


1955

Taxation - Federal Income Tax - Corporate Accumulations, Stock Dividends and the "Preferred Stock Bail-Out," and Taxability of the Corporation Upon the Distribution of "Inventory Assets" Under the Internal Revenue Code of 1954

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Recommended Citation

Alice Austin S.Ed., *Taxation - Federal Income Tax - Corporate Accumulations, Stock Dividends and the "Preferred Stock Bail-Out," and Taxability of the Corporation Upon the Distribution of "Inventory Assets" Under the Internal Revenue Code of 1954*, 53 MICH. L. REV. 725 (1955).

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COMMENTS

TAXATION — FEDERAL INCOME TAX — CORPORATE ACCUMULATIONS, STOCK DIVIDENDS AND THE "PREFERRED STOCK BAIL-OUT," AND TAXABILITY OF THE CORPORATION UPON THE DISTRIBUTION OF "INVENTORY ASSETS" UNDER THE INTERNAL REVENUE CODE OF 1954—
In enacting the Internal Revenue Code of 1954, Congress left substan-

tially unchanged many areas of existing law, made extensive changes in other areas, and incorporated into the statute a number of provisions which had never before appeared. Some of the most extensive changes in existing law occurred in the area of corporate accumulations and distributions.

The Senate Finance Committee was in full agreement with the House Ways and Means Committee as to the basic objectives to be accomplished by the enactment of the 1954 code:

"(1) . . . To make existing law more certain by redrafting existing provisions so as to clarify their meaning and by supplying statutory provisions where none now exist. . . .

"(3) To make impossible a number of tax avoidance devices which exist under the present statute and have received the sanction of court decisions."¹

An inspection of these provisions in the new code which bear on corporate accumulations and distributions makes it clear that Congress has, in many respects, accomplished its basic objectives with regard thereto. It is also clear, however, that Congress not only has failed to resolve many of the interpretative difficulties existing under the Internal Revenue Code of 1939, but, in addition, has created new ones. It is the purpose of this discussion to indicate, with respect to corporate accumulations and distributions, some of the major interpretative problems existing under the 1939 code which Congress has failed to resolve, as well as some of the major interpretative difficulties which arise for the first time under the 1954 code.

I. *Corporate Accumulations*

Section 102 of the Internal Revenue Code of 1939 imposed a penalty surtax upon the "undistributed Section 102 net income" of any corporation "formed or availed of for the purpose of preventing the imposition of the surtax upon its shareholders or the shareholders of any other corporation, through the medium of permitting earnings or profits to accumulate instead of being divided or distributed."² The statute further provided that if earnings or profits were permitted to accumulate beyond the reasonable needs of the business, this fact would be considered determinative of the purpose to avoid the tax

¹ H. Rep. 1337, 83d Cong., 2d sess., part I, p. 34 (1954); S. Rep. 1622, 83d Cong., 2d sess., part I, p. 41 (1954).

² I.R.C. (1939), §102(a).

unless the corporation proved otherwise by the clear preponderance of the evidence.³

The Internal Revenue Code of 1954 has made two important changes in the prior law under section 102, I.R.C. (1939), both of which raise interpretative problems. These changes relate to (1) the burden of proof and (2) the meaning of the phrase "reasonable needs of the business."

In respect to the changes made in the 1954 code regarding the burden of proof, several interpretative difficulties may arise. Under the 1939 code, the fact that earnings or profits were permitted to accumulate beyond the reasonable needs of the business was determinative of the purpose to avoid the surtax upon the shareholders unless the corporation, "by the *clear* preponderance of the evidence," should prove to the contrary.⁴ Under the 1954 code, such fact is determinative of the purpose to avoid the surtax unless the corporation, "by the preponderance of the evidence," should prove to the contrary.⁵ The question immediately arises, therefore: may the taxpayer rebut the presumption raised under the 1954 code by a lesser weight of evidence than was needed to rebut the presumption raised by the 1939 code? The omission of the word "clear" from the 1954 code might be significant in that it leaves the courts free to answer the question in the affirmative. A negative answer to the question is more likely, however, for as a practical matter courts do not appear to distinguish between "a preponderance of the evidence" and "a *clear* preponderance of the evidence."⁶

