June 1931

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Recommended Citation
Bert L. Klooster, Capital Taxed as Income, 9 Chi.-Kent L. Rev. 149 (1931).
Available at: https://scholarship.kentlaw.iit.edu/cklawreview/vol9/iss3/1
CAPITAL TAXED AS INCOME*

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INVESTMENT surplus, which is part of the capital of consolidated corporations, becomes taxable income when a parent corporation sells the capital stock of its subsidiary. At least, this is the conclusion of rather recent tax decisions. That such capital may be taxed as income is an idea which seems to have originated with the Remington-Rand case, decided by a United States Circuit Court of Appeals—a case we shall carefully consider.

As this concept is an outgrowth of the contrary doctrine that certain income is capital and not subject to income tax, the pendulum has thus swung to the other extreme. The two extremes are yet so closely related that as part of our thesis, the taxation of capital as income, we shall first discuss the exemption of certain income in the guise of capital.

TAX FREE STOCK MARKET GAINS

The administration of the income tax law has given rise to the curious theory that a corporation can realize neither a profit nor a loss when trading in its own capital stock.² The United States Board of Tax Appeals

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goes farther and holds that where a parent controls a subsidiary company by ownership of the subsidiary's capital stock, the purchase and sale by the subsidiary of some of the capital stock of the parent does not result in taxable gain to the consolidated companies. Again the board holds that where a parent sells a subsidiary company's stock to stockholders of the parent, affiliation continuing, no taxable gain results.

The theory is reasoned thus: When a corporation sells its own capital stock, the sum received is a contribution of additional capital and therefore is not income. When a corporation buys its own stock, there is a partial liquidation and return to the stockholder of a portion of the corporation's capital. So a purchase of 100 shares at 50 would be a liquidation to the extent of $5,000, and the subsequent sale of the same 100 shares at 75 would be a new capital contribution to the extent of $7,500. That there has been a surplus increase of $2,500 is true, but this is not income; the combined transactions have resulted in a contribution of new capital and the resultant surplus increase is therefore additional capital and not income.

This is pretty reasoning, but it disregards the truth: corporation profits always increase the investment or surplus, just as do new capital contributions, but that fact alone is insufficient to change real profits into tax-free capital accretions. The mere fact of the increase in invested capital would be evidence of a profit derived from the transaction. In each particular case the facts should govern. Ordinarily, a capital contribution or a capital liquidation can easily be distinguished from the process of having the corporation trade in its own stock.

The Board of Tax Appeals attempted to restrict the rule to cases in which only cash was involved. Where a corporation exchanged stocks and bonds of other corporations plus $10,000 in cash as the purchase price of

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3 Appeal of Farmers Deposit National Bank, 5 B. T. A. 520; Appeal of John Scowcroft & Sons Co., 18 B. T. A. 532.
4 Appeal of Interurban Construction Co., 5 B. T. A. 529.
its own stock, the board in 1928 held that the corporation sustained a loss which should be recognized for income tax purposes.\(^5\) Again in 1929 the board departed from the rule and held that where a corporation sold capital assets and as part of the selling price received some of its own capital stock in exchange, the transaction resulted in gain or loss to be measured by the market value of its own stock when received by the corporation.\(^6\) These departures from the established rule apparently were reasoned by only two members, one for each decision. When, in December, 1930, the entire board took part in a decision involving this point, the majority of the members in a long opinion\(^7\) reaffirmed the rule that a corporation realizes no gain or loss from the purchase and sale of its own stock, and held that the rule applied even where property is exchanged as part of the consideration. The earlier two decisions were expressly overruled. It is significant, however, that seven of the sixteen members of the board joined in a dissenting opinion.

The chief evil of considering such transactions as not resulting in income, is that stockholders may thereby evade taxes in certain stock market transactions. If a stockholder gained $10,000 by personally dealing in stock of his own corporation, he would pay a normal tax not exceeding 5 per cent under present laws—with surtax added if he had other income. If, however, he gained this sum through stock dealings carried on in the name of his corporation, the gain would not be taxable to the corporation, and by way of dividends the individual would receive his $10,000 without being liable for a normal tax thereon.

