

Michigan Law Review

Volume 44 | Issue 5

1946

TAXATION-INCOME TAX-DEDUCTIONS-DIVIDENDS OR INTEREST

Milton D. Solomon S.Ed.
University of Michigan Law School

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



Part of the [Business Organizations Law Commons](#), and the [Tax Law Commons](#)

Recommended Citation

Milton D. Solomon S.Ed., *TAXATION-INCOME TAX-DEDUCTIONS-DIVIDENDS OR INTEREST*, 44 MICH. L. REV. 827 (1946).

Available at: <https://repository.law.umich.edu/mlr/vol44/iss5/9>

This Response or Comment 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—INCOME TAX—DEDUCTIONS—DIVIDENDS OR INTEREST—The difficulty of determining whether payments made by a corporation on its securities are dividends or interest has been highlighted by two recent cases, involving substantially similar facts, which came before the Supreme Court on review.¹

In the *John Kelley Company* case, a corporation, all of whose common and preferred stock was owned by a family group, was reorganized. There were issued \$250,000 worth of "income debenture bearer bonds" under a trust indenture calling for 8 per cent interest, noncumulative. These securities had a maturity date twenty years after issue; the interest was to be paid out of earnings; rights of the holders were subordinate to creditors but superior to stockholders; provision was made for acceleration in case of specific default; the holders were given no right to participate in management. Part of the "debentures" were issued on subscription and the balance in exchange for all of the corporation's outstanding preferred stock which was retired. In the *Talbot Mills* case, taxpayer, a family corporation, issued, in exchange for four-fifths of its outstanding capital stock, "registered notes" having a fixed maturity date, and bearing interest at a variable rate from 2 per cent to 10 per cent computed with reference to profits. "Interest" payments were deferrable in the discretion of the corporation's directors and both "interest" and principal were subordinate to claims of creditors.

In filing income tax returns for the years concerned, both taxpayers treated the payments made to the respective security-holders as interest and deducted the payments from gross income. The commissioner assessed a deficiency on the ground that the payments were dividends and hence nondeductible. In the *John Kelley Company* case, the Tax Court decided in favor of the taxpayer² but the circuit court of appeals reversed.³ In the *Talbot Mills* case, the Tax Court

¹ *John Kelley Co. v. Comm. of Internal Revenue, Talbot Mills v. Same* (U.S. 1946) 66 S. Ct. 299.

² *John Kelley Co. v. Comm.*, 1 T.C. 457 (1943).

³ *Comm. v. John Kelley Co.*, (C.C.A. 7th, 1944) 146 F. (2) 466.

found for the government⁴ and the circuit court of appeals affirmed.⁵ The Supreme Court held that the findings by the Tax Court that payments in the *John Kelley Company* case were interest and that payments in the *Talbot Mills* case were dividends were conclusive and could not be disturbed by the reviewing tribunals. Accordingly, the decision of the circuit court of appeals in the *Kelley* case was reversed and the decision in the *Talbot Mills* case was affirmed.⁶

The majority of the Supreme Court, in the principal case, refused to consider the merits of the controversy, on the theory that the rule of the *Dobson* case,⁷ as applied to the situation before the Court, required approval of the Tax Court's conclusions.⁸ The problems here raised as to the scope of judicial review of the Tax Court's determinations are of first importance.⁹ However, this comment will be restricted to the substantive question that still confronts the Tax Court, and primary consideration will be given to a number of recent decisions of that tribunal.¹⁰

⁴ *Talbot Mills Co. v. Comm.*, 3 T.C. 95 (1944).

⁵ *Talbot Mills Co. v. Comm.*, (C.C.A. 1st, 1944) 146 F. (2d) 809.

