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Income-tax Department

EDITED BY STEPHEN G. RUSK

A. W. Gregg, solicitor of internal revenue, while conferring with the ways and means committee in reference to federal tax matters, is reported to have said:

> "The original recommendation of the treasury department was for the establishing of an independent board to settle tax cases. Congress changed that and gave us instead a court to establish precedents for the disposition of other cases pending in the bureau,—also a much-needed body.
>
> "Having done that, it seems to me that congress should go the whole way and establish it in name in other respects as they have established it in fact, as a court; call it a court and give the members long terms.
>
> "I think making it a court involves making the appointments to it for life on good behavior, and give the members salaries that are adequate, and continue what we have now—a body to create precedent for the disposition of other cases in the bureau."

These comments by Mr. Gregg are illuminating as indicating the viewpoint of the commissioner as to the purposes of the United States board of tax appeals. The viewpoint of the taxpayer, which may be erroneous however, is that the board stands between him and the commissioner on contested matters of fact as well as of interpretation of the provisions of the acts; that this body views impartially the questions brought before it and attempts to do exact justice in deciding each case.

It seems a fair assumption that congress had more of the taxpayer's viewpoint than that of Mr. Gregg when it started out to create such a body, though in the vicissitudes attending the enactment of the law, congress may have reluctantly changed the phraseology to indicate the purpose seen by Mr. Gregg.

A review of the cases decided by the board reveals that it has been as untiring in finding facts as it has been in interpreting the law. Such review reveals also that many, if not indeed a majority, of the cases adjudicated have been decided upon the showing of facts. That this is so is evidenced by the fact that accountant representatives of taxpayers in their earlier contacts found it so difficult properly to apprise the board of facts known to the representatives. Without knowledge of the viewpoint of the board itself, it seems evident from the recorded history of the cases set before it that the board believes that it is authorized to find facts, and that it has in the course of its work found it necessary to establish precedents as to matters of interpretation of the law.

When the number of courts to which one may appeal for interpretation of the law is considered, it would appear that limiting the board's work to establishing precedents for use of the bureau would be a distinct disappointment to the large body of taxpayers who have been unable to settle their cases satisfactorily with the bureau.

As to appointing the members of the board for life and giving them adequate compensation, it is probable that no dissenting voice among the taxpayers will be heard. The latter have been in general well treated by the board whose members have been patient and assiduous in the consideration of their cases. Their duties are arduous and must involve many hours of labor after most of us are at home, and their work has been most praiseworthy.

It has been pointed out that if the board's activities were limited to establishing precedents in matters of law, there would be little use for certified public accountants to practise before that body. It is not quite apparent that this is the fact, for many of the accountants admitted to practice are able to argue upon the matters of law involved in their cases, as they are to bring the facts properly to the board's notice. Whether or not the board would permit certified public accountants to practise before it if the scope of its work were limited as indicated is quite another matter. As the large majority of its members are of the legal profession, it is probable that the board would feel more confidence in arguments made by lawyers, and that it would feel that accountants generally were not properly equipped to render this service.

It will be a matter of great interest to follow the development of the thought of congress upon this subject, and it seems probable that congress, before enacting the law, will ponder quite seriously the question of what it is that the taxpayer wants.

TREASURY RULINGS

(T. D. 3751, September 3, 1925)

Income and excess profits tax—Revenue act of 1918—Invested capital—Decision of court

EARNED SURPLUS—UNDIVIDED PROFITS.

Undistributed net earnings for a given year do not constitute earned surplus or undivided profits so long as there is an unprovided for debit item appearing on the books of the corporation.

The following decision of the United States district court for the district of Minnesota, third division, in the case of *Milton Dairy Co.* v. *Willcuts*, collector of internal revenue, is published for the information of internal-revenue officers and others concerned.

UNITED STATES DISTRICT COURT, DISTRICT OF MINNESOTA, THIRD DIVISION.

(No. 240)

Milton Dairy Co., plaintiff, v. *Willcuts, collector of internal revenue*

(July 31, 1925)

MEMORANDUM OPINION

MOLYNEAUX, district judge: The facts in this case may be stated as follows: In the computation by the taxpayer of its income and excess-profits tax for the fiscal year ended February 28, 1918, and the fiscal year ended February 28, 1920, it adopted an invested capital; that upon an audit of the return of the taxpayer the government refused to accept the invested capital set up, but reduced the invested capital of the corporation for the fiscal year 1919 by the sum of $11,489.26, and for the fiscal year of 1920 by the sum of $29,853.03, which amounts were claimed by the taxpayer to be undivided profits or earned surplus; that on February 28, 1917, the company had an operating deficit shown on its books of approximately seventy thousand ($70,000) dollars, and when it claimed to have earned surplus, it still had the same unprovided-for deficit which was greater than the total alleged earned surplus for the two years in question.