It may be argued that when a corporation sells its own stock the sum received in excess of par value becomes capital surplus—as distinguished from ordinary sur-

\(^5\) Behlow Estate Co., 12 B. T. A. 1365.
\(^7\) Houston Brothers Co., 21 B. T. A. 804.
plus—and is not available for dividends. Nevertheless, such excess may go to stockholders as dividends, whether or not it be considered as capital surplus. Most corporations do not declare dividends of all their profits but permit substantial sums to remain for investment in business expansion. Capital surplus, increased by stock market trading gains, would provide for some of this expansion and replace an equal amount of surplus arising through business operations, thus liberating ordinary surplus for dividends. For all practical purposes, therefore, a stockholder, by taking in his company's name his stock market gains on his company's stock, and increasing his dividends by such gains, ultimately puts them into his own pocket free from the corporation income tax of 12 per cent, free from the individual normal tax of 5 per cent, and subject only to individual surtaxes.

This plan appears to be particularly attractive where the stockholders of a large corporation form a pool for manipulating their own stock. If the individual stockholders are skillful they could arrange to take losses on their personal returns, and gains tax-free on the corporation returns, altogether resulting in quite a handsome tax saving.

This temptation should be removed. If the practice of regarding the sale by a corporation of its own stock as occasioning neither gain nor loss, has been too long indulged in for rectifying through administrative or judicial channels, this sort of transaction should be distinguished by statute from those involving capital contributions and liquidations. Borderline cases, concerning which there may be honest doubt, could be covered by a few proper regulations. Fraud penalties might be applied to evasions of this type. Where the facts indicate that stockholders are dealing in the stock of a corporation under the pretense that it is dealing in its own stock, gains should at least be taxed at the corporation rate, now 12 per cent.
The problem here discussed is best understood by an illustration:

March 1, 1916, the Baker-Vawter Company (the parent company) purchased all of the capital stock of the Commercial Stationery and Loose Leaf Company (the subsidiary company) for the sum of ........... $45,000.00

February 28, 1920, the parent sold the stock of the subsidiary for .................. 60,000.00

During the period of affiliation, March 1, 1916, to February 28, 1920, the subsidiary had accumulated profits which still remained in the business (herein designated Investment Surplus) in the sum of ...... 28,454.35

The Commissioner of Internal Revenue claimed that these transactions resulted in a profit of ........... 15,000.00

The taxpayer claimed a resultant loss of ........... 13,454.35

The Board of Tax Appeals held the foregoing to be a capital transaction resulting in neither a gain nor a loss; being the sale by an affiliated group of its own capital stock. Upon appeal to the Circuit Court of Appeals for the Second Circuit, that court in the case of Remington-Rand, Inc. v. Commissioner of Internal Revenue, reversed the board and held that the transaction was not a capital transaction but one which resulted in a profit or a loss. The court then proceeded to compute the resultant gain or loss, and found that the Commissioner’s contention was correct, and that the taxpayer had realized a gain of $15,000. If the investment surplus, that is, the subsidiary’s accumulated profits, in the sum of $28,454.35 had been added to the cost of the stock, a loss of $13,454.35, as contended by the taxpayer, would have resulted. The surplus, or net worth, of the parent company was actually $13,454.35 less after the sale than it was before. The reasoning of the court in refusing to add investment surplus to cost is considered below.


9 33 Fed. (2d) 77, certiorari denied.
In a case where the subsidiary's stock was purchased and sold at book value, and the book value at the time of sale included profits accumulated during the period of affiliation, the board in another case had held that the transaction did not result in taxable income. Five members of the board had dissented, but the decision was affirmed by oral opinion of the United States Circuit Court of Appeals for the Tenth Circuit. The board and court were apparently wrong in holding the transaction non-taxable, but right in the result, for in the view here taken the computation when the sale was at book value would have shown neither a gain nor a loss. This case has been relied upon to support the proposition that the Commissioner could not tax intercompany profits, and so may be considered as approved by decisions subsequent to the Remington-Rand case.

The board followed the method of computation indicated by the Remington-Rand case in later decisions. Although now holding that subsidiary gains previously included in taxable consolidated income may not be added to the cost of the subsidiary stock, the board also holds that accumulated losses of the subsidiary availed of by the parent in computing consolidated taxable income in prior tax returns, may not be availed of a second time when the parent sells the subsidiary stock, and therefore such losses must be deducted from the cost before the latter may be used as the basis for determining gain or loss from the sale. In other words, subsidiary profits must be taxed a second time, when the parent sells the subsidiary stock, but the losses may not be deducted a second time.

