264. Directors and officers and shareholders are required by the Statute and regulations to make periodical information returns. §§ 338 and 339. U. S. Treas. Reg. 101, Art. 338 and 339.

### B. *Other Personal Holding Companies*

A personal holding company within the meaning of Subchapter A of Chapter 2 of the Internal Revenue Code is a corporation, whether domestic or foreign,<sup>265</sup> which meets two requirements: the gross income requirement and the stock ownership requirement.<sup>266</sup>

1. *Gross income test.* The gross income requirement<sup>267</sup> is similar to the corresponding requirement in the case of foreign personal holding companies,<sup>268</sup> except that the percentages of personal holding company income are 80% and 70% instead of 60% and 50%.

2. *Stock ownership test.* The stock ownership requirement<sup>269</sup> is similar to the foreign personal holding company stock ownership requirement<sup>270</sup> except that in the case of a personal holding company under Subchapter A the test is met only if the requisite ownership exists at some time during the last half of the taxable year (instead of any time during the taxable year) and the requisite stock need not be owned by residents or citizens of the United States.

3. *Personal holding company income.* The definition of personal holding company income<sup>271</sup> is the same as that for foreign personal holding company income,<sup>272</sup> with the following exceptions: (a) mineral, oil and gas royalties are excluded if they constitute 50% or more of the gross income and the deductions allowable to the corporation as business expenses, other than salaries paid to stockholders, constitute 15% or more of the gross income. (This is to exclude legitimate oil operating companies); (b) the term "rents" includes interest on debts owed to the corporation representing the sale price of real estate held by the corporation primarily for sale to customers in the ordinary course of its business. This last provision was added by the 1938 Act and is intended to protect legitimate real estate corporations during a period of real estate inactivity.

4. *Foreign corporations.* A foreign corporation may be a personal holding company within the meaning of Section 501. There is thus

265. See p. 215 *infra*.

266. The item "personal holding company" does not include banks, life insurance companies, surety companies, corporations exempt from taxation under § 101, foreign personal holding companies of the type discussed in the preceding sections, and licensed small loan companies which meet the specifications set out in § 501 (b). (The 1938 Act was the first to exclude small loan companies). Railroad corporations filing a consolidated return under § 141 are subject to the surtax if the parent corporation meets the stock ownership requirement and the group meets the gross income requirement. Section 501(c).

267. Section 501 (a) (1).

268. See p. 207 *supra*.

269. Section 501 (a) (2).

270. See p. 208 *supra*.

271. Section 502.

272. See p. 209 *supra*.

created the anomalous "foreign-domestic" personal holding company — organized under some non-American jurisdiction and controlled by non-resident aliens. Supplement P, on the other hand, reaches a foreign corporation only if it is controlled by United States citizens or residents. While there are perfectly good reasons for including foreign corporations as personal holding companies under Subchapter A of Chapter 2,<sup>273</sup> a literal application of the Statute sometimes produces absurd results. For instance, suppose a foreign corporation having five or less shareholders, all non-resident aliens, receives \$2,000 in dividends from an American corporation, and that this amount constitutes its entire income from United States sources. Assume also that it has net income from non-United States sources of \$100,000, and that the bulk of the company's gross income for three years past has been from sources outside the United States. Even if such a corporation distributes its entire income to its shareholders, such distribution will not be taxable income to the shareholders under United States law.<sup>274</sup> Accordingly, such a dividend will not be allowed as a deduction<sup>275</sup> in computing the undistributed Subchapter A net income, and the \$2,000 will be subject to a 65% tax. In an attempt to avoid this result, the regulations contain a provision<sup>276</sup> to the effect that a foreign corporation will not be treated as a personal holding company if 50% or more of its gross income<sup>277</sup> is derived outside the United States, and if all its stock during the last half of its taxable year is owned, directly or indirectly, by non-resident aliens. While there is no provision in the Statute that authorizes this regulation, it seems reasonable and it is not likely to be challenged, since it is favorable to the taxpayer.

5. *Computation of tax.* The undistributed net income which measures the personal holding company surtax — the rates being 65% on the first \$2,000 and 75% on the remainder<sup>278</sup> is termed "undistributed Subchapter A net income."<sup>279</sup> It is computed in much the same fashion as the undistributed Supplement P net income which the shareholders of a foreign

273. Otherwise nonresident alien individuals with extensive American holdings could by transferring such holdings to a foreign corporation and accumulating the income therein, escape the higher surtax brackets. Even if § 102 were applicable, the maximum surtax would be 35%.

