Michigan Law Review

Volume 55 | Issue 2

1956

# Taxation - Federal Income Tax - Secret Withdrawals of Corporate Receipts by Stockholders as Income in Absence of Surplus

Kenneth H. Haynie S.Ed.
*University of Michigan Law School*

Follow this and additional works at: https://repository.law.umich.edu/mlr

Part of the Securities Law Commons, Taxation-Federal Commons, and the Tax Law Commons

## Recommended Citation

Kenneth H. Haynie S.Ed., *Taxation - Federal Income Tax - Secret Withdrawals of Corporate Receipts by Stockholders as Income in Absence of Surplus*, 55 MICH. L. REV. 308 (1956).
Available at: https://repository.law.umich.edu/mlr/vol55/iss2/16

This Recent Important Decisions is brought to you for free and open access by the Michigan Law Review at University of Michigan Law School Scholarship Repository. It has been accepted for inclusion in Michigan Law Review by an authorized editor of University of Michigan Law School Scholarship Repository. For more information, please contact mlaw.repository@umich.edu.

TAXATION—FEDERAL INCOME TAX—SECRET WITHDRAWALS OF CORPORATE RECEIPTS BY STOCKHOLDER AS INCOME IN ABSENCE OF SURPLUS—As sole stockholder of the Robbins Tire and Rubber Company, the defendant managed and controlled the affairs of the corporation. Over a period of years he intercepted the company's receipts from several of its large customers and diverted them to his own use. No entries of such receipts were made on the books of the company, nor was any tax paid on them. Defendant was convicted for attempted evasion of his personal income tax on these funds.[1] On appeal, *held,* affirmed. Taxation is concerned with actual command over property. It does not matter whether defendant got the funds as a legal distribution of corporate property or took them fraudulently, since he assumed command and dominion over the cash and received economic gain therefrom. *Davis v. United States,* (6th Cir. 1955) 226 F. (2d) 331, cert. den. 350 U.S. 965 (1956).

The crucial question involved is whether these withdrawals constituted income to the defendant. A taxpayer receives income when he obtains control over property to the extent that he derives readily realizable economic

[1] The government proved only that defendant had taken from the gross receipts of the corporation. The taxpayer argued that it had failed to prove that any tax liability arose from these transactions, since there was no showing that the company had any surplus in the years in question from which dividends could be paid.

value from it "even though it may have been obtained by fraud and his freedom to use it may be assailable by someone with a better title to it."[2] This rule would seem to apply to the funds received by the defendant in the principal case. The theory of the government, which the court adopts, was that the funds are fraudulent, unrecorded diversions from the corporation which are taxable as income under *United States v. Rutkin.*[3] *Commissioner v. Wilcox,*[4] which held that an embezzler's gain was not taxable income, is distinguished on the ground that defendant could not embezzle the funds of his wholly-owned corporation but merely took from himself under a different name.[5] Under this view, the determination that the case is controlled by the *Rutkin* decision rather than *Commissioner v. Wilcox* seems proper.[6] When a sole stockholder of a corporation takes the funds of the corporation secretly, pursuant to a plan of "covering his tracks" and avoiding any record of the transaction, the funds have the character of income as prescribed in the *Rutkin* case. The defendant in the principal case relied on specific provisions of the Internal Revenue Code to the effect that corporate distributions, other than dividends, are not taxable income but serve to reduce the basis of the taxpayer's stock.[7] He claimed that his actions constituted distributions by the company,[8] and there is some support for this position.[9] Congress has clearly divided

[2] Rutkin v. United States, 343 U.S. 130 (1952), holding that funds received by extortion were taxable as income. See also Corliss v. Bowers, 281 U.S. 376 (1930); Burnet v. Wells, 289 U.S. 670 (1933).

[3] Note 2 supra.

[4] 327 U.S. 404 (1946). The court held that the test of taxable income is twofold: (1) a claim of right to the funds, and (2) the absence of a definite, unconditional obligation to repay.