⁶ Justice Black concurred in the result of the *Talbot Mills* case and dissented in the *Kelley* case holding that the decision of the circuit court of appeals should be affirmed in that case for the reason set forth in the opinion therein. Thus Justice Black favored the conclusion that the payments were dividends in both cases. Justice Burton concurred in the result of the *Kelley* case and dissented from the result in the *Talbot Mills* case on the grounds stated in the dissenting opinion of Justice Magruder. Thus Justice Burton favors the conclusion that the payments were interest in both cases. Justice Rutledge, in his dissenting opinion (principal case at 304), took the position that the circuit courts of appeals should be affirmed in both cases for reasons set forth at length by him. Thus Justice Rutledge reaches the conclusion that the payments were dividends in both cases.

⁷ *Dobson v. Comm.*, 320 U.S. 489, 64 S. Ct. 239 (1943).

⁸ For a discussion of the *Dobson* case see Paul, "Dobson v. Commissioner; The Strange Ways of Law and Fact," 57 HARV. L. REV. 753 (1944), cited in footnote 8 of the principal case; p. 304.

⁹ Justice Magruder in his dissenting opinion in the *Talbot* case [146 F. (2d) 809] asserted that the rule of the *Dobson* case did not apply to the situation before the court. He wrote, at p. 814, "This is not even the kind of legal question with which the Tax Court may be assumed to have specialized familiarity, for the legal effect of the instruments as constituting an indebtedness, may arise in many ways outside the tax field. . . ." To this extent, at least, the principal case is an extension of the *Dobson* case. In the latter case, the Tax Court was dealing with a matter of tax accounting (the "Tax Benefit Rule"), a field in which it could be assumed that the Tax Court had acquired a high degree of specialized competence. Justice Rutledge, in his dissenting opinion in the principal case (66 S. Ct. 299 at 304), takes the view that the decisions of the Tax Court in the *Kelley* and *Talbot* cases are inconsistent with each other and therefore concludes that the rule of the *Dobson* case is made to apply in such a way as to foster inconsistencies in the law when it was one of the very purposes of that decision to avoid such inconsistencies.

¹⁰ In the opinion of the writer, the application of the *Dobson* case to this specific situation will require circuit courts of appeals to affirm Tax Court decisions in all

Interest paid or accrued during the taxable year is allowed as a deduction from gross income.¹¹ Dividends paid by a corporation may not be taken by it as a deduction.¹² The problem of determining whether a payment is interest or dividends within the meaning of the statute¹³ arises when the corporation has created hybrid securities, issued and outstanding, which incorporate some of the usual features of bonds or other types of corporate indebtedness on the one hand and of shares of stock on the other.¹⁴ This problem has given rise to a great deal of litigation.¹⁵ Over a relatively short period, running from October 22, 1942 to August 31, 1944, the Tax Court has handed down eight decisions¹⁶ turning on the question of whether corporate payments were interest or dividends. As the earlier decisions have been dealt with elsewhere,¹⁷ this comment will concentrate on the more recent cases in an attempt to determine what factors, if any, are given greater weight by the Tax Court in tipping the scale to one side or the other.¹⁸

cases involving the question whether payments by a corporation to its stockholders or bondholders are interest or dividends, since as a practical matter there will always be some factual evidence before the Tax Court pointing to either dividends or interest. In the light of the principal case, it would be a hardy taxpayer, indeed, who would appeal a decision of the Tax Court on this point.

¹¹ Internal Revenue Code, § 23(b).

¹² Internal Revenue Code, § 115(a) defines dividends. TREAS. REG. 103, § 19.23(b)-1, provides: "So called interest on preferred stock, which is in reality a dividend thereon, cannot be deducted in computing net income."

¹³ See notes 11 and 12, supra.

¹⁴ For a discussion of various types of hybrid securities see Berl, "The Vanishing Distinction Between Creditors and Stockholders," 76 UNIV. PA. L. REV. 814 (1928).

¹⁵ See 4 MERTENS, LAW OF FEDERAL INCOME TAXATION, §§ 26.09 and 26.10 (1942).