274. Section 119 (2) (B).

275. Section 27 (i).

276. U. S. Treas. Reg. 101, Art. 401-1 (last sentence).

277. For the period specified in § 119 (a) (2) (B).

278. Section 500. These rates are in addition to the ordinary income tax and are sufficiently high to practically force a personal holding company to distribute its income. But note the dilemma of personal holding companies without accumulated earnings or earnings of the taxable year. See pp. 202-204 *supra*.

279. U. S. Treas. Reg. 101, Art. 406-2, § 504, contains an illustration of the computation of "Subchapter A net income" and "undistributed Subchapter A net income."

personal holding company are required to report in their returns.<sup>280</sup> The major differences<sup>281</sup> consist of allowances for the two-year dividend carryover provided by Section 27(c);<sup>282</sup> amounts used or set aside to retire indebtedness<sup>283</sup> of any kind<sup>284</sup> incurred prior to January 1, 1934, if such amounts are reasonable<sup>285</sup> with reference to the size and terms of the indebtedness;<sup>286</sup> and finally dividends paid within two and one-half months after the close of the taxable year.<sup>287</sup> The last mentioned allowance<sup>288</sup> is optional, but is subject to certain limitations, the most important of which is that the after-year dividends may not exceed 10% of the dividends actually paid plus the consent dividends credit.<sup>289</sup> There is also a special credit<sup>290</sup> known as deficiency dividends credit which is

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280. See p. 211 *supra*. In the case of a "foreign-domestic" personal holding company, the starting point would be net income from United States sources, rather than the entire net income.

281. Minor differences are (1) the elimination of the adjustments referred to in note 251 *supra*; (2) a somewhat different computation of the 15% limitation on charitable contributions [§ 505 (a) (2)]; and (3) the allowance of a special deduction for charitable contributions in the case of certain corporations organized prior to January 1, 1936, to take over the assets and liabilities of the estate of a decedent. § 505 (a) (3).

282. This deduction was first granted by the 1938 Act and is allowed by reference from § 504 (a) to § 27 (a) (2). A 1939 amendment liberalizes somewhat the computation of this deduction.

283. The Treasury Department [Reg. 101, Art. 405-2(a)] has defined "indebtedness" as "an obligation, absolute and not contingent, to pay, on demand or within a given time, in cash or other medium, a fixed amount." But the Board has been more liberal; in *Tennessee Co. v. Comm'r*, 40 B.T.A. No. 31 (1939), the Board held that "income notes" payable—both as to interest and principal—only out of earnings, constituted "indebtedness."

284. The words "of any kind" were added by the 1937 Act. Prior thereto, the Treasury (Reg. 86, Art. 351-4) had attempted to confine the meaning of "indebtedness" to "bonds, debentures, or similar obligations representing indebtedness incurred . . . for the purpose of raising capital." But in *American Foundation Co. v. Comm'r*, 40 B.T.A. No. 85 (1939), the Board ruled that the Statute did not warrant any such narrow construction.

285. U. S. Treas. Reg. 101, Art. 405-2 (c) states that: "Ordinarily an amount used to pay or retire an indebtedness, in whole or in part, at or prior to the maturity and in accordance with the terms thereof will be considered reasonable . . ."

286. This deduction is allowed by § 504 (b).

287. In addition to the deductions mentioned, a bank affiliate is entitled to the special credit provided in § 26 (d). This by reference from § 504 (a) to 27 (a) (1) to 27 (b) (3).

288. Section 504 (c). This deduction was first granted by the 1938 Act, presumably to give the corporate officers an opportunity to correct, at least in part, any miscalculation they may have made in their attempt to distribute all of the corporate net income.

289. In other words, there can be shifted to the shareholders' returns for the following year, not more than 10% of the amount included for the taxable year. For the purpose of Subchapter A tax, such after-year dividends once claimed for the preceding year are not again considered as having been paid during the actual year of payment.

290. Section 506 allows the credit and sets forth the conditions under which it may be allowed. The statutory provisions are explained in U. S. Treas. Reg. 101, Arts. 407-1 to 407-7, inclusive.

designed to permit a corporation which has made a bona fide error in computing its income and hence distributed an insufficient amount, to correct the error by paying a dividend equal to the error after it becomes certain the error has been committed.