Reduction in invested capital operates to increase taxes. The increase was accordingly assessed and paid and the correctness of the assessment is now in dispute. The statute involved is revenue act of 1918 (40 Stat. L., pp. 1058, 1092, and 1093):

SEC. 326. (a) That as used in this title the term "invested capital" for any year means (except as provided in subdivisions (b) and (c) of this section):

(1) Actual cash bona fide paid in for stock or shares;

(2) Actual cash value of tangible property, other than cash, bona fide paid in for stock or shares, at the time of such payment, but in no case to exceed the par value of the original stock or shares specifically issued therefor, unless the actual

cash value of such tangible property at the time paid in is shown to the satisfaction of the commissioner to have been clearly and substantially in excess of such par value, in which case such excess shall be treated as paid-in surplus:

Provided, That the commissioner shall keep a record of all cases in which tangible property is included in invested capital at a value in excess of the stock or shares issued therefor, containing the name and address of each taxpayer, the business in which engaged, the amount of invested capital and net income shown by the return, the value of the tangible property at the time paid in, the par value of the stock or shares specifically issued therefor, and the amount included under this paragraph as paid-in surplus. The commissioner shall furnish a copy of such record and other detailed information with respect to such cases when required by resolution of either house of congress, without regard to the restrictions contained in section 257;

(3) Paid-in or earned surplus and undivided profits; not including surplus and undivided profits earned during the year;

(4) Intangible property bona fide paid in for stock or shares prior to March 3, 1917, in an amount not exceeding (a) the actual cash value of such property at the time paid in, (b) the par value of the stock or shares issued therefor, or (c) in the aggregate 25 per centum of the par value of the total stock or shares of the corporation outstanding on March 3, 1917, whichever is lowest;

(5) Intangible property bona fide paid in for stock or shares on or after March 3, 1917, in an amount not exceeding (a) the actual cash value of such property at the time paid in, (b) the par value of the stock or shares issued therefor, or (c) in the aggregate 25 per centum of the par value of the total stock or shares of the corporation outstanding at the beginning of the taxable year, whichever is lowest: *Provided*, That in no case shall the total amount included under paragraphs (4) and (5) exceed in the aggregate 25 per centum of the par value of the total stock or shares of the corporation outstanding at the beginning of the taxable year; but

(b) As used in this title the term "invested capital" does not include borrowed capital.

(c) There shall be deducted from invested capital as above defined a percentage thereof equal to the percentage which the amount of inadmissible assets is of the amount of admissible and inadmissible assets held during the taxable year.

(d) The invested capital for any period shall be the average invested capital for such period, but in the case of a corporation making a return for a fractional part of a year, it shall (except for the purpose of paragraph (2) of subdivision (a) of section 311) be the same fractional part of such average invested capital.

The average invested capital for the pre-war period shall be determined by dividing the number of years within that period during the whole of which the corporation was in existence into the sum of the average invested capital for such years.

Plaintiff's contention is that under the provision—(3) Paid-in or earned surplus and undivided profits, not including surplus and undivided profits earned during the year—the net profits for the two fiscal years above referred to should be added to the invested capital, reducing the tax in the sum claimed in the complaint, $1,804.19.

It is clearly provided by the statute that earned surplus or undivided profits constitute invested capital, but in my view the corporation did not have true earned surplus or undivided profits during the years in question. My view of this case is that the plaintiff's contention can not be sustained and that it violates the spirit and letter of section 326, revenue act of 1918 (40 Stat. L., pp. 1058, 1092, 1093).

The statute defines what assets shall go to make up "invested capital," at the time of the organization of the company or the inception of business, and an examination of the statute will show that such assets are to be taken at their real value in establishing the "invested capital," and as the corporation proceeds to conduct its business from year to year it may increase its capital stock by adding thereto the net surplus or profits. The question

involved is, did the taxpayer have any earned surplus or undivided profits for the fiscal year ended February 28, 1919, and the fiscal year ended February 28, 1920, which it could add to its "invested capital?" The statute provided the method of ascertaining invested capital at the organization of the corporation, specifically naming the items to be included, and the items permitted would reflect the net assets of the corporation. The "invested capital" established by the corporation at its inception is not in controversy in this case. The controversy arose over the right of the taxpayer to increase the amount of the "invested capital" by the amount of the alleged earned "undivided profits" while it had upon its books the deficit referred to. The government's claim is not that the earned surplus or undivided profits do not constitute "invested capital" but that the corporation had no true "earned surplus" or "undivided profits" during the years in question. At the time the corporation claimed to have "undivided profits" it had on its books a debit item denominated "operating deficit" which was in excess of the "undivided profits" for the two years in question.