¹⁶ *Industrial Additions Assn. v. Comm.*, 1 T.C. 378 (1942) (dividends); taxpayer's appeal dismissed by the Circuit Court of Appeals for the Sixth Circuit, 141 F. (2d) 636 (1944), on the ground of untimeliness of petition for review; reversed and remanded on this point by the Supreme Court, 323 U.S. 310, 65 S. Ct. 289 (1945); thereafter the Tax Court's decision was affirmed on the merits by the Circuit Court of Appeals for the Sixth Circuit, 149 F. (2d) 294 (1945); *Northern Refrigerator Line, Inc. v. Comm.*, 1 T.C. 824 (1943) (dividends); *John Wanamaker Philadelphia v. Comm.*, 1 T.C. 937 (1943), affirmed, (C.C.A. 2d, 1944) 139 F. (2d) 690 (dividends); *Golden Belt Lumber Co. v. Comm.*, 1 T.C. 741 (1943) (dividends); *Green Bay and Western Ry. Co. and Ahnapee & Western Ry. Co. v. Comm.*, 3 T.C. 372 (1944) (dividends), affirmed, (C.C.A. 7th, 1945) 147 F. (2d) 585; *Verifine Dairy Products Corp. of Sheboygan, Inc. v. Comm.*, 3 T.C. 269 (1944) (dividends); *John Kelley Co. v. Comm.*, 1 T.C. 457 (1943) (principal case) (interest), reversed by the circuit court of appeals, (C.C.A. 7th, 1944) 146 F. (2d) 466, reversed by the Supreme Court, (U.S. 1946) 66 S. Ct. 299; *Talbot Mills Co. v. Comm.*, 3 T.C. 95 (1944) (principal case) (dividends), affirmed by the Circuit Court of Appeals, 146 F. (2d) 80, affirmed by the Supreme Court, 66 S. Ct. 299.

¹⁷ See note 15, supra, and 40 COL. L. REV. 1084 (1940).

¹⁸ See note 16, supra.

The factors given consideration in the *Kelley* case¹⁹ were set out by the Tax Court in the following terms: "The determining factors are usually listed as the name given to the certificates, the presence or absence of maturity date, the source of the payments, the right to enforce the payment of principal and interest, participation in management, status equal to or inferior to that of regular corporate creditors, and intent of the parties."²⁰ The corporation's own designation of a certificate as a bond or note is not given much weight by the Tax Court,²¹ while, on the other hand, the listing of a certificate as stock, is considered more indicative of the nature of the payment.²² The presence of a fixed maturity date when the payment of the principal sum may be demanded by the security-holder tends to lead to the conclusion that a debtor-creditor relationship exists.²³ If payments are to be made out of corporate earnings only, the inference is that the payments are dividends, for this tends to indicate that the risk of the business is borne by the security-holders while payments that must be made whether earnings are sufficient to warrant them or not, are more properly characterized as interest.²⁴ Participation in management by the certificate holders is on the dividend side of the picture.²⁵ Status equal to or su-

¹⁹ See 1 T.C. 457 at 462 (1943).

²⁰ Cited with approval by the Tax Court in *Talbot Mills Co. v. Comm.*, 3 T.C. 95 at 99 (1944).

²¹ *Talbot Mills v. Comm.*, 3 T.C. 95 (1944) (certificates referred to as "registered notes"; payments held to be dividends); *Greenbay & Western Ry. Co. and Ahnapee & Western Ry. Co. v. Comm.*, 3 T.C. 372 (1944) (certificates called "debentures"; payments held to be dividends); 4 MERTENS, LAW OF FEDERAL INCOME TAXATION, § 26.10, p. 555 (1942).

²² *Industrial Addition Assn. v. Comm.*, 1 T.C. 378 (1942) (dividends); *Northern Refrigerator Line, Inc. v. Comm.*, 1 T.C. 824 (1943) (dividends); *John Wanamaker Philadelphia v. Comm.*, 1 T.C. 937 (1943) (dividends); *Verifine Dairy Products Corp. of Sheboygan, Inc. v. Comm.*, 3 T.C. 269 (1944) (dividends). The certificates involved in the above cases were referred to as stock.