As in the case of foreign personal holding companies, the deduction for dividends paid<sup>291</sup> apparently refers only to dividends which are taxable to the shareholders (other than exempt shareholders);<sup>292</sup> and the allowance for consent dividends is limited to the amount that would be allowed as a dividends paid credit had actual distribution been made.<sup>293</sup>

## V. CONCLUSION AND RECOMMENDATIONS

Although Section 102 (or its predecessors) has been in the tax law for more than twenty-five years, it has conspicuously failed to achieve its objectives. This was demonstrated when the undistributed profits surtax imposed by the 1936 Act, which was considerably less punitive than the tax imposed by Section 102, caused a flood of dividend distributions— from privately owned as well as publicly owned companies— without serious dislocation of the corporate economic structure.<sup>294</sup> It is significant that this flow of corporate distributions subsided when the undistributed profits tax was emasculated in 1938, even allowing for the fact that corporate earnings generally declined after 1937. The constant legislative efforts to increase the efficacy of the section also attest its relative lack of success.

The problem of protecting the revenue without thwarting legitimate corporate expansion is a difficult one; especially at a time like the present when the disparity between the corporate tax rate and the individual tax rates is so marked. But the present section is no more than a makeshift solution. It is not sufficiently effective in the case of a controlling stock-

291. The dividends paid deduction and the consent dividends deduction are allowed by reference from § 504 (a) to 27 (a) (1) to 27 (b) (1). The one-year net operating loss carryover is deductible by reference from § 504 (a) to 27 (a) (1) to 27 (b) (2).

292. See pp. 203-207 *supra*. An illustration of the strictness with which the deduction for dividends paid is construed is afforded by *Sanford Corp. v. Comm'r*, 38 B.T.A. 139 (1938), *aff'd*, C. C. A. 3d, Sept. 21, 1939. In this case, which, like the *Foley* case, involved § 351 (b) (2) (C) of the 1934 Act, the Sanford Company—a personal holding company—declared a dividend one day before the close of its tax year. However, the sole stockholder, who was the only person who had authority to sign checks, was in a distant state at the time, with the result that although funds were available and the stockholders' account had been credited, payment of the dividend could not be and was not effected until about a month after the close of the year. (The company's accounts were kept on the cash basis). Both the Board and the appellate court ruled that the dividend had not been paid during the taxable year and hence could not be deducted in computing the personal holding company surtax.

293. See pp. 203-204 *supra*.

294. *Report of Ways and Means Committee*, H. R. REP. No. 1860, 75th Cong., 3d Sess. (1938) 2.

holder in high brackets — the maximum penalty is 35% while the maximum individual rate is 79% — and it unfairly penalizes a non-controlling shareholder who happens to fall in the lower tax brackets.

The problem would be far better solved by a return (with corrective modifications) to the provisions of the early Acts of 1913, 1916 and 1918, under which the shareholders of a corporation found guilty of the condemned purpose would be taxed individually on the undistributed income of the corporation.<sup>295</sup> It is true that this method yielded little revenue while it was in force, but this was due partly to defects which can easily be eliminated and partly to the early timidity of the Treasury Department in applying the section. In justice to the Department it should be noted that not only the Treasury but Congress as well was beset by constitutional doubts (which have since been largely dispelled), and that the judicial temper and personnel — allowing for a certain amount of lag — reflected economic and political conditions which were much different then from what they are now. In view of the statement in the *National Grocery Company* opinion that Congress could, if it chose, tax the shareholder on the corporation's income,<sup>296</sup> the constitutional spectre may be considered embalmed.

The scheme of taxing the shareholders under the accumulation penalty section, rather than the corporation, is substantially similar to the British method, the principal difference being that under the British method the reasonableness of the accumulation, rather than the motives behind it, is made the test of applicability.<sup>297</sup> While this has the advantage of determining liability by a less subjective measuring rod, it loses in flexibility. The penalty may result from an honest mistake or mere difference of opinion between the stockholders and the Government as to the reasonableness of the accumulation, and liability may be imposed even in the face of the most innocent motives. The Canadian approach to the problem of corporate accumulations is somewhat different. If the Minister of National Revenue is of the opinion that the accumulation is unreasonable, he may notify the corporation of the amount he considers excessive and if such amount is not distributed during the tax year in which the notice is given, the shareholders are deemed to have received such amount as a dividend on the last day of such tax year.<sup>298</sup>

A tax against the shareholders rather than against the corporation is preferable chiefly because it burdens the stockholders to the same degree and in the same proportions that they benefited taxwise from non-distrib-

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295. Sherman, *op. cit. supra* note 51, advocated a reversion to this procedure.