10 Appeal of H. S. Crocker Co., 5 B. T. A. 537.
12 Utica Knitting Company v. United States, 68 Court of Claims 77; Riggs National Bank, 17 B. T. A. 615, appeal by Commissioner now pending before the United States Circuit Court of Appeals for the Fourth Circuit.
14 Riggs National Bank, 17 B. T. A. 615, appeal by Commissioner now pending before the Circuit Court of Appeals for the Fourth Circuit.
In refusing to add investment surplus to cost, the court in the Remington-Rand case reasoned as follows:

Concededly a gain of $15,000 was realized, unless the parent company may take into account as additional cost of the stock the subsidiary's accumulated earnings of $28,454.35. It is argued that the parent company could have had its subsidiary declare its net profits as dividends, without subjecting the parent company to any tax, . . . and that it could then have invested such dividends in the business of the subsidiary, in which event they would be treated as an addition to the price paid for the stock. In other words, we are urged to hold that the accumulation of earnings by the subsidiary was a constructive receipt of dividends and reinvestment of them by the parent company. But the same argument could be made with equal force in respect to an individual or corporate owner of stock sufficient in amount to control the board of directors of the subsidiary, yet insufficient to result in affiliation. Tax liabilities must be determined by what in fact was done. . . . The fact is that no declaration of dividends and no reinvestment of them has occurred in either case, and it would seem unreasonable to accept the theory of constructive receipt and investment in the one case, but not in the other. Where affiliation is absent, no one doubts that the theory would be rejected; to accept it would contradict the theory of Eisner v. Macomber, 252 U. S. 189.

Again, it is urged that a failure to treat the accumulated earnings as an addition to the cost of the stock will produce the inequitable result of double taxation, because the earnings have already been taxed as income of the affiliated group. But double taxation of this character will exist, though there be no affiliation between the owner of the stock and the corporation which issued it, and is, as pointed out in Hellmich v. Hellman, 276 U. S. 233, 237, the ordinary incident of a profitable sale of stock. We hold, therefore, that the sale resulted in taxable gain of $15,000.

It might be argued that the matter of computing the profits was not properly before the court. The Board of Tax Appeals having decided that the transaction was
a capital transaction not resulting in gain or loss, it was only necessary for the court to reverse this decision whereupon the case might have been remanded to permit the board first to make the computation. Instead, the court made the computation. Under the circumstances, the court decided this question for the first time and it was not heard on appeal.

There was at least a doubt as to whether the accumulated earnings of the subsidiary were capital or income, and in taxation doubts are construed in favor of the taxpayer, for the real burden of proof rests not on the taxpayer but on the government. The court reasoned that "concededly" accumulated profits were not part of the cost, if the taxpayer's theories that they were cost, failed. Both of the taxpayer's theories failed, and consequently accumulated profits were not permitted to be taken as cost. Therefore, the burden of proof was in this manner erroneously placed on the taxpayer.

Assuming, however, that the burden of proof was properly placed on the taxpayer, it appears that the taxpayer might have succeeded by a third theory, or in reality the first theory changed to remove its objections.

The first theory relied on was that the parent company had constructively received such accumulated profits as dividends which it had reinvested in the subsidiary and

15 Radin v. Commissioner, 33 Fed. (2d) 39, C. C. A. 3, 1929, in which the court considered the question as to whether a sale of an interest in real estate was personal estate or real estate, and said: "The Board of Tax Appeals, being uncertain which it was, negatively upheld the Commissioner on a statement that it was 'unable from the evidence to hold that the Commissioner erred in taxing the profit.' But the Commissioner, although he had before him only the evidence that was before the Board, was required to know which it was in order to determine a valid tax. Whether it was personal estate or real estate cannot be left to surmise."

16 Edson v. Lucas, 40 Fed. (2d) 398, 400, C. C. A. 8, 1930, in which the court stated: "In Hellmich v. Hellman, 18 Fed. (2d) 239, 243, this court said: 'It is both the English and the American rule that doubts in taxation statutes are resolved in favor of the taxpayer, and that laws imposing taxes are to be strictly construed and not extended beyond the clear import of the language used. It is the duty of taxing powers to make clear what is to be taxed and how.' See also, United States v. Merriam, 263 U. S. 173, 188; Crocker v. Malley, 249 U. S. 223, 233; Rodenbough v. United States, 25 Fed. (2d) 13, 15; Eaton v. English & Mersick Co., 7 Fed. (2d) 54, 57."
such constructive dividends were just as much cost as original investment. With regard to this, the court said that dividends were not in fact declared and that tax liabilities must be determined by what in fact was done.

