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Corporations - Capital Reduction Surplus as a Source of Divided Payments

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CORPORATIONS—CAPITAL REDUCTION SURPLUS AS A SOURCE OF DIVIDEND PAYMENTS—At the beginning of 1936, plaintiff, a Wisconsin corporation, had an earned surplus deficit of $106,134.89, and a surplus of $685,642.89 created by a reduction of capital stock. Net earnings for 1936 were $121,515.96, none of which were distributed as dividends. An undistributed profits surtax[1] was assessed on the entire current net earnings. Plaintiff sued for a partial refund under an amendment[2] providing retroactive relief for corporations which were prohibited by law from paying dividends during the existence of a deficit in accumulated earnings at the time when the tax was paid. The district court denied relief.[3] On appeal, *held,* reversed. In Wisconsin, net profits exist only after the earned surplus deficit is eliminated, and the analysis of the lower court would not create the net profits necessary for a valid dividend under Wisconsin law.[4] *Hamilton Mfg. Co. v. United States,* (7th Cir. 1954) 214 F. (2d) 644.

If state law prohibited a deficit corporation from paying dividends, including dividends from current earnings, at the time when the surtax was assessed, a refund must be granted.[5] Was plaintiff still "prohibited by law" if its capital reduction surplus exceeded an earned surplus deficit? The principal case is the first of the refund cases to answer this question.[6] Wisconsin in 1936 did not treat a reduction surplus as income, nor as a source of dividends. Had plaintiff distributed that surplus, it would have been a return of capital.[7] Since the purpose of the surtax was to force payment of dividends which would be taxable

[1] Revenue Act of 1936, §14, 49 Stat. L. 1655 (1936).

[2] Revenue Act of 1936, §26(c), 49 Stat. L. 1664, as amended by Revenue Act of 1942, §501(a)(3), 56 Stat. L. 954 (1942).

[3] Hamilton Mfg. Co. v. United States, (D.C. Wis. 1953) 116 F. Supp. 524.

[4] Wis. Stat. (1935) §182.19(1). Dividends are to be paid "only out of net profits properly applicable thereto, and which shall not in any way impair or diminish the capital." Net profits are equated with the balance sheet earned surplus amount. Williams v. Brewster, 117 Wis. 370, 93 N.W. 479 (1903); Soehnlein v. Soehnlein, 146 Wis. 330, 131 N.W. 739 (1911).

[5] United States v. Ogilvie Hardware Co., 330 U.S. 709, 67 S.Ct. 997 (1947).

[6] In Grand Traverse Hotel Co. v. United States, (D.C. Mich. 1948) 79 F. Supp. 860, this issue was raised but not decided. The court disposed of the case on the grounds that state law allowed dividends from current earnings despite a deficit in earned surplus.

[7] Hull v. Pfister & Vogel Leather Co., 235 Wis. 653, 294 N.W. 18 (1940). Wisconsin law is now patterned after the Model Business Corporation Act, which allows such dividends.

as income when received by stockholders, no credit would be allowed for this non-taxable distribution.[8] Thus a distribution of the surplus *qua* surplus still would not have saved the earnings of 1936 from the surtax, and plaintiff would be entitled to a refund.[9] The district court, however, reasoning that the creation of a capital surplus worked an automatic absorption of the deficit,[10] held that the plaintiff was not "prohibited by law" from paying a taxable dividend out of surplus as created by the current earnings. This analysis makes theoretically non-existent the fact of an existing deficit. Besides logical difficulties with this approach, there is reason to believe that the Wisconsin legislature never intended this "automatic absorption" result.[11] The district court's decision was further based upon the fact that the board by mere resolution could have used a two step process, permitted by state law, in order to (1) transfer enough reduction surplus to remove the deficit, and (2) declare a dividend out of earned surplus as created by the current earnings. As to step one, the court gave novel application to the equitable maxim that what should be done will be considered as having been done. Then plaintiff could not claim to be prevented by law from paying dividends merely because its board refused to declare a dividend. The language used by the court of appeals[12] indicates that the district court's analysis was rejected because in effect it required payment of dividends directly out of capital. It may be questioned whether the court of appeals, in citing *Hull v. Pfister & Vogel Leather Co.*[13] (prohibiting dividends directly from reduction surplus) as controlling, had a broad enough premise to support its conclusion that plaintiff was still prevented *by law* from paying a dividend. The district court relied on the premise that the reduction surplus was created for the purpose of absorbing the deficit, and that it was thus possible for the board to remove the capital deficit barrier. The implied conclusion from this premise is that plaintiff has taken the unrealistic and inconsistent action of (1) subjecting its earnings to a surtax which it could have avoided by applying the surplus to the deficit and then declaring a dividend out of current earnings, and (2) in the next year eliminating the deficit in order to distribute the earnings which remained after the tax. The purpose of the surtax makes the cost of paying

[8] Revenue Act of 1936, §27(h), 49 Stat. L. 1665 (1936). See S. Rep. 1631, 77th Cong., 2d sess., 244, 245 (1942); 1942-2 Cum. Bul. 683.

[9] *Contra,* Sumter Farm and Stock Co. v. United States, 151 F. (2d) 975 (1945).

[10] Haggard v. Lexington Utilities Co., 260 Ky. 261, 84 S.W. (2d) 84 (1935), supports the "automatic absorption" analysis.

[11] ". . . 'Capital Surplus' is redefined to prevent automatic reduction by [and, conversely, of] an earned surplus deficit . . . thus being in accord with existing sec. 180.61(3)." Annotations to 1953 Wisconsin Business Corporation Law, §180.02, from the Committee Report of the Joint Committee of Wisconsin and Milwaukee Bars.

[12] [The statute] grants no privilege to declare dividends payable out of capital assets. . . . Should the corporation have attempted to divert unenhanced capital assets to dividends . . . it would have acted directly in face of the statute. . . ." Principal case at 648.

[13] Note 5 *supra.*

either the surtax or the dividend about equal.[14] Given this choice, a corporation would obviously prefer to pay dividends if at all possible. Plaintiff's failure to avoid the surtax emphasizes the probability[15] that the reduction surplus was created for a restricted purpose,[16] so that the board was not legally able to make those resolutions which were essential to the district court's premise. Further, while not expressed, the opinion of the court of appeal is so phrased as to suggest disapproval of a view necessitating retroactive overriding of the board's judgment in business matters, especially where the result is to give effect to a defunct surtax at the expense of the present policy of relief. The purpose of the relief statute is to grant a refund automatically if, when the surtax was imposed, a payment of dividends was prevented by state law.[17] It should be immaterial that the corporation would not have paid a dividend even if a possible reorganization of the capital structure had created an available source for dividends.

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[14] Revenue Act of 1936, §27, 49 Stat. L. 1665 (1936) allowed a credit for dividends paid. Compare I.R.C. (1954), §561, providing for a deduction rather than a credit in regard to the special corporation taxes imposed by §§531 and 541.

[15] The issue was stipulated by a pre-trial conference, so there is no evidence in the record on this point.

[16] E.g., reserve for contingent or existing liabilities.

[17] In United States v. Ogilvie Hardware Co., note 5 supra, at 715, the Supreme Court discussed the purpose of the refund provision, and declared state law to be controlling. ". . . Congress intended to provide . . . the refund without regard to tax definitions. . . ."