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TAXATION - I.R.C. SECTION 115 (G) -TRANSACTION EQUIVALENT TO TAXABLE DIVIDEND

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TAXATION — I.R.C. SECTION 115(G) — TRANSACTION EQUIVALENT TO TAXABLE DIVIDEND—*P* and *B* owned all the outstanding shares of *X* Corporation. In 1937 *P* purchased *B*'s shares and gave as consideration his notes bearing maturity dates varying from one to ten years. Two years later *P* transferred these shares to *X* Corporation, to be held as treasury stock, in return for the corporation's promise to discharge *P*'s obligations to *B* as they matured. Pursuant to this agreement *X* paid $5,000 to *B* in discharge of one of *P*'s notes. The commissioner treated this payment as a taxable dividend to *P* under section 115 (g) of the Internal Revenue Code [1] and assessed a deficiency. *P* paid the tax and brought an action in the district court to recover the payment, but his claim was denied. On appeal, *held*, affirmed. *Wall v. United States*, (C.C.A. 4th, 1947) 164 F. (2d) 462.

The forerunner of section 115 (g) was section 201 (d) [2] of the Revenue Act of 1921. In 1920 the Supreme Court had held in *Eisner v. Macomber* [3] that Congress did not have the power to tax stock dividends. With this in mind Congress, in the Revenue Act of 1921, expressly exempted stock dividends from taxation but enacted section 201 (d) which provided that a distribution of earnings by stock dividends was to be treated as taxable income if and when this stock was cancelled or redeemed in such a manner as to make the transaction the substantial equivalent of a taxable dividend. This provision was repeated as section 201 (f) [4] in the 1924 Revenue Act but it became much more significant inasmuch as section 201 (c) of that act declared that distributions in liquidation, including partial liquidation were to be treated as proceeds of sale or exchange of stock. Thus but for section 201 (f) there would have been nothing to deter a corporation from distributing earned surplus by redeeming or cancelling stock dividends and giving its stockholders the benefit of the capital gain provisions of the act [5] rather than subjecting them to the high surtax which would have been imposed if cash dividends had been paid. With the purpose of the statute in mind, obviously the redemption of stock dividends which had been issued for the sole purpose of obtaining the tax advantages of a partial liquidation fell within the provisions of section 201 (f).[6] Even if the stock dividends were issued for a valid business purpose, some courts held the subsequent redemption or cancellation the equivalent of a dividend.[7] Since 1926 the various Revenue Acts have inserted a provision in 115 (g) which makes the section applicable whether or not such stock was issued as a stock dividend.[8] Thus, when the

[1] 52 Stat. L. 496 (1938), 26 U.S.C. (1940) § 115 (g).

[2] 42 Stat. L. 228, § 201 (d) (1921).

[3] 252 U.S. 189, 40 S.Ct. 189 (1920); 9 A.L.R. 1594 (1920).

[4] 43 Stat. L. 254 at 255, § 201 (1924). This section amended the 1921 Act to include the situation where cancellation or redemption preceded the stock dividend.

[5] Section 208 of the 1924 Act, 43 Stat. L. 263 (1924), gave taxpayers other than corporations an option to be taxed on capital net gains at a rate of 12½ per cent provided they had owned the capital asset for two years. Under the 1921 Act, liquidating distributions, partial or complete, were taxable as dividends. See Commissioner v. Sansome, (C.C.A. 2d, 1932) 60 F. (2d) 931, cert. den., 287 U.S. 667, 53 S.Ct. 291 (1932).

[6] C. A. Goding, 34 B.T.A. 201 (1936); Leopold Adler, 30 B.T.A. 897 (1934), affd., (C.C.A. 5th, 1935) 77 F. (2d) 733.