296. 304 U. S. 282, 288 (1938).

297. FINANCE ACT OF 1922, § 21, as amended by §§ 31 and 32 of the FINANCE ACT OF 1927. For an explanation of the *modus operandi* of the British provisions, see KONSTAM, *THE LAW OF INCOME TAX* (6th ed. 1933) 336-346.

298. WAR INCOME TAX ACT, § 13.

bution.<sup>299</sup> If we are to return to this system, the statutory presumptions now in Section 102 should be retained and even strengthened. It is suggested that a presumption of unreasonableness of accumulation should be made to arise whenever a corporation fails to distribute 70% of its net earnings *provided* that the current asset and liability ratio of the corporation after such distribution would be better than two to one. This would incorporate into the Statute some of the indicia of liability set out in the Regulations.<sup>300</sup> It is recognized that particularity in a statute precludes flexibility and may cause hardship. However, complete flexibility will not be lost by virtue of the suggested presumption — a sort of presumption within a presumption — as the failure to distribute the requisite amount would not *ipso facto* determine liability, but would only create an inference which the taxpayer could overcome in a proper case. The chief objection to the method of taxing the shareholders would be that administrative difficulties might arise in the case of a corporation with many shareholders, but such corporations are not as likely to run afoul of the section as those with few stockholders. Another objection is that the penalty is not severe enough: the stockholders of a corporation which has distributed none of its earnings would be no worse off after the application of the penalty (except for interest on the additional tax and the expense of contesting it) than the stockholders of a corporation which had distributed all of its earnings. This objection might be overcome by increasing the interest rate on such deficiencies or adding an additional penalty of say 10%. At any rate even without this additional penalty, the proposed plan would probably produce much greater revenue than the existing one.

If the present plan of assessing the penalty against the corporation is to be retained, the recent decision of the Department is a step in the right direction.<sup>301</sup> In fact, that part which states that a failure to distribute 70% of the earnings invites scrutiny, should be incorporated into the law, subject to the current asset and liability ratio proviso. This will put corporations which are well able to pay dividends on the defensive, where they belong. In addition, the maximum penalty rate should be increased beyond 35%, since the present section loses much of its effect in the case of a corporation whose shareholders pass the 35% bracket. One other alteration to the section is suggested, to wit: the elimination

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299. It also would minimize the possibility of injustice which might result from a sale of stock to a purchaser not on the alert to protect himself against liability of the company for tax under § 102.

300. See notes 60 and 61 *supra*.

301. T. D. 4914, INT. REV. BULL. No. 31, at § (1939). See note 61 *supra*. It is to be hoped, however, that the Treasury Department, in its zeal for revenue, will not use the new decision as a club with which to scare innocent taxpayers into settlements. (The vast majority of § 102 cases are settled without litigation).

of the net loss carryover in computing the net income which measures the penalty tax. If the corporation is guilty of the condemned purpose during the taxable year, there is no reason why a loss in the preceding year should mitigate the penalty. Such loss is already taken into consideration in determining whether the accumulation was unreasonable and the proscribed purpose was present.

In 1938, the House Ways and Means Committee attempted a solution in the form of the so-called "third basket" provision which imposed high rates of undistributed profits surtax on closely held corporations; but the proposal never passed the House. This method is undesirable in that it would place closely held corporations at a disadvantage in comparison with competing corporations whose ownership was widely diversified. Looking through the corporate entity, there is no sound reason why a stockholder in the Ford Motor Company — assuming that it is a closely held corporation — should pay a higher rate of tax on his share of the earnings than a stockholder in General Motors. Moreover, many publicly owned companies are privately controlled: it is well known that the more scattered the ownership of a corporation, the smaller will be the percentage of stock required to control it. If we are to have an undistributed profits surtax, let it be made applicable to *all* corporations.<sup>302</sup>