²³ In *Industrial Addition Association v. Comm.*, 1 T.C. 378, the court quotes at 385 from *United States v. South Ga. Ry. Co.*, (C.C.A. 5th, 1939) 107 F. (2d) 3 at 5, as follows: "There is, thus an entire absence here of the most significant, if not the essential feature of a debtor and creditor as opposed to a stockholder relationship, the existence of a fixed maturity for the principal sum with the right to force payment of the sum as a debt in the event of default." See also 4 MERTENS, LAW OF FEDERAL INCOME TAXATION, § 26.10, pp. 556, 557 (1942).

²⁴ *Northern Refrigerator Line, Inc. v. Comm.*, 1 T.C. 824 (1943); *John Wanamaker Philadelphia v. Comm.*, 1 T.C. 937 (1943); *Green Bay & Western Ry. Co. and Ahnapee & Western Ry. Co. v. Comm.*, 3 T.C. 372 (1944).

²⁵ 4 MERTENS, LAW OF FEDERAL INCOME TAXATION, § 26.10, p. 557 (1942); *Green Bay & Western Ry. Co. and Ahnapee & Western Ry. Co.* 3 T.C. 372 at 379 (1944), "It is true that the holders of these debentures had no vote and could not participate in the management of the company, but that is by no means uncommon to holders of proprietary interests."

rior to that of general corporate creditors points to the payments as interest.²⁶ Intent of the parties to create a debtor-creditor relationship between the shareholder and the corporation suggests that the payments are interest, while an intent to give the certificate holders a proprietary interest in the corporation leads to the contrary conclusion.²⁷ Which of these factors is given the greatest weight by the Tax Court in deciding the controversy of dividends vs. interest? At least this much may be said: The writer has been unable to find any case holding the payments to be interest when they were payable out of the earnings of the corporation only and when the securities did not have a fixed date of maturity (a promise to repay the principal sum at a date certain in the future).²⁸ Capital invested on these terms is uniformly held to be "risk" capital. It is only in situations involving securities having a fixed maturity date on the one hand and providing for payments to be made out of earnings only, on the other hand, that the additional factors, mentioned above, seem to be given weight by the Court²⁹ and it is the net effect of these additional factors that decides the particular case. This is illustrated by the diverse results reached by the Tax Court in the *Kelley* and *Talbot* cases. In both of these cases payments were to

²⁶ 4 MERTENS, LAW OF FEDERAL INCOME TAXATION, § 26.10, p. 556 (1942).

²⁷ *Verifine Dairy Products Corp. of Sheboygan, Inc. v. Comm.*, 3 T.C. 269 at 276 (1944), "In determining a question of this kind, of extreme importance is the intent of the parties."

²⁸ *Industrial Addition Assn. v. Comm.*, 1 T.C. 378 (1942); *John Wanamaker Philadelphia v. Comm.*, 1 T.C. 937 (1943), affirmed, (C.C.A. 3d, 1943) 139 F. (2d) 644; *Golden Belt Lumber Co. v. Comm.*, 1 T.C. 741 (1943); *Green Bay & Western Ry. and Ahnapee & Western Ry. v. Comm.*, 3 T.C. 372 (1944), affirmed, (C.C.A. 7th, 1945) 147 F. (2d) 585; *Ticker Publishing Co.*, 46 B.T.A. 399 (1942); *Comm. v. Schmoll Fils Assn., Inc.*, (C.C.A. 2d, 1940) 110 F. (2d) 611; *Parisian Inc. v. Comm.*, (C.C.A. 5th, 1942) 131 F. (2d) 394; *Northern Refrigerator Line, Inc. v. Comm.*, 1 T.C. 824 (1943) (A definite maturity date was provided for only if payment could be made without impairment of capital. The Court, in holding the payments made to be dividends, emphasizes that the qualification of the definite maturity date indicated that there was not a debtor-creditor relationship).