[7] J. Natwick, 36 B.T.A. 866 (1937); Annie Watts Hill, 27 B.T.A. 73 (1932), affd., (C.C.A. 4th, 1933) 66 F. (2d) 45; contra, Patty v. Helvering, (C.C.A. 2d, 1938) 98 F. (2d) 717, but see Kirschenbaum v. Commissioner, (C.C.A. 2d, 1946) 155 F. (2d) 23 at 24, overruling the Patty case and others as supposedly inconsistent with Commissioner v. Estate of Bedford, 325 U.S. 283, 65 S.Ct. 1157 (1945).

[8] 44 Stat. L. 11, § 201 (g) (1926); this section was changed to 115 (g) in 1928, 45 Stat. L. 822, § 115 (g) (1928).

stock has not been issued as a dividend the courts have looked to the particular facts of the case to determine whether the same result could have been effected by paying a dividend.[9] Applying this flexible test to the principal case it seems clear that the transaction was equivalent to a dividend since *P*'s personal obligation was paid out of corporate earned surplus.[10] It cannot be said that the stock transferred to the corporation was consideration for the discharge of his obligation for in actual effect he still owned 100 per cent of the outstanding stock so that his control and proportionate interest were undiminished.[11] *P* argued that since this stock was held as treasury stock it was not redeemed or cancelled within the meaning of the statute. This argument has not prevailed in other cases [12] and is particularly weak in the principal case, for the corporation is a one-man corporation and whether this stock will be redeemed or cancelled depends entirely on *P*'s determination. The taxpayer's final contention was that the two transactions should be considered as a direct sale from *B* to *X* corporation and therefore he should incur no tax liability. This contention was rejected by the Court on the grounds that *P* had actually become indebted to *B* and that a taxpayer's method of attaining a result is determinative for tax purposes. [13] It is submitted that a more desirable answer to *P*'s argument would be to point out the fallacy of his assuming he had two methods of achieving the desired result. It is doubtful that in 1937 *B* would have agreed to sell his shares directly to the corporation knowing that the transaction might have been considered a distribution in partial liquidation instead of a sale; at that time such distributions were treated as short term capital gains and *B* would have been taking the needless risk of subjecting himself to a higher tax.[14]

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[9] Hyman v. Helvering, 63 App. D.C. 221, 71 F. (2d) 342 (1934); Brown v. Commissioner, (C.C.A. 3d, 1935) 79 F. (2d) 73; McGuire v. Commissioner, (C.C.A. 7th, 1936) 84 F. (2d) 431.

[10] Douglas v. Willcuts, 296 U.S. 1 at 9, 56 S.Ct. 59 (1935); 101 A.L.R. 397 (1936).

[11] See Hyman v. Helvering, 63 App. D.C. 221, 71 F. (2d) 342 at 344 (1934).

[12] James D. Robinson, 27 B.T.A. 1018 (1933), affd., (C.C.A. 5th, 1934) 69 F. (2d) 972; J. Natwick, 36 B.T.A. 866 (1937); contra, Alpers v. Commissioner, (C.C.A. 2d, 1942) 126 F. (2d) 58.

[13] This was the language used in Woodruff v. Commissioner, (C.C.A. 5th, 1942) 131 F. (2d) 429 at 430.

[14] I.R.C., § 115 (c), 49 Stat. L. 1687 (1936), declared: "Despite the provisions of 117 (a), 100 per centum of the gain . . . recognized shall be taken into account in computing net income, except in the case of amounts distributed in complete liquidation of a corporation." Actually, as is pointed out by Darrell, "Corporate Liquidations and the Federal Income Tax," 89 UNIV. PA. L. REV. 907 at 911 (1941), the courts were quick to help the taxpayers and call the transaction a sale to give them the benefit of 117 (a). Nevertheless, it was a risk to contend with and *B* would probably have not desired to take it. Today distributions in liquidation are accorded the same treatment as sales and exchanges [26 U.S.C. (Supp. V, 1946) § 115 (c)]. If a taxpayer is faced with a business situation similar to the one in the principal case it would certainly be to his advantage to persuade the vendor to sell the stock to the corporation.