With respect to personal holding companies the best solution seems to be the taxation of the shareholders of such corporations as if they were partners.<sup>303</sup> This would permit the use of such corporations for legitimate ends without in any way interfering with the collection of federal revenue. If it is felt that some price should be exacted by the Federal Government for the privileges attached to corporate existence, let the normal corporate tax imposed on corporations be applicable to such companies as well. In fairness, if the shareholders are to be taxed on the corporation's income let them also be permitted to take their proportionate shares of the corporation's losses in the same way that the members of a partnership are entitled to take their respective shares of the partner-

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302. The undistributed profits surtax appears to be politically taboo. Most of the hue and cry against the 1936 surtax was made by people who failed to realize that it did not impose a crushing burden. The maximum tax of a corporation which distributed only 30% of its net income was only about 25%. *Report of Subcommittee of Ways and Means Committee, 75th Cong., 3d Sess. (1938) 5.* The British standard income tax rate has often been as high as 25% (it is now 35%).

303. Under the 1918 Act (and up to Dec. 31, 1921, under the 1921 Act) the shareholders of personal service corporations were taxed like the members of a partnership. The corporation itself was not taxed. § 218. The Canadian income tax law formerly gave the stockholders of "family corporations" an election to be taxed as partners. WAR INCOME TAX ACT, § 22, repealed in 1932. Concurrently, the Canadian law provides [§ 21] that the income of "personal corporations" (corresponding roughly to our personal holding companies) shall be deemed to be distributed on the last day of the taxable year, whether actually distributed or not. The corporation itself is taxed only on income which is deemed to be distributed to nonresidents.

ship's losses. It is not contended that this method is entirely free from complications, but the problems attached to it would certainly be no more troublesome and would probably be simpler than those which arise out of the present provisions. While it still would be necessary to retain the elaborate provisions defining a personal holding company, it would be possible to eliminate the distinction between foreign personal holding companies and other personal holding companies, and to eliminate the problems inherent in credits for dividends paid, amounts used to retire indebtedness, deficiency dividends, etc. Moreover, the shareholders of such companies could rest easier in their minds throughout the year, instead of being ever on the alert to avoid the pitfalls surrounding the present provisions. In view of recent decisions, notably the *National Grocery Company* case,<sup>304</sup> constitutional doubts about the suggested method of taxing shareholders of personal holding companies are not too grave.

#### APPENDIX

##### *List of Cases Involving Section 102 or the Corresponding Provisions of Prior Revenue Laws*

##### A. Cases won by Government:

##### 1. Mercantile or Manufacturing Corporations:

*National Grocery Co. v. Comm'r*, 35 B.T.A. 163 (1936), *aff'd*, 304 U. S. 282 (1938), *rev'g*, 92 F. (2d) 931 (C. C. A. 3d, 1937).

##### 2. Companies which would be now classed as personal holding companies:

##### a. Incorporated talent cases:

*Reynard Corp. v. Comm'r*, 37 B.T.A. 552 (1938).

*Wm. C. DeMille Productions, Inc. v. Comm'r*, 30 B.T.A. 826 (1934), *petition for review dismissed*, 80 F. (2d) 1010 (C. C. A. 9th, 1936) (held taxable for three of the five years involved).

##### b. Others:

*Williams Investment Co. v. United States*, 3 F. Supp. 225 (Ct. Cl. 1933).

*Keck Investment Co. v. Comm'r*, 29 B.T.A. 143 (1933), *aff'd*, 77 F. (2d) 244 (C. C. A. 9th, 1935), *cert. denied*, 296 U. S. 633 (1935).

*A. D. Saenger, Inc. v. Comm'r*, 33 B.T.A. 135 (1935), *aff'd*, 84 F. (2d) 23 (C. C. A. 5th, 1936), *cert. denied*, 299 U. S. 578 (1936).

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304. *National Grocery Co. v. Comm'r*, 304 U. S. 282 (1938). Note particularly footnote 4 of the Court's opinion.

- Rands, Inc. v. Comm'r, 34 B.T.A. 1094 (1936), *appeal dismissed*, 101 F. (2d) 1018 (C. C. A. 6th, 1939).  
 Almours Securities, Inc. v. Comm'r, 35 B.T.A. 61 (1936), *aff'd*, 91 F. (2d) 427 (C. C. A. 5th, 1937), *cert. denied*, 302 U. S. 765 (1938).  
 Nipoch Corp. v. Comm'r, 36 B.T.A. 662 (1937).  
 R. L. Blaffer & Co. v. Comm'r, 37 B.T.A. 851 (1938), *aff'd*, 103 F. (2d) 487 (C. C. A. 5th, 1939), *cert. denied*, U. S. Sup. Ct. No. 169 (Oct. 1939).  
 Mead Corp. v. Comm'r, 38 B.T.A. 687.  
 A. & J., Inc. v. Comm'r, 38 B.T.A. 1248 (1938).  
 The Beim Co. v. Landy, D. Minn., Sept. 19, 1939.