Whereas under the 1939 code, if the Commissioner of Internal Revenue proposed a deficiency on the ground that the taxpayer had accumulated earnings and profits in excess of the reasonable needs of the business, the taxpayer had the burden of proving the reasonableness of the accumulation,⁷ under the 1954 code, the burden of proof is placed upon the Commissioner in certain enumerated instances.⁸ Under the 1954 code, in order to shift the burden of proving the reasonableness of the accumulation from the taxpayer to the Commissioner, one of two events must occur: the Commissioner must fail to send a

³ I.R.C. (1939), §102(c).

⁴ *Ibid.*

⁵ I.R.C. (1954), §533(a).

⁶ *Northwestern Electric Co. v. Federal Power Commission*, (9th Cir. 1943) 134 F. (2d) 740; *Livanovitch v. Livanovitch*, 99 Vt. 327, 131 A. 799 (1926).

⁷ I.R.C. (1939), §102(c).

⁸ I.R.C. (1954), §534.

notification to the taxpayer as prescribed in section 534(b),⁹ or the taxpayer must submit a "statement of the grounds (together with facts sufficient to show the basis thereof) on which [he] relies to establish that all or any part of the earnings or profits have not been permitted to accumulate beyond the reasonable needs of the business."¹⁰

In regard to the statement which may be submitted by the taxpayer, the question will arise as to what constitutes "facts sufficient to show the basis" of the grounds upon which the taxpayer relies. Two interpretations of this phrase are possible: (1) conclusions of fact; (2) conclusions of fact supported by much of the evidentiary material required to substantiate such facts. It should be noted that if the latter interpretation is adopted the result would be to require the taxpayer to prove the reasonableness of the accumulation before the Commissioner is required to prove the unreasonableness of the accumulation. In other words, adoption of the latter interpretation would nullify the efforts of Congress to shift the burden of proof in "accumulated earning tax" cases where the taxpayer elects to submit a statement under sections 534(a)(2) and 534(c).

The major interpretative difficulty arising under section 102 of the 1939 code was the meaning of the phrase "reasonable needs of the business."¹¹ The House Ways and Means Committee, feeling that improper criteria were applied in the interpretation of this phrase,¹² expressly provided in the House version of the 1954 code that "reasonable needs of the business" shall include the "reasonably *anticipated* needs of the business."¹³ The Report of the Committee on Ways and Means indicates that the Committee felt that the new provision would eliminate the test under which there must be an *immediate* need for the funds in order to justify the retention of earnings.¹⁴ The Committee was of the opinion that the new provision would cover the case where the taxpayer has specific and definite plans for the acquisition of buildings or equipment for use in the business, but would not apply where future plans are vague or indefinite, or where execution of the plans is postponed indefinitely.¹⁵

Insofar as the term "reasonable needs of the business" has been interpreted with reference to the size of the surplus retained by the

⁹ I.R.C. (1954), §534(a)(1).

¹⁰ I.R.C. (1954), §§534(a)(2) and 534(c).

¹¹ 7 MERTENS, LAW OF FEDERAL INCOME TAXATION §§40.11 to 40.14 (1943).

¹² H. Rep. 1337, 83d Cong., 2d sess., part I, p. 53 (1954).

¹³ H.R. 8300, §533, now I.R.C. (1954), §537.

¹⁴ H. Rep. 1337, 83d Cong., 2d sess., part I, p. 53 (1954).

¹⁵ *Ibid.*

corporation, it would appear that Congress has accomplished its objective in amending the phrase to include "reasonably anticipated needs of the business." It should be noted, however, that the phrase "reasonable needs of the business" refers to the purpose behind the accumulation as well as to the size of the surplus. The factual question arising in this context is whether the purpose for which the surplus is accumulated may reasonably be considered to be a "need" of the business. By changing the statutory language, Congress may be said to have done nothing more than to cause the question to be whether the purpose for which the surplus is accumulated may now, or in the anticipated future, reasonably be considered to be a "need" of the business. The interpretative difficulty involved in determining what constitutes a "need" remains the same under the 1954 code as under the 1939 code.