This was a charge against the assets and reduced the assets in the amount of the debt. In computing its "surplus" or "undivided profits" it failed to take into account such debit. I think the scheme of the statutes is to ascertain the true value of the assets at the inception of the corporation and to maintain the true value of the assets throughout the duration of the corporation, as the basis of calculating the amount of invested capital on which the tax is to be computed.

The corporation had a fixed invested capital at its inception, which represented the uninflated value of its assets. Only true earned surplus and undivided profits can be included in the computation of "invested capital," and if for any reason the books do not properly reflect the true surplus such adjustments must be made as are necessary in order to arrive at the accurate amount. (Holmes on *Federal Taxation*, 1919 ed., 728.)

In order to do this in the present case it will be necessary to apply the earnings for the fiscal year 1919, $11,489.26, and the fiscal year 1920, in the sum of $29,853.03, against the $70,000 deficit upon the books.

(T. D. 3755, September 26, 1925)

Income tax—Revenue act of 1916—Decision of supreme court

1. Income—Dividends—Exchange of Stock for Stock.

   Where stockholders of a corporation organize a new corporation in another state to take over the business and assets of the old corporation, stockholders of the old corporation exchanging their stock for stock in the new corporation on the basis of one share of common stock for five shares of common and one share of 7 per cent preferred for one and one-third shares of 6 per cent preferred, a different proportional interest, and the old corporation is thereupon dissolved, income is realized by stockholders under the provisions of the revenue act of 1916 to the extent that the stock received in the new corporation was greater in value than the cost of the stock of the old corporation.

2. Corporations—Reorganization—Separate Entity.

   Where stockholders of an existing corporation organize a new corporation under the laws of another state with a larger and different capitalization of preferred and common stock to take over the entire business and assets and existing surplus of the old corporation, the new corporation is a separate and distinct corporate entity and the exchange of stock for stock results in taxable income being received by stockholders.

3. Cases Followed and Distinguished.

   United States v. *Phellis* (257 U. S. 156, T. D. 3270); *Rockefeller* v. *United States* (257 U. S. 176, T. D. 3271); *Cullinan* v. *Walker* (262 U. S. 134, T. D. 3508) followed. *Eisner* v. *Macomber* (252 U. S. 189, T. D. 3010); *Weiss* v. *Stearn* (265 U. S. 242, T. D. 3609) distinguished.

The following decision of the supreme court of the United States, in the case of *Walter L. Marr* v. *United States*, is published for the information of internal-revenue officers and others concerned.

SUPREME COURT OF THE UNITED STATES. (1793)
Walter L. Marr, appellant, v. *United States*
APPEAL from Court of Claims
(June 1, 1925)

Prior to March 1, 1913, Marr and wife purchased 339 shares of the preferred and 425 shares of the common stock of the General Motors Co. of New Jersey for $76,400. In 1916 they received in exchange for this stock 451 shares of the preferred and 2,125 shares of the common stock of the General Motors Corporation of Delaware, which (including a small cash payment) had the aggregate market value of $400,866.57. The difference between the cost of their stock in the New Jersey corporation and the value of the stock in the Delaware corporation was $324,466.57. The treasury department ruled that this difference was gain or income under the act of September 8, 1916 (ch. 463, Title I, secs. 1 and 2, 39 Stat. 756, 757), and assessed on that account an additional income tax for 1916, which amounted, with interest, to $24,944.12. That sum Marr paid under protest. He then appealed to the commissioner of internal revenue by filing a claim for a refund, and upon the disallowance of that claim brought this suit in the court of claims to recover the amount. Judgment was entered for the United States. (58 Ct. Cls. 658.) The case is here on appeal under section 242 of the judicial code.

