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TAXATION-INCOME TAX-DEALINGS BY CORPORATION IN ITS OWN STOCK

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TAXATION — INCOME TAX — DEALINGS BY CORPORATION IN ITS OWN STOCK — From 1921 to 1929, appellee corporation bought shares of its own stock, not for retirement, but to sustain the market, to increase the number of shareholders by resale in smaller blocks, and for other reasons. This stock was held as treasury stock. In 1929 it was sold by the corporation, at a profit. From 1920 to 1934 the Treasury Regulations [1] exempted the proceeds of such a transaction from income tax, treating the purchase and sale as separate decrease and increase in the capital, and not as resulting in income.[2] But in 1934 the regulation was changed, so as to tax ultimate gain from such transactions as income, in cases where there was no purpose of retiring the stock at the time when the purchase was made; that is, where the corporation dealt in its own stock as it would in that of another corporation.[3] Revenue Acts were enacted in 1919, 1921, 1924, 1926, 1928, 1932, 1936 and 1938, without changing the clause defining income.[4] After the change in the regulations, the commissioner at-

[1] For example, Treas. Reg. 74, art. 66 (1928). All of the pertinent Treasury Regulations are set out in footnotes to the report of the principal case, and need not be cited here.

[2] Accord: Simmons v. Hammond Mfg. Co., 1 B. T. A. 803 (1925).

[3] Treas. Reg. 77, art. 66 (1932), as amended by Treas. Dec. 4430 (May 1934); Treas. Reg. 94, art. 22 (a)-16 (1936).

[4] Section 213a of 40 Stat. L. 1065 (1919), 42 Stat. L. 238 (1921), 43 Stat. L. 267 (1924), and 44 Stat. L. 23 (1926); § 22a of 45 Stat. L. 759 (1928), 47 Stat. L. 178 (1932), 49 Stat. L. 1657 (1936), and 52 Stat. L. 457 (1938).

tempted to assess an income tax for 1929 upon these stock profits. *Held*, that the reenactments of the Revenue Act clause defining income, including that of 1928, had given to the former treasury regulation the effect of law [5] by 1929, which could not be retroactively changed in 1934. *Helvering v. Reynolds Tobacco Co.*, (U. S. 1939) 59 S. Ct. 423.[6]

The nature of transactions involving a transfer of stock has long troubled the federal circuit courts. It is clear that a simple purchase or sale of its own stock does not result in a taxable gain or loss to the corporation. It is merely a readjustment of the capital structure, with a corresponding reduction or increase in the number of proprietorship claims.[7] On the other hand, when a corporation transfers property in exchange for its stock, or for cash and stock, it seems illogical that there should be no taxable gain or loss, merely because of the use of stock as a part of the consideration; and courts have held that such transactions may result in taxable gain, if the market value of the stock, plus the cash, exceeds the value of the property conveyed.[8] It has been suggested that

[5] That such reenactment is persuasive evidence of legislative intent to adopt the administrative regulation: Brewster v. Gage, 280 U. S. 327 at 336-337, 50 S. Ct. 115 (1929); McCaughn v. Hershey Chocolate Co., 283 U. S. 488, 51 S. Ct. 510 (1930). But a regulation clearly out of harmony with the statute is a nullity. Manhattan General Equipment Co. v. Commr., 297 U. S. 129, 56 S. Ct. 397 (1935). Of course a regulation cannot constitutionally be given the effect of law, if it purports to tax that which is not in fact income. Koshland v. Helvering, 298 U. S. 441, 56 S. Ct. 767 (1935).

[6] Affirming, (C. C. A. 4th, 1938) 97 F. (2d) 302, which reversed 35 B. T. A. 949 (1937). In First Chrold Corp. v. Commr., (U. S. 1939) 59 S. Ct. 427, the Court on the same issues reversed (C. C. A. 3d, 1938) 97 F. (2d) 22. Accord: E. R. Squibb & Sons v. Helvering, (C. C. A. 2d, 1938) 98 F. (2d) 69 (incorrect headnote).

In the principal case the Court stated that section 605 of the act, 48 Stat. L. 757 (1934), 26 U. S. C. (Supp. 1938), § 1691(b) (authorizing the Treasury to change its regulations, and forbidding retroactive application of the changes only when the secretary states that they are not to apply retroactively), was intended merely to permit corrections in the Treasury's interpretation of the law, and could not be used to change a former regulation which had acquired the effect of law by successive reenactment of the act without change. It intimated, however, that the later acts of 1936 and 1938 may have validated the change made in the Treasury Regulation in 1934, prospectively. The Court stated: "It may be that by the passage of the Revenue Act of 1936 the Treasury was authorized thereafter to apply the regulation in its amended form. But we have no occasion to decide this question since we are of opinion that the reenactment of the section, without more, does not amount to sanction of retroactive enforcement of the amendment, in the teeth of the former regulation which received Congressional approval, by the passage of successive Revenue Acts including that of 1928." 59 S. Ct. 423 at 427. Thus, in the future, the taxability of such transactions will apparently be determined by examining the original purpose for which the stock was bought by the company.

[7] Johnson v. Commr., (C. C. A. 5th, 1932) 56 F. (2d) 58, cert. den. 286 U. S. 551, 52 S. Ct. 502 (1931) (purchase of stock); Carter Hotel Co. v. Commr., (C. C. A. 4th, 1933) 67 F. (2d) 642 (sale of stock).

[8] Commissioner v. Boca Ceiga Development Co., (C. C. A. 3d, 1933) 66 F. (2d) 1004; Allyne-Zerk Co. v. Commr., (C. C. A. 6th, 1936) 83 F. (2d) 525;

this view may be rationalized by considering the transaction as an exchange of property for cash, with the corporation then using part of the cash to buy in its own stock. The first part of the transaction would result in taxable gain, regardless of the introduction of stock into the picture at a theoretically subsequent point of time.[9] But how can it be known when this fiction should be applied unless it appears at the time that the corporation's officers intended no retirement of the stock to take place? It is submitted that in spite of the difficulties of proof involved, the nature of the distinction between income and additions to capital-structure renders it necessary to use intent or purpose as the criterion, in determining into which category a given transaction is to fall.[10] Consequently when a corporation deals in its own stock without retiring it, such a transaction may properly be considered in the future to involve taxable gain or loss, upon resale of the stock, as provided for in the present regulations.

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Dorsey Co. v. Commr., (C. C. A. 5th, 1935) 76 F. (2d) 339, cert. den. 296 U. S. 589, 56 S. Ct. 101 (1935); Commissioner v. S. A. Woods Machine Co., (C. C. A. 1st, 1932) 57 F. (2d) 635, cert. den. 287 U. S. 613, 53 S. Ct. 15 (1932) (corporation took its own stock in satisfaction of awarded damages).

[9] See 47 YALE L. J. 111 (1937), comment on the B. T. A. holding in the principal case; and 27 ILL. L. REV. 566 (1933), note on the S. A. Woods case cited in the preceding footnote.

It has also been held that the sale of stock of a subsidiary corporation results in taxable gain. Consolidated Utilities Co. v. Commr., (C. C. A. 5th, 1936) 84 F. (2d) 548.

[10] Cf. Harvey, "Some Indicia of Capital Transfers under the Federal Income Tax Laws," 37 MICH. L. REV. 745 (1939).