²⁹ *Verifine Dairy Products Corp. of Sheboygan, Inc. v. Comm.*, 3 T.C. 269 (1944) (payments on so-called "preferred stock" payable out of earnings and having a fixed maturity date held to be dividends—weight given to nomenclature, intent of the parties, and status of certificate holders in relation to general creditors); *John Kelley Co. v. Comm.*, 1 T.C. 457 (1943) (weight given to nomenclature, status of certificate holders and management participation in holding the payments interest); *Talbot Mills v. Comm.*, 3 T.C. 95 (1945) (weight given to the intent of the parties, deferment of payments, and issuance of new certificates exclusively to owners of old certificates exclusively to owners of old certificates in holding the payments to be dividends); *H.R. de Milt Co.*, 7 B.T.A. 7 (1927) (interest—weight given to name used and intent of the parties); *United States v. Title Guarantee and Trust Co.*, (C.C.A. 6th, 1943) 133 F. (2d) 990 (interest—weight given to cumulative feature of payments and non-participation in management by certificate holders).

be made out of earnings only³⁰ and there was a fixed maturity on both obligations. The Tax Court in the *Talbot* case held that the following differences between the securities in that case and the *Kelley* case were sufficient to warrant a different conclusion: "In *John Kelley Co.* . . . there was a flat rate of interest, though payable out of income, as contrasted with the variable, profit-determined rate of the *Talbot* notes; the interest payments were due whenever the net income was sufficient, with provision for suit in case of default in punctual payment, whereas in the instant case [*Talbot*] the payment of interest might be deferred, though the net income was sufficient, for such time as the directors might see fit, and the debentures remaining after the exchange were issued on subscription to the stockholders, whereas this transaction was exclusively an exchange."³¹ In the opinion of the writer, none of these factors alone or in combination warrants calling one of the payments interest and the other dividends.³² In view of the purpose of the particular statute,³³ where payments are to be made by the corporation solely out of earnings, such payments should be considered dividends whether there is a fixed maturity date on the obligation or not.³⁴ All other factors should be considered irrelevant. As the above analysis has attempted to demonstrate, this conclusion is reached by the Tax Court in every case where a lack of a fixed maturity date is added to the fact that payments are to be made out of earnings only.³⁵ The policy of allowing a deduction for interest and not for dividends would be adhered to if the Internal Revenue Code were amended to provide that payments by a corporation on its certificates are taxable as dividends when the certificate requires payments to be made out of earnings only.³⁶ But it might be advisable for Congress, before amending the Code in this respect, to reconsider the entire subject of double

³⁰ In the *Talbot* case 2 per cent interest was guaranteed but the interest in greater part was dependent on earnings of the corporation and all payments could be deferred in the discretion of the directors.

³¹ 3 T.C. 95 at 99 (1944).

³² See dissent of Justice Rutledge, principal case at 304.

³³ Internal Revenue Code, § 23(b).

³⁴ As Justice Rutledge points out in the principal case, at 305, a remote right of suit for enforcement of payment some twenty-five years in the future varies but slightly from the right of preferred stockholders to share in the corporation's assets on dissolution. The reason for the passage of § 23(b), Internal Revenue Code might well have been the unfairness of taxing an individual or corporation on something it was required to pay out, i.e., interest, whether there were earnings or not. Such inequity does not exist when the corporation is required to make payments only when there are earnings.

³⁵ See note 28, supra.

³⁶ The author of the decision note in 40 COL. L. REV. 1084 (1940) suggested that a similar test be applied by the courts. It is the opinion of the author of this comment that the present confused situation can best be remedied by legislation.

taxation of corporate earnings.³⁷ The present system of double taxation of corporate earnings favors debtor financing by corporations and is responsible, in a large measure, for the issuance of the hybrid types of securities discussed above.³⁸ A decision by Congress that corporate earnings should be taxed only when paid to shareholders would lead to statutory revisions eliminating the problem dealt with in this comment.³⁹

Milton D. Solomon, S.Ed.

³⁷ MAGILL, *TAXABLE INCOME*, rev. ed., 26 (1945).

³⁸ GUTHMANN & DOUGALL, *CORPORATE FINANCIAL POLICY* 519 (1942). A study of the cases discussed in this note is also illustrative of this point.

³⁹ It is recognized that the problem herein discussed presents only a single phase of the whole complex subject of double taxation.