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TAXATION—INCOME TAX—REALIZATION OF INCOME BY CORPORATION IN DISTRIBUTION OF NOTES TO SHAREHOLDERS—A corporation charged off notes as worthless prior to 1942. Anticipating future collections on the notes, the corporation distributed them as a dividend in kind. The commissioner determined that the amount collected subsequent to distribution was taxable to the corporation. The Tax Court held that no income was realized by the corporation.¹ On appeal,

¹ First State Bank of Stratford, 8 T.C. 831 (1947).

held, reversed. This was not a distribution of capital assets but rather an assignment of anticipated income. *Commissioner v. First State Bank of Stratford*, (C.C.A. 5th, 1948) 168 F. (2d) 1004, certiorari denied, 335 U.S. 867, 69 S.Ct. 137 (1948).

A distribution of appreciated capital assets as a dividend in kind was held not to be a realization of income by the corporation in *General Utilities & Operating Co. v. Helvering*.² Although this view has been uniformly followed,³ broader concepts of income have been developed around the core of *Helvering v. Horst*,⁴ where it was held that realization of income may be found in the exercise of the power to procure its payment to another. The *Horst* doctrine, from its inception an effective means of limiting surtax avoidance within a family unit,⁵ has recently been used as a weapon against the avoidance of corporate taxation.⁶ The clear case of a lease of corporate property in exchange for fixed payments to the lessor's shareholders was held to result in income to the lessor corporation.⁷ The theory in the principal case, however, meets more serious difficulties. The property aspect of a note fits easily into the *General Utilities* pattern, even though it may represent in whole or in part a claim to interest. In a recent attempt to tax collections made on a demand note as income to the donor who had given the note to a charity, the commissioner relied heavily on the *Horst* line of cases. The Sixth Circuit Court of Appeals, however, declined to accept this argument and held that the income was not taxable to the donor since there was no "constructive receipt" of the income before transfer.⁸ The court in the principal case exhibits greater facility

² 296 U.S. 200, 56 S.Ct. 185 (1935).

³ For ramifications of the *General Utilities* case and allied problems, see Galvin, "Taxable Income to a Corporation from Dividends in Kind," 42 ILL. L. REV. 534 (1947); 3 TAX L. REV. 250 (1948); 1 TAX L. REV. 86 (1945), with a reply, 1 TAX. L. REV. 93 (1945).

⁴ 311 U.S. 112, 61 S.Ct. 144 (1940). See Shattuck, "Taxation of Deflected Income—The *Horst* and *Eubank* Cases," 13 ROCKY MTR. L. REV. 220 (1941); 41 COL. L. REV. 340 (1941).

⁵ See the excellent discussion by Surrey, "The Supreme Court and the Federal Income Tax: Some Implications of the Recent Decisions," 35 ILL. L. REV. 779 at 784-791 (1941). See also *Commissioner v. Tower*, 327 U.S. 280, 66 S.Ct. 532 (1946); *Commissioner v. Sunnen*, 333 U.S. 591, 68 S.Ct. 715 (1948); *Harrison v. Schaffner*, 312 U.S. 579, 61 S.Ct. 759 (1941) Cf. *Blair v. Commissioner*, 300 U.S. 5, 57 S.Ct. 330 (1937).

⁶ Since great emphasis is placed upon the corporate entity in justifying the double taxation of corporate income, one might ask if avoidance of the corporate tax by formal devices should be considered in the same manner as individual surtax avoidance? See Cleary, "The Corporate Entity in Tax Cases," 1 TAX L. REV. 3 at 11 (1945); Angell, "Tax Evasion and Tax Avoidance," 38 COL. L. REV. 80 (1938).

⁷ *United States v. Joliet & Chi. R. Co.*, 315 U.S. 44, 62 S.Ct. 442 (1942); *Brooklyn and Richmond Ferry Co., Inc.*, 9 T.C. 865 (1947).

⁸ See *Commissioner v. Timken*, (C.C.A. 6th, 1944) 141 F. (2d) 625, affirming 47 B.T.A. 494 (1942), where the argument of the commissioner was very similar to the reasoning adopted by the court in the principal case. In dismissing this argument the court in the *Timken* case said, id. at 629: "It is certain that [donor] had no 'economic benefit' from the note or interest therein." Accord, *Annie A. Colby*, 45 B.T.A. 536 (1941). Both of these cases are distinguishable from the *Horst* case on the ground that the income was not collected by the donee in the same year the gift was made.

in applying the *Horst* case and distinguishing the *General Utilities* doctrine. Since charging off the notes was a tax benefit, any collections on the notes were thereafter taxable as income.⁹ Therefore, the court concludes this was an assignment of anticipated income and clearly distinguishable from a dividend of appreciated assets.¹⁰ This graceful reconciliation would seem to belie the fundamentally different income concepts of the *Horst* and *General Utilities* cases.¹¹ It is difficult to see any substantial difference between a dividend of an asset representing unrealized appreciation and a dividend of an asset representing unrealized but anticipated income. In either case the corporation controls a "potential" gain. The reduction of the cost basis of the notes by a prior bad debt deduction clearly makes more of the later collection taxable, but this alone should not change the nature of the assignment from one of an appreciated capital asset to one of future income. It is said that the corporation received "enjoyment" from the distribution to the shareholders,¹² but would it not receive like pleasure in seeing its shareholders reap large capital gains? While adding doubts as to the ultimate tax advantage of any dividend in kind under the *Horst* approach, the principal case indicates an area of uncertainty in the interpretation of the revenue laws which will breed litigation and confusion until clarified.

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⁹ *National Bank of Commerce v. Commissioner*, (C.C.A. 9th, 1940) 115 F.(2d) 875.

¹⁰ "In the former [*General Utilities* case], the fruit was on the tree; in the latter [principal case], the tree itself represents fruit of prior years that was not taxed." Principal case at 1009. Compare *Helvering v. Horst*, 311 U.S. 112 at 120, 61 S.Ct. 144 (1940); and the interesting discussion of fruit and trees in *Estate of Bertha May Holmes*, 1 T.C. 508 at 512 (1943).

¹¹ Compare the application of the *Horst* theory to the dividend of appreciated property in *Galvin*, "Taxable Income to a Corporation from Dividends in Kind," 42 ILL. L. REV. 534 at 538 (1947).

¹² "The payment of dividends to its shareholders was the enjoyment of its income. A body corporate can be said to enjoy its income in no other way." Principal case at 1009. But note that the court actually held the income is not realized until the money is collected for the shareholders. Principal case at 1010.