In addition to its failure to resolve the principal interpretative difficulty under section 102, I.R.C. (1939), Congress has created a new problem. In amending the language of the statute to read "reasonably anticipated needs of the business," Congress has raised the question of how far into the future a corporation may plan if it is to meet a standard of reasonable anticipation. This question necessarily is a factual one which must depend in each case upon the particular business involved. It may also turn upon the vagueness or definiteness of the plans under consideration.¹⁶

In fairness to Congress it must be stated that the interpretative difficulties raised by the word "reasonable" are impossible of resolution through legislative action. For reasonableness is at best an amorphous concept which the courts alone can delineate with clarity.

II. *Stock Dividends and the "Preferred Stock Bail-Out"*

Two of the major problems which arose under the 1939 code with reference to the effect of corporate distributions upon shareholders involved stock dividends¹⁷ and the so-called "preferred stock bail-out." In enacting the Internal Revenue Code of 1954, Congress has attempted to provide solutions to both of these problems.

Under the 1939 code, the taxability of a particular stock dividend depended upon whether the distribution constituted income to the shareholder within the meaning of the Sixteenth Amendment to the United

¹⁶ Ibid.

¹⁷ Distributions by a corporation to its shareholders of its stock or of rights to acquire its stock.

States Constitution.¹⁸ If so, the distribution was taxable.¹⁹ The enactment by Congress of the 1954 code has solved this problem by providing that, with certain exceptions, ". . . gross income does not include the amount of any distribution made by a corporation to its shareholders, with respect to the stock of such corporation, in its stock or in rights to acquire its stock."²⁰

One of the exceptions to this rule, however, may raise a serious constitutional question. The 1954 code provides that a distribution by a corporation of its stock or of rights to acquire its stock shall be treated as other dividend distributions are treated ". . . to the extent that the distribution is made in discharge of preference dividends for the taxable year of the corporation in which the distribution is made or for the preceding taxable year. . . ."²¹

This exception to the general rule raises once more the question of whether the distribution constitutes income to the distributee within the meaning of the Sixteenth Amendment. On the one hand, it is clear that where certain types of stock dividends are distributed in discharge of preference dividends, e.g., distribution of common stock to preferred shareholders, they would not be exempt from taxation under the Sixteenth Amendment.²² But there have been cases which have held to the contrary in certain types of situations.

In *Tourtlot v. Commissioner*²³ and *Wiegand v. Commissioner*,²⁴ the corporation had only class A and class B stock; the classes differing as to par value, voting power, and participation in *dividend distributions* and liquidation distributions. The corporation paid a 50 percent dividend in class A shares to holders of that class, and a 50 percent dividend in class B shares to holders of that class. The dividends had been declared as stock dividends. As a result of the stock dividend, the rights of each class of stock to dividend and liquidation distributions changed. The dividends were held non-taxable in the *Tourtlot* case, where a stockholder held an equal proportion of shares of each class of stock. In the *Wiegand* case, where the stockholders held either only one class of stock or a different percentage of each class, the dividends

¹⁸ I.R.C. (1939), §115(f)(1); *Eisner v. Macomber*, 252 U.S. 189, 40 S.Ct. 189 (1910).

¹⁹ *Ibid.*

²⁰ I.R.C. (1954), §305(a).

²¹ I.R.C. (1954), §305(b)(1).

²² Distributions of common on preferred: *Koshland v. Helvering*, 298 U.S. 441, 56 S.Ct. 767 (1936); distribution of preferred on preferred: *Helms Bakeries*, 46 B.T.A. 308 (1942).

²³ (7th Cir. 1951) 189 F. (2d) 167.