The exchange of securities was effected in this way: The New Jersey corporation had outstanding $15,000,000 of 7 per cent preferred stock and $15,000,000 of the common stock, all shares being of the par value of $100. It had accumulated from profits a large surplus. The actual value of the common stock was then $842.50 a share. Its officers caused to be organized the Delaware corporation, with an authorized capital of $20,000,000 in 6 per cent nonvoting preferred stock and $82,600,000 in common stock, all shares being of the par value of $100. The Delaware corporation made to stockholders in the New Jersey corporation the following offer for exchange of securities: For every share of common stock of the New Jersey corporation five shares of common stock of the Delaware corporation. For every share of the preferred stock of the New Jersey corporation one and one-third shares of preferred stock of the Delaware corporation. In lieu of a certificate for fractional shares of stock in the Delaware corporation payment was to be made in cash at the rate of $100 a share for its preferred and at the rate of $150 a share for its common stock. On this basis all the common stock of the New Jersey corporation was exchanged and all the preferred stock except a few shares. These few were redeemed in cash. For acquiring the stock of the New Jersey corporation only $75,000,000 of the common stock of the Delaware corporation was needed. The remaining $7,600,000 of the authorized common stock was either sold or held for sale as additional capital should be desired. The Delaware corporation, having thus become the owner of all the outstanding stock of the New Jersey corporation, took a transfer of its assets and assumed its liabilities. The latter was then dissolved.

It is clear that all new securities issued in excess of an amount equal to the capitalization of the New Jersey corporation represented income earned by it; that the new securities received by the Marrs in excess of the cost of the securities of the New Jersey corporation theretofore held were financially the equivalent of $324,466.51 in cash; and that congress intended to tax as income of stockholders such gains when so distributed. The serious question for decision is whether it had power to do so. Marr contends that, since the new corporation was organized to take over the assets and continue the business of the old, and his capital remained invested in the same business enterprise, the additional securities distributed were in legal effect a stock dividend; and that under the rule of *Eisner* v. *Macomber* (252 U. S. 189), applied in *Weiss* v. *Stearn* (265 U. S. 242), he was not taxable thereon as income, because he still held the whole investment. The government insists that identity of the business enterprise is not conclusive; that gain in value resulting from profits is taxable as income, not only when it is represented by an interest in a different business enterprise or property, but also when it is represented by an essentially different interest in the same business enterprise or property; that in the case at

bar, the gain actually made is represented by securities with essentially different characteristics in an essentially different corporation; and that, consequently, the additional value of the new securities, although they are still held by the Marrs, is income under the rule applied in *United States* v. *Phellis* (257 U. S. 156); *Rockefeller* v. *United States* (257 U. S. 176); and *Cullinan* v. *Walker* (262 U. S. 134). In our opinion the government is right.

In each of the five cases named, as in the case at bar, the business enterprise actually conducted remained exactly the same. In *United States* v. *Phellis*, in *Rockefeller* v. *United States*, and in *Cullinan* v. *Walker*, where the additional value in new securities distributed was held to be taxable as income, there had been changes of corporate identity—that is, the corporate property, or a part thereof, was no longer held and operated by the same corporation; and, after the distribution, the stockholders no longer owned merely the same proportional interest of the same character in the same corporation. In *Eisner* v. *Macomber* and in *Weiss* v. *Stearn*, where the additional value in new securities was held not to be taxable, the identity was deemed to have been preserved. In *Eisner* v. *Macomber* the identity was literally maintained. There was no new corporate entity. The same interest in the same corporation was represented after the distribution by more shares of precisely the same character. It was as if the par value of the stock had been reduced, and three shares of reduced par-value stock had been issued in place of every two old shares—that is, there was an exchange of certificates but not of interest. In *Weiss* v. *Stearn* a new corporation had, in fact, been organized to take over the assets and business of the old. Technically there was a new entity; but the corporate identity was deemed to have been substantially maintained because the new corporation was organized under the laws of the same state, with presumably the same powers as the old. There was also no change in the character of securities issued. By reason of these facts, the proportional interest of the stockholder after the distribution of the new securities was deemed to be exactly the same as if the par value of the stock in the old corporation had been reduced, and five shares of reduced par value stock had been issued in place of every two shares of the old stock. Thus, in *Weiss* v. *Stearn*, as in *Eisner* v. *Macomber*, the transaction was considered, in essence, an exchange of certificates representing the same interests, not an exchange of interests.

In the case at bar the new corporation is essentially different from the old. A corporation organized under the laws of Delaware does not have the same rights and powers as one organized under the laws of New Jersey. Because of these inherent differences in rights and powers, both the preferred and the common stock of the old corporation is an essentially different thing from stock of the same general kind in the new. But there are also adventitious differences, substantial in character. A 6 per cent nonvoting preferred stock is an essentially different thing from a 7 per cent voting preferred stock. A common stock subject to the priority of $20,000,000 preferred and a $1,200,000 annual dividend charge is an essentially different thing from a common stock subject only to $15,000,000 preferred and a $1,050,000 annual dividend charge. The case at bar is not one in which after the distribution the stockholders have the same proportional interest of the same kind in essentially the same corporation. Affirmed.