[5] Kann v. Commissioner, (3d Cir. 1953) 210 F. (2d) 247, cert. den. 347 U.S. 967 (1954), held that receipts taken by a president of a corporation for his personal use were income. The Wilcox case was distinguished on the fact that the taxpayer was a large stockholder and not merely an employee. The court felt that the possibility that a sole owner could embezzle the funds of his own corporation under local law should not determine tax liability.

[6] The Wilcox case was severely limited by the Rutkin case, note 2 supra, which expressly limited it to its facts (embezzlement). Subsequent cases have left considerable doubt as to the exact status of the Wilcox decision. See Kann v. Commissioner, note 5 supra. The same view was taken in United Mercantile Agencies Inc. v. Commissioner, 23 T.C. 1105 (1955). See also Briggs v. United States, (4th Cir. 1954) 214 F. (2d) 699, cert. den. 348 U.S. 864 (1954); Marienfield v. United States, (8th Cir. 1954) 214 F. (2d) 632, cert. den. 348 U.S. 865 (1954); Berra v. United States, (8th Cir. 1955) 221 F. (2d) 590. In United States v. Bruswitz, (2d Cir. 1955) 219 F. (2d) 59, cert. den. 349 U.S. 913 (1955), the court stated that the possession and control criterion was diametrically opposed to the "claim of right" doctrine and that it was difficult to see what, if anything, remained of the Wilcox decision. Yet, the same court in Dix v. Commissioner, (2d Cir. 1955) 223 F. (2d) 436, cert. den. 350 U.S. 894 (1955), followed the Wilcox case where the president of a family corporation embezzled its funds. See Gelfand, "Wilcox or Rutkin—Is the Fog Lifting?" 34 TAXES 109 (1956).

[7] I.R.C., §§316 (a), 301 (c); I.R.C. (1939), §115 (d).

[8] A formal declaration of dividends is not necessary to constitute corporate distributions. Christopher v. Burnet, (D.C. Cir. 1931) 55 F. (2d) 527; Wiese v. Commissioner, (8th Cir. 1938) 93 F. (2d) 921, cert. den. 304 U.S. 562 (1937). See note 6 supra.

[9] Although the question has not been clearly raised heretofore, in Currier v. United

corporate distributions into two categories—dividends and non-dividends. The former are taxable as income while the latter are not taxed except when they have exceeded the cost basis of the stock, at which time they are taxed as gain from the sale of property.[10] In order to create a tax liability, the distribution must have resulted in a dividend or a return of capital in excess of cost basis.[11] The position of the court appears to be that section 301 properly applies only to conventional corporate distributions.[12] Where money is taken pursuant to a scheme of total concealment, it does not result in a distribution of the character referred to by section 301 but results in income by wrongful diversion of corporation funds. The question, then, is one of degree. This rule can be rather easily applied to the extreme facts of the principal case, but future decisions must spell out at what point the secret character of the transaction removes it from the operation of section 301. The operation of such a rule should not be extended beyond the type of covert withdrawal involved in the principal case.

*Kenneth H. Haynie, S.Ed.*

States, (1st Cir. 1948) 166 F. (2d) 346, the owner of 75% of the stock in a corporation (his wife owned the remainder) took receipts of the company. Part of the money was held taxable as a constructive dividend, the court holding that any further amounts were a return of capital or money wrongfully taken. See also United States v. Augustine, (3d Cir. 1950) 185 F. (2d) 407, revd. (3d Cir. 1951) 189 F. (2d) 587.

[10] I.R.C., §301; I.R.C. (1939), §115 (d).

[11] It is worthy of note that the holding of the Rutkin case, note 2 supra, was issued in a different context. Since the test there adopted applies equally well to dividends or capital returns, its utility in this area may be questioned.

[12] The Shield Company v. Commissioner, 2 T.C. 763 (1943); George M. Gross v. Commissioner, 23 T.C. 756 (1955); Estate of Esther M. Stein, 25 T.C. No. 109 (1956). See also Estate of Ida S. Godley v. Commissioner, 19 T.C. 1082 (1953), revd. (3d Cir. 1954) 213 F. (2d) 529.