²⁴ (3d Cir. 1952) 194 F. (2d) 479.

also were held non-taxable. The theory of these cases was that there was no change in the stockholders' strict legal rights, and thus their proportional interest in the corporation remained the same. It may thus be seen that if a corporation, in distributing its stock or stock rights in discharge of preference dividends, does so in such a way as to bring the distribution within the rule of the *Tourtlot* and *Wiegand* cases, the distribution may well be held to be constitutionally exempt from taxation under section 305(b)(1) of the 1954 code.

It should be noted, however, that if the stock distributed in discharge of preference dividends is held to be non-taxable under section 305 of the 1954 code, it well may be considered as section "306 stock" within the meaning of section 306(c) of the 1954 code.²⁵

Congress, in enacting section 306 of the new code, has attempted to deal with the problem of the "preferred stock bail-out." This problem was raised in *Chamberlin v. Commissioner*,²⁶ in which the corporation distributed a dividend in preferred stock to the common stockholders of the corporation. The dividend was issued pursuant to a plan whereby the shareholders would sell the preferred stock and report their gain upon the transaction at capital gain rates rather than receive a cash dividend and report it at ordinary income rates. The United States Court of Appeals for the Sixth Circuit held that the dividend was not taxable.

"A stock dividend, legally created and distributed, which is a dividend in substance as well as in form, does not change from a non-taxable dividend into a taxable one because of the purpose of its issuance or on account of the good or bad judgment of the directors in declaring it."²⁷

The court further stated that "A non-taxable stock dividend does not become a taxable cash dividend upon its sale by the recipient. On the contrary, it is the sale of a capital asset."²⁸

Section 306 of the 1954 code makes a flank attack on this problem in that it provides, with certain exceptions, for the taxation at ordinary income rates, of the gain received by a shareholder upon the disposition by him of section "306 stock" as defined in section 306(c).²⁹ The administration of this provision is certain to present many interpretative problems, the principal one being: what constitutes section "306 stock"?

²⁵ Treas. Reg. §1.305-1.

²⁶ (6th Cir. 1953) 207 F. (2d) 462.

²⁷ Id. at 469.

²⁸ Ibid.

²⁹ I.R.C. (1954), §306(a).

The 1954 code excludes from the definition of section "306 stock" that stock which may be classified as common stock,³⁰ with the exception of ". . . common stock with respect to which there is a privilege of converting into stock other than common stock (or into property), whether or not the conversion privilege is contained in such stock. . . ."³¹ One must deal, then, with the question: what constitutes "common stock" within the meaning of section 306(c) of the new code?

It is apparent that the factor of corporate control was one of the principal reasons why tax conscious planners used preferred stock rather than common stock to extract earnings and profits from a corporation at capital gain rates. The issuance of preferred stock as a dividend would not change the control of the corporation, whereas the issuance of common stock as a dividend well might do so. The purpose behind the enactment of section 306 of the 1954 code was to prevent the use of the "*preferred stock bail-out.*" Common stock may have been omitted from the statutory definition of section "306 stock" for the reason that the factor of corporate control would normally inhibit its use as a means of extracting earnings and profits from a corporation at capital gain rates.

If the courts are to interpret section 306(c) in strict accord with the congressional intent, they might well state that only common stock possessed of voting rights (i.e., only common stock the issuance of which might affect corporate control) is within the exception set forth in section 306.

On the other hand, the courts might hold that the exception set forth in section 306(c) encompasses all stock which, under state law, is characterized as common stock. The exception would then cover non-voting as well as voting common stock, and there then might come into being a "non-voting common stock bail-out" which would accomplish the same purpose as the "preferred stock bail-out," and which would not in any way affect control of the corporation.³²

A third possible interpretation which the courts might give to the term "common stock" is that it includes that stock denominated, for example, by the corporation as "class A stock" or "class B stock," etc., which is *nominally* common stock, but which actually is preferred stock. If such an unfortunate interpretation is given to the phrase "common stock," it is clear that a corporation could issue a dividend in what is essentially preferred stock, without entailing the disadvantages accruing

³⁰ I.R.C. (1954), §306(c).

³¹ I.R.C. (1954), §306(e)(2).