The second theory relied on was that double taxation resulted from failing to consider accumulated earnings as part of the cost "because the earnings have been taxed as income of the affiliated group." To upset this, the court pointed out that "double taxation of this character will exist though there be no affiliation between the owner of the stock and the corporation which issued it, and is . . . . the ordinary incident of a profitable sale of stock," and cited *Hellmich v. Hellman*.

In that case the United States Supreme Court held that corporation gains accumulated after March 1, 1913, when distributed in liquidation of a corporation, were not exempt from the normal individual tax as dividends, but were subject to both individual normal tax and surtax, even though the imposition of such normal tax resulted in double taxation; for the reason that "when, as here, Congress has clearly expressed its intention, the statute must be sustained even though double taxation results." In the Remington-Rand case the court showed no such clearly expressed intention in the statute.

The theory which the court apparently did not consider was that the profits gained by the subsidiary during the period of affiliation, had already passed into the surplus account and so had become part of the invested capital of the parent and the consolidated group. The court held that the entire proposition of constructive receipt of dividends and their reinvestment fell by the showing that there could be no constructive receipt of dividends. The court apparently did not consider the question of reinvestment as a fact solely by itself. Yet in a normal situation profits become capital when a corporation does not remove them from the business as dividends. Remaining in the business, such accumulated profits are called surplus and as a matter of fact are

17 276 U. S. 233.
invested in productive assets and working capital, the same as the original capital. This process of reinvestment is common knowledge and would seem to require no proof. By becoming surplus and invested capital of one member of the group, they automatically became surplus and invested capital of the group.

The court failed to consider the effect of the transaction upon invested capital although in previous decisions the same court had held that in consolidations the separate members are considered as a unit, and their "income and invested capital are really the income and invested capital of a single enterprise." The underlying principle in permitting consolidated returns, is that affiliated corporations in reality operate as an economic unit and must be taxed as such. Only in this way can tax evasion be prevented and the entire group be taxed fairly from the standpoint of losses by some of the affiliated companies and gains by others. It is a mistake to consider the group for tax purposes in one instance as a unit and in another as separate corporations. The existence of the affiliated group continued as a unit after one subsidiary was dropped. If there were only a single subsidiary, the sale of its stock had no effect on the continued existence of the parent, and the parent, as the head of the two affiliated corporations had already added the subsidiary's profits to its own surplus and invested capital for tax purposes, and such profits were actually capital before affiliation ceased. The reasoning is the same whether or not the parent follows the practice of reflecting on its own balance sheet the accumulated profits of the subsidiary in an asset account designated "Investment Surplus," with the offsetting credit to its own surplus account; for the reason that the subsidiary's accumulated profits have already become capital regardless of bookkeeping entries.

At the instant the subsidiary's stock is sold, affiliation between parent and subsidiary ceases. Nevertheless, the same surplus is possessed by the parent both before

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and after the sale. On the asset side of the balance sheet, the subsidiary’s stock and investment surplus are replaced by cash. When stock and investment surplus together equal the cash received, there is no change in consolidated invested capital and no gain or loss from the sale. If the cash received is more than the subsidiary’s stock and investment surplus together, consolidated surplus is increased by the excess of cash and there is a gain to the extent of such excess. Likewise, if cash received is less in amount than the asset accounts reflecting the investment in the subsidiary, the consolidated capital is decreased correspondingly and there is a loss pro tanto. In other words, the gain or loss is measured by the resultant increase or decrease in consolidated invested capital.

Although sound on the proposition that the transaction resulted in a realization of gain or loss, the Remington-Rand decision erroneously computed the gain or loss by reasoning that consolidated capital was income. Now, by reason of extremely wide powers bestowed upon him by the present Revenue Act, the Commissioner of Internal Revenue has promulgated regulations which enforce the rule of computation laid down in the Remington-Rand case, together with certain exceptions. In fact, the exceptions by correcting the application of the rule in some situations, further indicate that the rule itself is unsound. But for 1929 and any years thereafter, a corporation may not contest the validity of an income tax imposed on investment surplus, for the reason that the regulations permit the filing of a consolidated return only on condition that the several affiliated corporations consent to all the regulations, “and the making of a consolidated return shall be considered as such consent.”

Regardless of whether such regulations are valid, there is need of a revised statute to require observance of the effect of a given transaction on consolidated capital—thus to eliminate much highly involved and doubtful reasoning.

19 Section 141 of Regulations 75.