3. Miscellaneous companies:

- United Business Corp. of America v. Comm'r, 19 B.T.A. 809 (1930), *aff'd*, 62 F. (2d) 754 (C. C. A. 2d, 1933), *cert. denied*, 290 U. S. 635 (1933) (held taxable for one of the two years involved).  
 United Business Corp. of America v. Comm'r, 33 B.T.A. 83 (1935).  
 Edward G. Swartz, Inc. v. Comm'r, 33 B.T.A. 355 (1935).  
 R. & L., Inc. v. Comm'r, 33 B.T.A. 857 (1935), *aff'd*, 84 F. (2d) 721 (C. C. A. 5th, 1936), *cert. denied*, 299 U. S. 588 (1936).  
 Gardiner v. Welch, 17 A.F.T.R. 1047 (S. D. Cal. 1936).

B. Cases won by taxpayer:

1. Mercantile or Manufacturing Corporations:

- R. C. Tway Sales Co. v. United States, 3 F. Supp. 668 (W. D. Ky. 1933), *aff'd*, 75 F. (2d) 336 (C. C. A. 6th, 1935).  
 Charleston Lumber Co. v. United States, 20 F. Supp. 83 (S. D. W. Va. 1937), *petition for review dismissed*, 93 F. (2d) 1018 (C. C. A. 4th, 1937).  
 C. H. Spitzner & Son, Inc. v. Comm'r, 37 B.T.A. 511 (1938).  
 Dill Mfg. Co. v. Comm'r, 39 B.T.A. 1023 (1939).  
 J. E. Baker Co. v. Comm'r, B.T.A. Docket No. 87,758, June 6, 1939.

2. Companies which would now be classed as personal holding companies:

a. Incorporated talent cases:

- Cecil B. DeMille *et al.* v. Comm'r, 31 B.T.A. 1161 (1935), *aff'd*, 90 F. (2d) 12 (C. C. A. 9th, 1937), *cert. denied*, 302 U. S. 713 (1937).  
 Fisher & Fisher, Inc. v. Comm'r, 32 B.T.A. 211 (1935), *aff'd per curiam*, 84 F. (2d) 996 (C. C. A. 2d, 1936).

b. Others:

- Irvington Investment Co. v. Comm'r, 32 B.T.A. 1165 (1935).

Sauk Investment Co. v. Comm'r, 34 B.T.A. 732 (1936).  
 W. S. Farish & Co. v. Comm'r, 38 B.T.A. 150 (1938),  
*aff'd*, 104 F. (2d) 833 (C. C. A. 5th, 1939).  
 Mellbank Corp. v. Comm'r, 38 B.T.A. 1108 (1938).  
 Mellon *et al.*, Executors v. Comm'r, 38 B.T.A. 1259  
 (1938).  
 Rofam, Inc. v. Comm'r, Memo. B.T.A. Docket No. 81,597,  
 Apr. 17, 1937.  
 Industrial Bankers Securities Corp. v. Higgins, 104 F.  
 (2d) 177 (C. C. A. 2d, 1939).

3. Miscellaneous companies:

Seaboard Security Co. v. Comm'r, 38 B.T.A. 560 (1938).

C. Cases involving the section only indirectly:

French Mortgage & Bond Co. v. Woodworth, 38 F. (2d) 841  
 (E. D. Mich. 1930) (holds that injunction will not lie to  
 prevent collection of penalty tax).  
 Kales v. Woodworth, 32 F. (2d) 37 (C. C. A. 6th, 1929),  
*aff'g*, 20 F. (2d) 395 (E. D. Mich. 1927), *cert. denied*, 280  
 U. S. 570 (1929) (shareholder sought to invoke application  
 of Sec. 3 of 1916 Act).  
 Stern v. Comm'r, 11 B.T.A. 1309 (1928) (shareholder sought  
 to deduct share of corporate loss).