³² I.R.C. (1954), §306(c)(1)(A) excludes from the definition of "§306 stock" common stock distributed on common stock.

under section 306 from the issuance of a dividend in preferred stock.³³

The Treasury Regulations promulgated under the 1954 code do not shed any light upon the meaning of the phrase "common stock" contained in section 306(c).

Section 306(c)(1)(B) provides that section "306 stock" includes stock which is not common stock, which is not a stock dividend, and the receipt of which in a corporate distribution otherwise would be tax-free, provided that ". . . the effect of the transaction was substantially the same as the receipt of a stock dividend. . . ."³⁴ It is apparent that the same interpretative difficulties will arise in connection with the phrase "substantially the same as the receipt of a stock dividend" as arose in connection with the phrase "essentially equivalent to the distribution of a taxable dividend," under section 115(g) of the 1939 code.³⁵ The new question which will arise, however, is whether the word "substantially" will be interpreted to mean "essentially," or whether the word "substantially" requires the application of a different standard, more favorable to the government. It should be noted that the word "substantially," like the word "reasonable," cannot be clarified to any great extent by legislative enactment. The standard of substantiality, like the standard of reasonableness, must be left to the courts for interpretation.³⁶

III. *Taxability of the Corporation upon the Distribution of Inventory Assets*

Section 311 of the new code is a provision which never before has appeared in the statute. However, subsection (a) thereof actually incorporates existing law upon the subject³⁷ by providing that ". . . no gain or loss shall be recognized by a corporation on the distribution,

³³ Note in this connection the distributions in *Tourtelot v. Commissioner*, (7th Cir. 1951) 189 F. (2d) 167 and *Wiegand v. Commissioner*, (3d Cir. 1952) 194 F. (2d) 479.

³⁴ I.R.C. (1954), §306(c)(1)(B).

³⁵ Under §115(g)(1) of I.R.C. (1939), some courts made the question turn upon whether the redemption was for an honest business purpose: *Commissioner v. James*, (2d Cir. 1931) 49 F. (2d) 707; *Commissioner v. Quackenbos*, (2d Cir. 1935) 78 F. (2d) 156; *Commissioner v. Cordingley*, (1st Cir. 1935) 78 F. (2d) 118; *Commissioner v. Champion*, (6th Cir. 1935) 78 F. (2d) 513; *Brown v. Commissioner*, (3d Cir. 1935) 79 F. (2d) 73; *Patty v. Helvering*, (2d Cir. 1938) 98 F. (2d) 717. Other courts felt that it was the net effect of the distribution, not the motives and plans of the taxpayer, which was determinative: *Flanagan v. Helvering*, (D.C. Cir. 1940) 116 F. (2d) 937; *Smith v. United States*, (3d Cir. 1941) 121 F. (2d) 692.

³⁶ The Treasury Regulations promulgated under the 1954 code do not shed any light upon this matter.

³⁷ *Treas. Reg. 118, §39.22(a)-15 (1953)*; *General Utilities & Operating Co. v. Helvering*, 296 U.S. 200, 56 S.Ct. 185 (1935); *Commissioner v. First State Bank of Stratford*, (5th Cir. 1948) 168 F. (2d) 1004.

with respect to its stock, of (1) its stock (or rights to acquire its stock) or (2) property.”³⁸ Subsections (b) and (c) of section 311 provide exceptions to the general rule stated in section 311(a). Subsection (b) of section 311 deals with distributions of “inventory assets” as defined in section 311(b)(2)(A), providing that in certain cases the corporation shall realize a taxable gain upon such distributions at capital gain rates.³⁹

The principal interpretative problem arising in connection with section 311 of the new code is with reference to the phrase “inventory assets.” Section 311(b)(2)(A) defines “inventory assets” to be “. . . stock in trade of the corporation, or other property of a kind which would properly be included in the inventory of the corporation if on hand at the close of the taxable year.”

The first question which may arise is whether the definition of “inventory assets” in section 311(b)(2)(A) is to be interpreted in a vacuum, or in the light of other provisions of the code. The language used in section 311(b)(2)(A) is the same as that used in section 1221(1) of the new code, formerly section 117(a)(1)(A) of the old code, and the courts may well hold, on the basis of identity of statutory language, that Congress intended section 311(b)(2)(A) of the new code to be interpreted as section 117(a)(1)(A) of the old code was interpreted. However, it should also be noted that section 312(b)(2)(A) of the new code defines “inventory assets” for purposes of section 312, and that such definition includes not only “inventory assets” as defined in section 312(b)(2)(A),⁴⁰ but also includes “. . . (ii) property held by the corporation primarily for sale to customers in the ordinary course of its trade or business. . . .”

It is clear from a reading of sections 311 and 312 of the new code that Congress intended the term “inventory assets” to have different meanings in different contexts. It is not, however, clear whether Congress intended the phrase “stock in trade of the corporation, or other property of a kind which would properly be included in the inventory of the corporation if on hand at the close of the taxable year” to have different meanings in different contexts.⁴¹ If Congress intended the phrase to have a constant meaning throughout the code, then it does not encompass “property held by the corporation primarily for sale to

³⁸ I.R.C. (1954), §311(a).

³⁹ I.R.C. (1954), §311(b)(1).

⁴⁰ I.R.C. (1954), §312(b)(2)(A)(i).

⁴¹ The Treasury Regulations promulgated under the 1954 code shed no light upon this matter.

customers in the ordinary course of its trade or business." This interpretation is supported by the fact that in several places in the code, Congress has drawn a distinction between "stock in trade of the corporation, or other property of a kind which would properly be included in the inventory of the corporation if on hand at the close of the taxable year," and "property held by the corporation primarily for sale to customers in the ordinary course of its trade or business."⁴² It could be said, however, that since Congress failed to draw this distinction in section 311(b)(2)(A), it did not intend the former phrase to have a constant meaning throughout the code. In such case, "inventory assets," for purposes of section 311 of the 1954 code, might be said to include "property held by the corporation primarily for sale to customers in the ordinary course of its trade or business."

Conclusion

As pointed out above, the major interpretative difficulties existing under the 1939 code which Congress failed to resolve through its enactment of the 1954 code are (1) the meaning of the phrase "reasonable needs of the business" with reference to the accumulated earnings tax; and (2) the taxability of stock dividends as income to the distributee. It would seem that the problem of "reasonable needs of the business" is incapable of clarification through legislative enactment because of the amorphous quality of the word "reasonable." The problem in regard to the taxability of stock dividends distributed in discharge of preference dividends would be solved if the courts were to hold that the class A and class B stock of the type distributed in the *Tourtelot* and *Wiegand* cases are not common stock, but preferred stock. The Treasury Regulations promulgated under the 1954 code provide that where stock which is not common stock is distributed in discharge of preference dividends, and such distribution is held non-taxable under section 305 of the 1954 code, such stock is to be considered as section "306 stock," and the distributee will be taxed at ordinary income rates upon his disposition of such stock.⁴³

Insofar as the interpretative difficulties raised by the 1954 code are concerned, all but one may be resolved by legislative enactment. It would be relatively easy for Congress to clarify the meaning of "facts sufficient to show the basis thereof," as that phrase appears in connec-

⁴² I.R.C. (1939), §117(a)(1)(A), now I.R.C. (1954), §1221(1); I.R.C. (1954), §312(b)(2)(A).

⁴³ Treas. Reg. §1.306-3(a) and (c); Treas. Reg. §1.305-1.

tion with the problem of the burden of proof under the statutory provisions taxing corporate accumulations. It would also be simple for Congress to state what is meant by the term "common stock" as it appears in section 306(c) of the new code. Likewise, by an explanatory paragraph, Congress can clearly delineate the meaning of the phrase "inventory assets" as it appears in section 311(b)(2)(A). The interpretative difficulties raised by the phrase "substantially the same as the receipt of a stock dividend," which appears in section 306(c)(1)(B) are not so easily solved. These difficulties may be resolved only through judicial interpretation. Such interpretation, however, will be aided by the large body of judicial interpretation which has grown up under section 115(g)(1) of the 1939 code, which contains substantially similar language.

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